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DEBT, DEMOCRACY AND THE WELFARE STATE

Are Modern Democracies Living on Borrowed Time and Money?

Rögnvaldur Hannesson

Debt, Democracy and the Welfare State

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The Rising Tide of Debt

Abstract: *In this chapter, the development of government debt in the traditional OECD member states since the Second World War is traced. Some countries were saddled with a large debt as a legacy of the war, but their debt as percent of GDP gradually fell until the mid-1970s. After the energy crisis of 1973 the debt began to rise in most countries. In many countries the debt has continued to rise ever since, almost without interruption, and in some countries it has reached world war proportions. Some countries have managed to reverse the debt accumulation, all of them relatively small.*

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Not so long ago, government debt emerged as a topic of actuality. A generation ago it was hardly even mentioned in textbooks on economics or even public finance. There were, of course, the pathological cases of the German, Austrian and Hungarian hyperinflations that happened in the years after the First World War when governments borrowed money from their central bank to pay for their deficits, essentially printing money (even in a literary sense[1]). But for governments borrowing money from the capital markets, and perhaps a little bit from their central bank, the topic seemed hardly worthy of attention, and certainly not the question whether they could go on doing so and whether their lenders could be confident in getting their money back.

It was not always thus. European monarchs in times past were notorious for defaulting on their borrowings, in particular King Charles of Spain. Lenders had few recourses to get their money back from such borrowers and so became wary of lending to kings. Some historians think that the British Empire owed its emergence and its victory over Napoleon to its superior finances and a history of no defaults, even if that history was relatively recent (since the Glorious Revolution of 1688).[2] Its indebtedness after the Napoleonic wars is supposed to have reached an all time high, in comparison to its national product, even if such a comparison for times well over a hundred years before anything like national accounting was invented seems courageous. But for someone growing up in the Western world after the Second World War, concerns about government debt seem a recent phenomenon.

Figure 1.1 illustrates why. The figure shows government debt as percent of GDP (gross domestic product) for 22 OECD (Organisation for Economic Cooperation and Development) countries. It bears emphasizing that when we talk about a rising or falling level of debt we mean debt as a percentage of GDP and not its absolute level. This is, in our view, the most relevant comparison; the ability to pay surely is more closely related to debt in relation to income (GDP) than its absolute level alone, even if expressed in constant value of money. Also, it must be noted that the "debt" we are talking about in this book is government debt and not private debt. Excessive private debt financing creates its own problems,[3] but is not a subject of this book.

The countries we are looking at are all "traditional" OECD members from before the end of the cold war and so do not include the countries of Eastern Europe and other relatively recent members such as Chile, South Korea, Israel and Mexico.[4] These traditional OECD members

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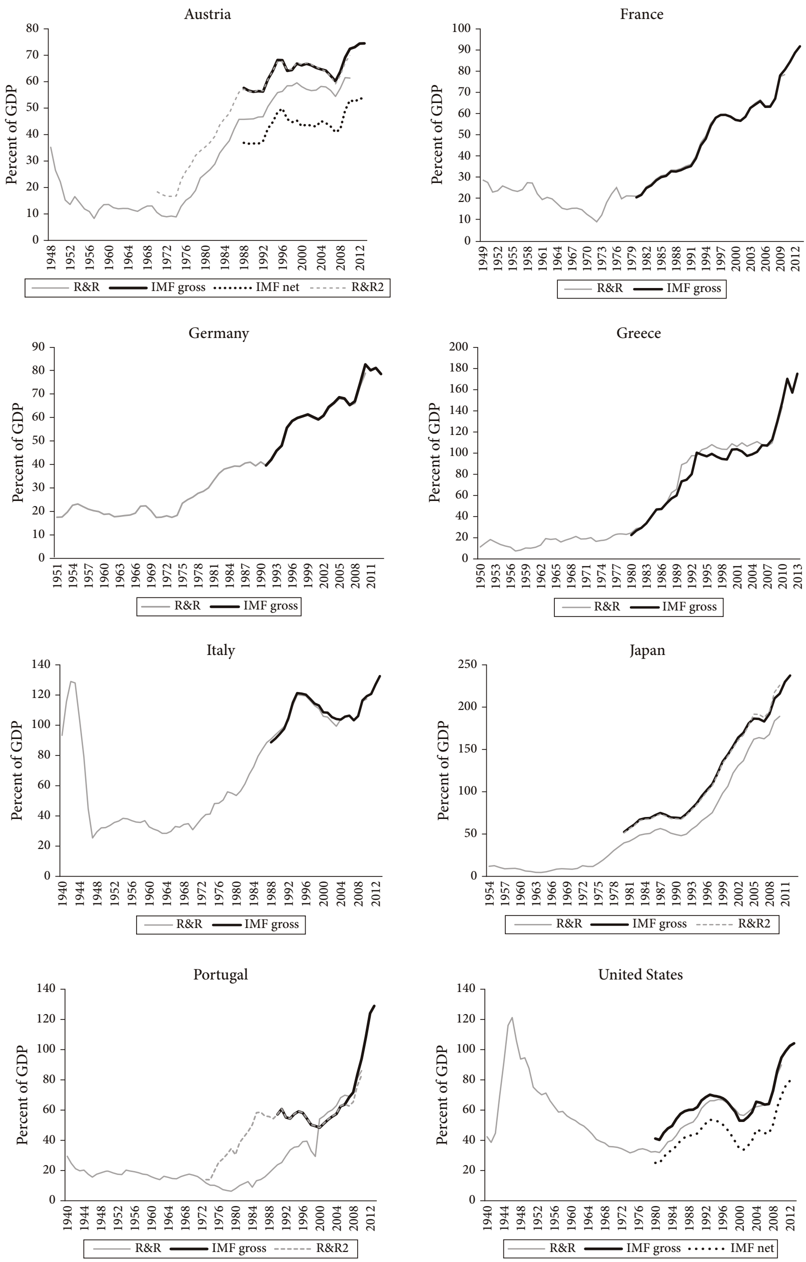

FIGURE 1.1 *Government debt, in percent of GDP*
(a) the relentless borrowers

Sources: Reinhart and Rogoff (2011), used with permission, and IMF's World Economic Outlook database.

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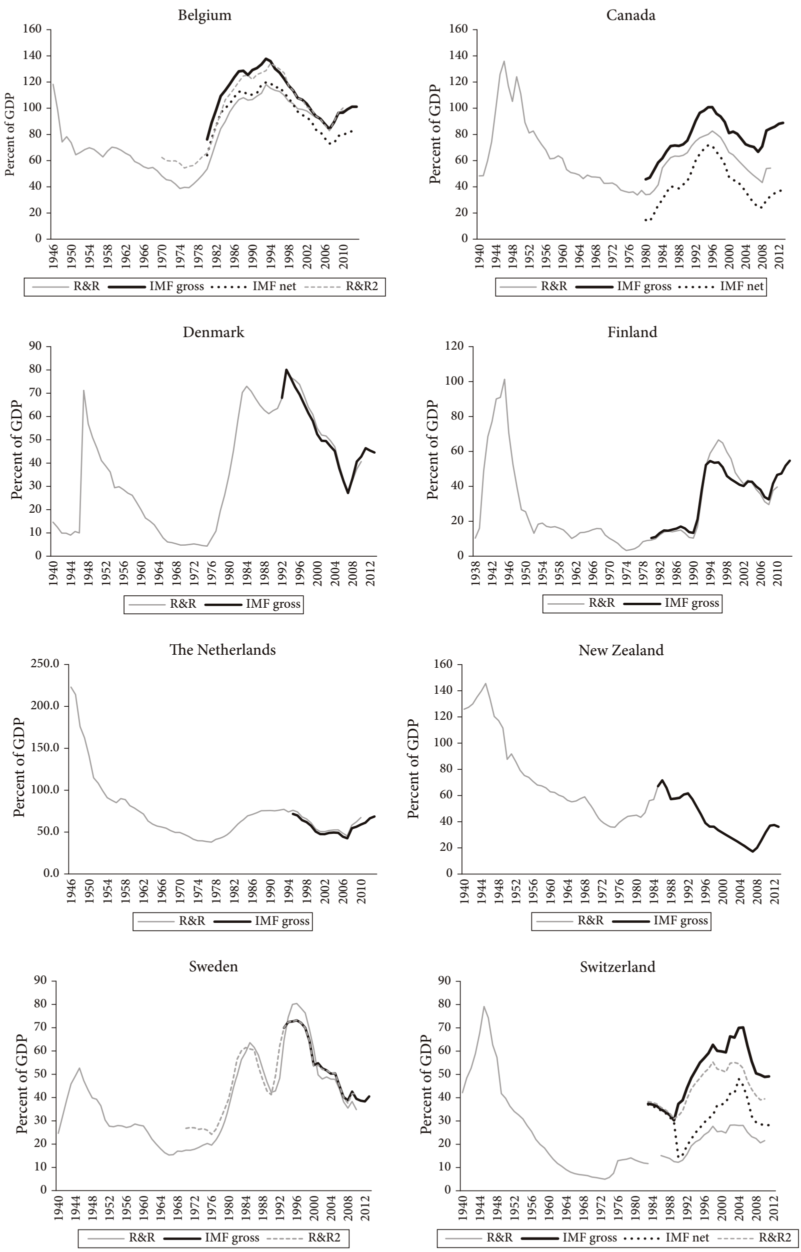

FIGURE 1.1 *Continued*
(b) the repentant borrowers

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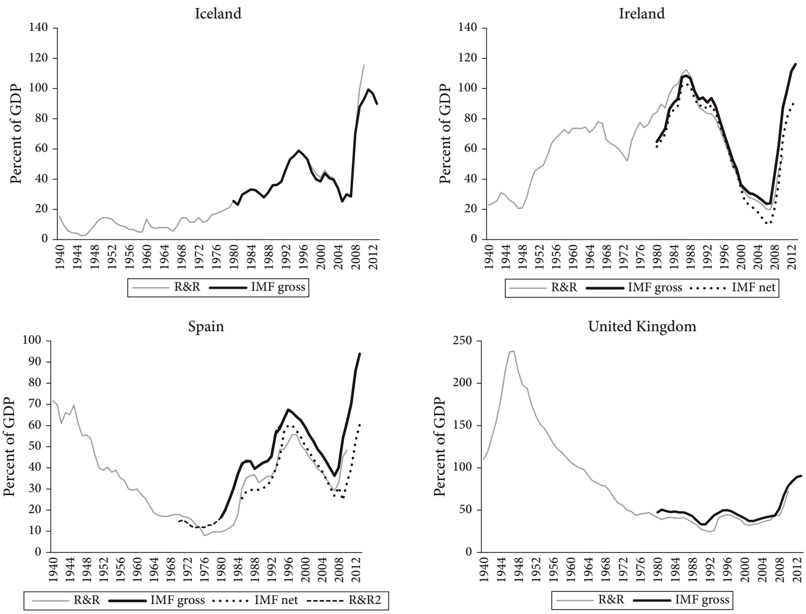

(c) victims of the financial crisis

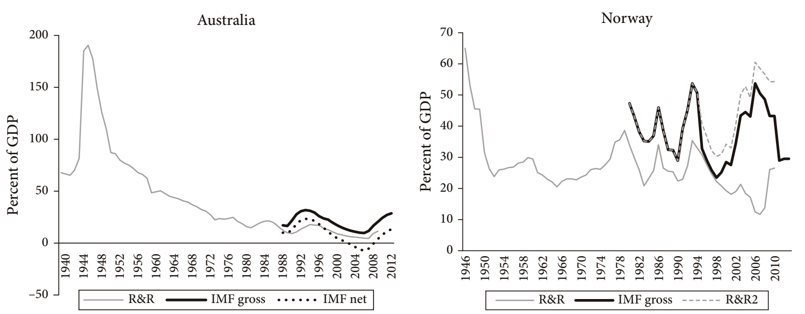

FIGURE 1.1 *Continued*
(d) the debt avoiders

comprise most of the richest countries in the world and those that have gone furthest in developing their welfare states, a point not without relevance, as is discussed later (a few rich countries, one of them being Singapore, are not members of the OECD). The series begin at somewhat different times, but for most countries they begin at the end of the

Second World War or even a bit earlier. With few exceptions the series show a sharply rising trend from about the mid-1970s. In some countries the debt has now attained a level comparable to what it was at the end of the Second World War. An uninitiated observer might ask by what comparable calamity these countries have been hit in the years since the 1970s.

The countries for which the debt series take an upward, and in some cases an apparently irreversible turn around 1975, are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Japan, the Netherlands, New Zealand, Portugal, Spain, and Switzerland. For some others the debt began to rise a bit earlier or later. Italy and Sweden began to accumulate debt earlier than this; Italy already in the early 1960s and then more rapidly from 1970 on, Sweden from the late 1960s and then more rapidly from the mid-1970s. The United States began to accumulate debt from 1981, the year President Reagan came into office. So did Canada, although presumably without Reagan having anything to do with it. The United Kingdom and Australia are notable exceptions and saw little change in their government debt in the 1970s or 1980s, continuing to wind down their debt from the Second World War.

Some countries have continued to accumulate debt virtually without interruption. This is true of France and, surprisingly perhaps for those who follow the news, also Germany. It is largely true of Japan, the United States, Austria, Greece, Italy and Portugal as well, even if the buildup in Austria and Greece slowed down temporarily, and Italy managed to reverse it for a few years (1995–2003), as did the United States under President Clinton (1994–2001). We could call these eight the relentless borrowers. Yet other countries have managed to reverse the buildup of debt, even if some of those have resumed debt accumulation in the wake of the financial crisis of 2008; Belgium, Canada, Denmark, Finland, the Netherlands (in 2013 almost back at the top reached in 1994), New Zealand, Sweden and Switzerland. Sweden, incidentally, is now among the European Union countries with the lowest debt to GDP ratio and largely avoided any "relapse" into debt accumulation in the wake of the financial crisis. We may note that all of those that have managed to reverse the accumulation of debt are relatively small countries. Perhaps we could call them repentant borrowers.

Then there are a few which experienced rapid buildup of debt in the wake of the financial crisis of 2008, from a moderate level to crisis or near-crisis proportions caused by a collapse or at least precariousness of

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their banks. These are Iceland, Ireland, Spain and the United Kingdom. Iceland's and Ireland's debt went from 25 percent of GDP to over 100 over just a few years, Spain's from 35 to 85, the United Kingdom's from 40 to 90. These could be labeled victims of the financial crisis. Finally, there are two countries, Australia and Norway, that are difficult to bundle with any other. In Australia there has been some accumulation of debt since the financial crisis, but to a level still moderate by comparison, about 30 percent of GDP. Norway is, of course, a highly special case because of its petroleum wealth, which has been transformed into a huge financial wealth of the Norwegian government, a process that is still ongoing (the Norwegian petroleum fund is the largest sovereign wealth fund in the world). Like Norway, Australia owes its good fortune in no small measure to its riches of mineral resources.

Why worry?

Observing the formidable buildup of government debt over such a long time in so many countries, and rich ones at that, begs three questions: (1) why has it happened; (2) is it a problem; and (3) if it is, what would be the "safe" or "sustainable" level of debt? We attempt to answer the first question in the following chapters, but first a few words about what the problem might be and what the sustainable level of debt would be. Accumulating debt may work quite smoothly for quite a while in "good" times. Tax revenues will rise in a growing economy even without increasing rates, and even if the debt is growing at a slow but steady rate it may not raise eyebrows among lenders. But if a country falls into a recession, especially a deep and protracted one, eyebrows will be raised. In a recession government revenues fall while expenditures increase; taxes decline while welfare expenditures for the unemployed rise and others remain as committed, and the borrowing requirement of governments increases fast. Then it may dawn on lenders that they might have been overconfident in lending to governments. Hence, at the same time that governments need to cover a hopefully temporary shortfall in their revenues, lenders may suddenly become unwilling to lend more. Governments may then find themselves in a situation similar to going to the pawnbroker; they will be able to sell new bonds (in addition to debt and the "rolling over" of existing debt) only with a huge discount, which in turn will make it still less likely that they will ever pay back their debt. The breakdown of confidence is likely to be sudden, causing panic in policy circles. We have seen a bit of that in recent years. For a time the return on government bonds in Southern Europe (Italy, Greece, Spain and Portugal) rose way above the return on German, French and British bonds. This essentially means that the bonds sold at a discount; the return on the bonds is a predetermined amount, but if the bonds can be sold only at a price lower than their nominal value, the effective return expressed as a percentage of the market price goes up.

But pinpointing a sustainable debt level, that is, debt as a percent of GDP, is easier said than done. Consider Japan and Greece. Japan has the highest government debt level of any country, almost 240 percent of GDP as of 2012, Greece "only" 175 as of 2013. Yet we hear nothing of bondholders losing confidence in the Japanese government to pay back its debt, while the case of Greece is too well known to need much elaboration. So what is the difference? The lenders to the Japanese government are mainly Japanese individuals and firms, and these have not, yet anyway, lost confidence in the Japanese government's ability to pay them back. Besides, Japan has its own central bank to which it can resort in order to pay its debt, although central bank financing of debt is not without its own risk, as the post–First World War history of Germany, Austria and Hungary shows. Furthermore, the Japanese central bank holds enormous foreign assets in the form of US dollars. Greece borrows largely from foreign lenders and does not have any central bank of its own to fall back on if it becomes impossible to roll the debt forward (redeem old bonds with new ones) and finance an ongoing deficit. So the question of debt sustainability involves questions about who owns the debt and who controls the currency and what assets the government may have. There is no single magic number that fits all countries telling us how much debt a government can take on without running into difficulties.

Or consider Spain versus the United States. Government debt in the Unites States was more than 100 percent of GDP in 2013, while in Spain it was "only" a bit over 90. Yet it was Spain which experienced collapse in bondholders' confidence and had problems in rolling forward its debt, while the United States could continue doing so at an almost symbolic rate of interest. The world's bondholders are obviously willing to take on further American debt despite its relatively high level and with no end to its accumulation in sight, because the US dollar is still the world's reserve currency. Clearly, the size of national economies and their dominance in the world economy has something to do with how much debt

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a country can take on. This gets us back to the earlier observation that those countries that have been able to reverse their debt accumulation are relatively small. "Had to" may be a better expression than "were able to." It is not unlikely that the critical debt level at which bondholders in the world's capital markets lose confidence in a country's ability to pay is lower for small countries than for large countries. Another reason why small countries meet constraints on borrowing earlier than large countries is that governments of small countries more often borrow foreign currency, as a deficit on the government's budget often is accompanied by a trade deficit as well. This increases their exposure to international capital markets.

This gets us to the point that there is less difference between government debt and the debt of private individuals than even reputed economists are prone to pronounce. A legacy of Keynesian macroeconomics is that government debt is something entirely different from debts of individuals and private firms. Hence the pronouncements that governments can "stimulate" their economies by raising expenditures without raising taxes, or perhaps lowering taxes as well. Could they do so endlessly? Hardly. As we have seen, governments can lose the confidence of their financiers. Banks lend only to individuals and firms they expect will be able to pay back, and financiers lend only to governments they expect to be able to pay back. It certainly takes more to lose confidence in a government's ability to pay than it takes to lose confidence in an individual's or even a corporation's ability to pay, but it does not mean that a government will enjoy such confidence no matter what. It is unlikely that Keynes intended his prescriptions to mean a license for governments to borrow without limit, and in fact they cannot even if that limit varies from case to case. The governments of the rich countries of the world would have been in a better shape to tackle the financial crisis of 2008 in the "good old Keynesian way" if they had managed their finances in the preceding years more prudently.

But lenders are not the only ones whose confidence is likely to be lost as a result of unsustainable government debt. Modern democracies are best described as a rule by competing elites, as discussed in Chapter 5. Elites are voted into power, or kept in power, by a mostly uninformed electorate that votes for them in the expectation that they will govern well, which mostly means high and rising standards of living. When the elites fail to deliver, they are voted out. The temptation is strong, therefore, for the elites to ensure that living standards for the electorate rise,

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which means increasing the volume of public services and rising after-tax income to buy market goods. The former is likely to be a high priority for the governing elites, because they are naturally held responsible for the services that governments have taken on to provide. But raising taxes is not popular, and the connection between taxes and public services is not equally obvious to all and is also, admittedly, not always tight. The temptation to finance an expanding government sector by increasing debt is therefore strong, which is also what has happened in most rich countries, as we have seen. Governing elites may well be aware that this may end badly, but it could be beyond their time horizon; there are elections every fourth year or so, and somebody else might have to clean up the mess. As the French King Louis XV is supposed to have put it: *après mois, le déluge* (after me, the flood). And after him came the French Revolution.

But just like the times of the *ancien régime* in France, this cozy development could end abruptly. The economy may be humming along nicely, with rising after-tax income, more public services and social transfers (pensions, disability payments, etc.), and slowly accumulating government debt. Then, some disturbance may happen, such as the financial crisis in 2008, the economy falls into a deep recession, the gap between government expenditure and revenue rises quickly, and lenders suddenly begin to doubt the ability of governments to pay them back. Governments are forced to respond quickly and forcefully. With lessened ability to borrow, either taxes must be raised or expenditures cut, or both. To the electorate this looks, rightly or wrongly, like the governing elites not having delivered. Worse, it may look as if the elites have been deceptive. The elite in power at the time will be thrown out of office. Under the best of circumstances there will be a competing and competent elite ready to take over, but this may also be the moment of the incompetent populists and potential usurpers whom the electorate may vote into office as untainted and worth a try. This is how the Nazis came to power in Germany in the wake of the Great Depression of the early 1930s and the hyperinflation of the 1920s.

In recent years we have the Icelandic revolt in the wake of the bank collapse. The governing elite got blamed for the entire debacle, even if it had limited responsibility for what happened and none for the specific events that led to the collapse. The ruling elite tolerated the expansion of the banks, and their liberal economic regime supported the business environment in which the banks throve, but if truth be told, any

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government that had opposed the Icelandic bank saga while the going was good would have been thrown out of office. The Icelandic bankers were popular while the going was good; the bank expansion benefited the entire economy while it lasted, and the bank tycoons had the good sense to use some of their profits for conspicuous projects benefiting the general public. After the collapse the search for scapegoats began, there were protests in the streets and the sitting government abdicated with its tail down. Fortunately, there was an alternative and reasonably competent elite who could take over in a parliamentary manner so the Icelanders were spared both a "French" revolution or a Nazi-like coup. Not that it would have hurt anyone but themselves.

The Second World War debt legacy

For some countries we have debt graphs that begin before the Second World War or right after; Australia, Belgium, Canada, Denmark, Finland, Iceland, Ireland, Italy, the Netherlands, New Zealand, Portugal, Spain, Sweden, Switzerland, the United Kingdom and the United States. The countries that were active participants in the war – Australia, Canada, Finland, Italy, New Zealand, the United Kingdom and the United States – all financed their war effort by accumulating debt. For all of these the debt level at the end of the Second World War vastly exceeded recent levels except for Italy and the United States; Italy's debt level was in 2013 about the same as it was in 1942, while the US level is not far behind, just above 100 percent of GDP in 2013 compared with 120 in 1946. Other countries that were either occupied (Belgium, Denmark, the Netherlands) or had to support their neutrality by extraordinary expenditures (Sweden, Switzerland) also accumulated a large government debt during the war. The high war time debt reflects not only an extraordinary debt accumulation, but also a low level of GDP, which was seriously depressed by the war. Still, the fact that the debt in recent years has approached or even exceeded its war time level is extraordinary for a time of peace. The rapid fall in the debt ratio in some countries immediately after the war reflects partly economic recovery, but also rapid inflation (Italy) that reduced the real value of the debt.

Ireland, Portugal and Spain were not affected by the war and avoided building up debt. Iceland profited from the war through high prices of fish in wartime Britain as well as from expenditures by American and

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British troops, the latter welcome occupiers, the former coming by invitation, and so avoided building up debt.

The war debt incurred by belligerents and others was in part “paid” by governments forcing their lenders, mainly their own citizens at the time, to pay for the wartime debts by what Reinhart and Rogoff have called financial repression.[5] Inflation, moderate but persistent, eroded the real value of the debt, and interest rates were held low so that lenders got a negative return on their assets. Since incomes were rising in the first three decades after the war when the debt was paid off, it partly evaporated without leaving too many tears. Furthermore, the lenders were primarily the better off, so there was little general outrage or sympathy for those who lost part of their wealth in this way. As mentioned at the beginning of this chapter, this was a time when government debt was hardly an issue, even among connoisseurs. The globalization of financial markets has probably foreclosed the option of inflating away a part of the debt, as holders of debt from inflationary countries would flee to other more secure assets, unless offered an exorbitant rate of return. The United States might be an exception, as its currency is so widely accepted and its government debt is to a large extent held by foreigners. Another exception could be Japan, whose debt is largely held by its own citizens and firms.

An outline of the other chapters in the book

Why is it that government debt has risen to world war proportions in a time of peace? There are two mechanisms behind this. One is the rise of the welfare state, with governments providing ever more services and handouts to their citizens without making them pay for it in full by taxes. In the next chapter we track the rise in public services and transfers, a process that was relatively easy in the golden years after the Second World War but led to persistent deficits as economic growth slowed down in the mid-1970s. The other mechanism is that government services tend, by their very nature, to become relatively more expensive in a growing economy. This, the so-called cost-disease, is the subject of Chapter 3.

It is perhaps unnecessary to ask why the welfare state is popular. Who does not like getting things for free? For free? Don’t people have to pay taxes to finance all the welfare they get? Well, taxes are paid by people

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with income and wealth, the more so the more they have of either. Financing the welfare state involves a measure of redistribution from those who have more to those who have less. The distribution of income and wealth is in all societies skewed in such a way that the majority of people have income below the average, so redistribution is popular. Redistribution would be fine and well were it not for the inconvenience that the generation of wealth not only creates such a skewed distribution but may also depend on an unequal distribution. In Chapter 4 we discuss the welfare state and its origins and how it is a logical consequence of modern democracy, while in Chapter 5 we discuss the modern democratic way of governing and how it is the outcome of economic growth beginning under not so democratic government. Democracy is better at distributing wealth widely than in generating it in the first place. Does it carry within itself the seeds of its own destruction?

Some of the euro countries have been foremost among rich countries suffering from a debt crisis in the wake of the financial crisis of 2008. Is the euro the root of their problems, or do the roots lie elsewhere? Would the euro countries, at any rate some them, improve their lot by abandoning this currency? The euro was created for cementing the European Union and for providing the discipline needed to deal with inflation and erosion in currency values brought about by unsustainable wage and salary increases. It has provided that discipline with a vengeance, but has also created other problems. Chapter 6 discusses the European Union and identifies its problems not with the much-touted "democratic deficit" but with the absence of European identity.

The optimistic message of this book is in Chapter 7, which deals with how Sweden tackled the crises of its welfare state in the 1970s–1990s. The ambitions were adjusted to what the economy could support, facilitated by a broad consensus across the governing elites. The Swedish welfare state is still alive and well, but probably better founded and more sustainable than it was 30 years ago. Sweden is now among the financially sounder economies in the European Union. Finally, Chapter 8 concludes.

Notes

1 On printing money during the German hyperinflation, see Adam Ferguson (1975), *When Money Dies*.

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2 On the impact of the Glorious Revolution on England's finances, see North and Weingast (1989).
3 See Carmen Reinhart and Kenneth Rogoff (2009), *This Time Is Different*.
4 Luxembourg is also excluded because of insufficient data on government debt. Turkey became a member of the OECD already in 1961, but could not then and hardly even now be regarded as a rich country.
5 See Reinhart and Rogoff (2009), *This Time Is Different*.

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2

Why Has Government Debt Increased?

Abstract: *Government debt rises because expenditures exceed revenues. Expenditures are the result of government consumption and transfers. In this chapter the development of public expenditure and consumption in the traditional OECD countries in the postwar period is traced. Also shown is the annual growth rate of GDP. In most countries the growth rate was higher before the mid-1970s than later, which facilitated growth in public expenditures. In most countries public consumption has grown more slowly since the mid-1970s. Countries with the highest government debt are typically not those with the highest GDP per capita, nor the ones with the largest government expenditures or consumption.*

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In the previous chapter we saw that government debt, in the majority of rich countries, began to rise in the mid-1970s, shortly after the energy crisis of 1973. That confluence of events was no coincidence; the energy crisis put an end to what is often called the golden age of economic growth in what was sometimes called the First World, the industrialized countries of Western Europe and North America plus Japan (the Second World was the communist countries and the Third World the so-called developing countries). Behind this economic growth was rapid productivity increase in manufacturing. Parallel to rising private incomes and consumption the public sector expanded: both provision of public services and transfer payments such as pensions and support for the unemployed and disabled. This benign development was interrupted by the energy crisis when the price of oil quadrupled over a period of a few months. The rising price of oil pulled up the price of many other energy carriers, especially close substitutes such as natural gas and coal.

The governments in the countries we are looking at were taken aback by this. The recession that followed in the wake of the oil price rise was widely regarded as temporary, and in a good Keynesian tradition the problem was seen as one of bridging the business cycle "gap" between the downturn and the upturn, although some countries proceeded less aggressively in this than others. There was talk about "recycling the petrodollars," the vastly increased sums that the oil-importing countries paid to the oil exporters, because the latter were conceived of as unable in the short run to spend all that money, which therefore would be withdrawn from the global purchasing power unless lent to countries willing to spend it. But the recession did not abate, and yet prices rose; this was when the word "stagflation" entered the vocabulary. Then, in 1978–1979 there was another energy crisis, the oil price doubled and the recession deepened. Even if the oil price fell again in 1986 about as dramatically as it had increased earlier it did not quite fall to its previous level even in real terms, and the good old years of the 1950s and 1960s did not quite come back.

But adjusting to leaner times is not easy, especially for democratic governments that have to convince an electorate unwilling to believe that the good old times are gone. Even as it became increasingly clear that the good old times were indeed gone, it was still tempting for politicians seeking reelection to continue debt financing instead of raising taxes or cutting expenditures as necessary to make ends meet. Both of these, needless to say, are unpopular. Cutting expenditures means

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either cutting transfers such as pensions, unemployment compensation and support of ailing industries or reducing government-financed health services and education. In this chapter we look at the time series of both aggregate government spending and public consumption. The development of these provide a clue to what may have caused increased government debt, increased public services such as health and education or increased expenditure despite stagnant public consumption, which implies increased transfers. A third possibility is that public debt grew despite stagnant public expenditure, in which case government revenue must have declined. As we shall see, the causes differed somewhat from one country to another.

Figure 2.1 shows economic growth, total government expenditure and public consumption since 1950 for the traditional OECD countries identified in the previous chapter. Government expenditure and consumption are expressed in percent of GDP, just like the debt series that we showed in Figure 1.1. Therefore, when we talk about rising or falling public consumption or government expenditure, we are talking about shares of GDP and not levels. Note the somewhat uneven development of government expenditure and consumption, which is caused by their being expressed as percent of GDP. Government consumption is more stable than GDP, which changes in response to good or bad times in the private sector of the economy. A decline in GDP will produce an increase in government consumption as measured here if the latter stays steady. Government expenditure often increases as the GDP declines, because of increased payments to the unemployed or to industries in trouble, so government expenditure as a percentage of GDP will increase all the more. What matters, however, for government debt is the long-term development of government expenditure and revenue. If government revenue falls behind government expenditure in any particular year it will generate a deficit, and as long as the deficit persists the debt will rise; debt is the accumulation of deficits.

Most of the countries under consideration are characterized by a similar profile of development: increase in government expenditure and public consumption until the 1980s and after that stabilization or even decline. The expansion was fueled by a rapid economic growth in the years before the energy crisis of 1973. The growth rate in most rich countries was generally lower after 1973 than it had been before. It apparently took some time for governments to realize that times were not quite as good as they used to be, and so the adjustment of expansion in

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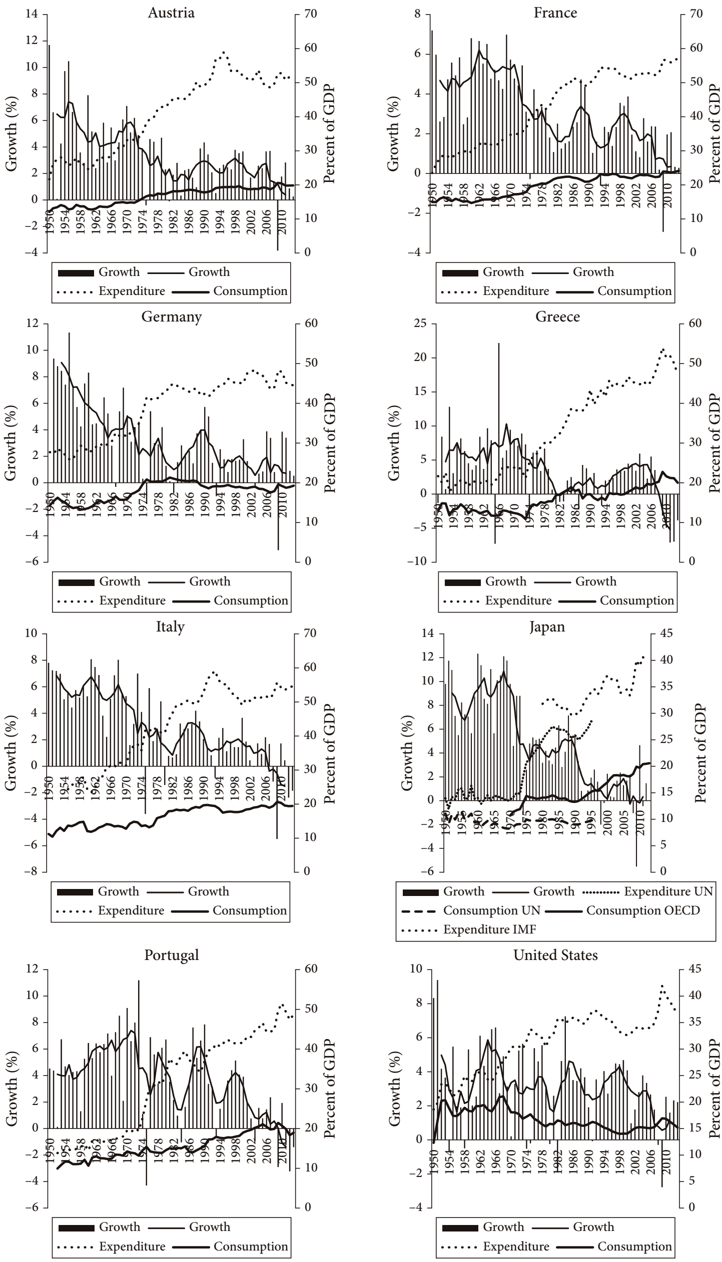

FIGURE 2.1 *Government expenditure and consumption, in percent of GDP, and the rate of growth, with columns showing annual rate and lines showing a five-year moving average*
(a) the relentless borrowers
Source: See Appendix.

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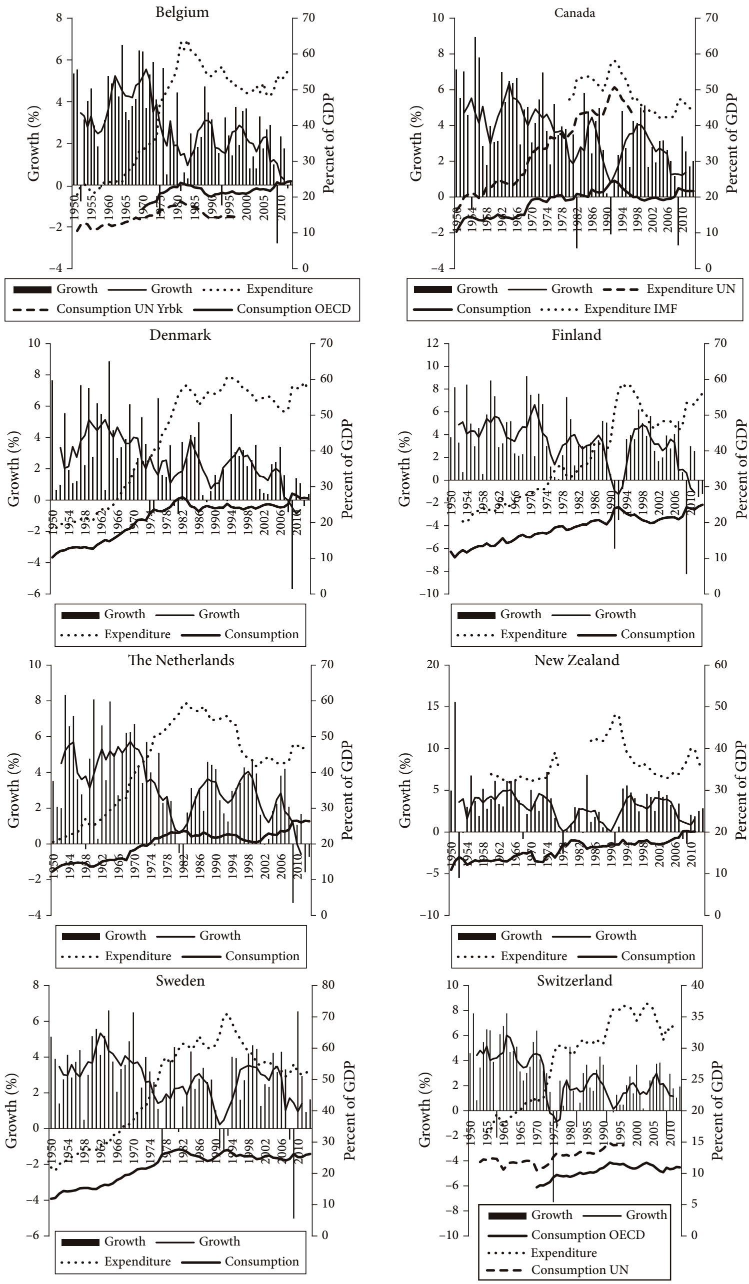

FIGURE 2.1 *Continued*
(b) the repentant borrowers

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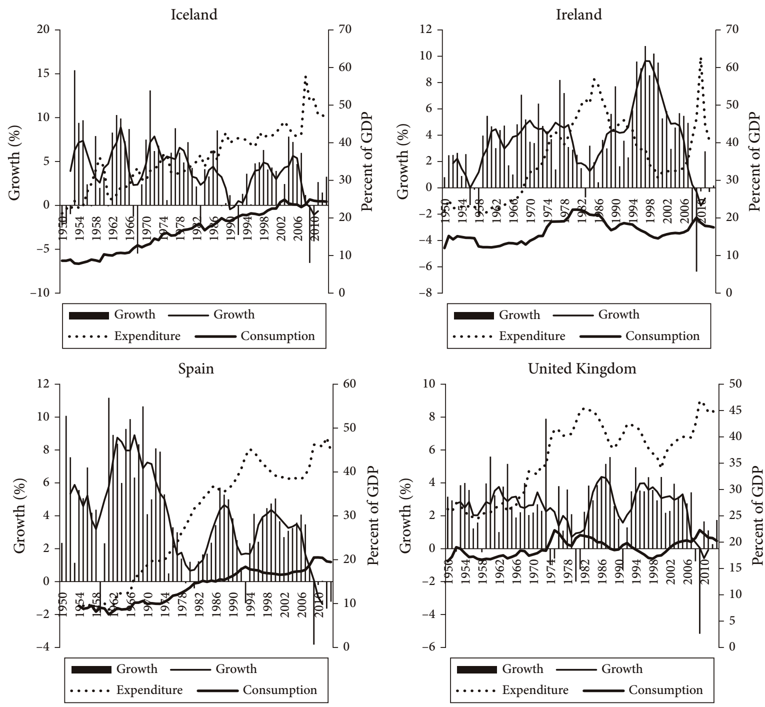

(c) victims of the financial crisis

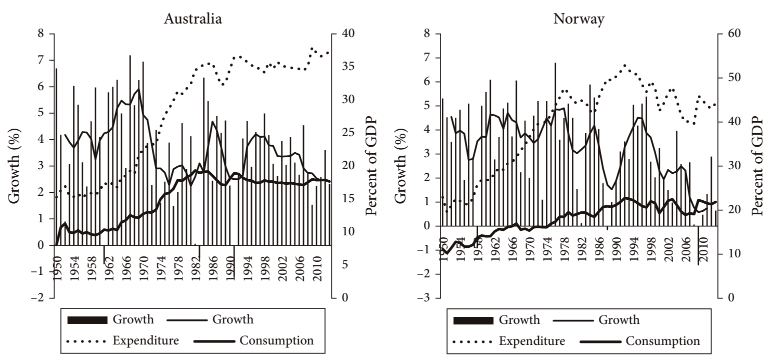

FIGURE 2.1 *Continued*
(d) the debt avoiders

public expenditure and consumption to lesser ability to spend also took some time. In the meantime, continuing high expenditure was financed by borrowing. Sooner or later, though, borrowing must stop and even be reversed, which requires higher taxes or reduction in public expenditure through less public consumption or lower transfers (pensions, unemployment insurance, subsidies to private industry). The longer it takes to adjust to leaner times the more debt will be accumulated, which means higher interest payments on the outstanding debt. Some debt accumulation after 1973 is not unexpected, but then reversal after some time would have been needed, the sharper and longer the more debt had been accumulated. The development in many of the countries considered followed this path, but with some differences, and some countries did not follow this path at all. In the following section we briefly discuss the individual countries, dividing them into four categories identified in the previous chapter: (1) the relentless borrowers; (2) the repentant borrowers; (3) victims of the financial crisis in 2008 and (4) those that have avoided debt accumulation.

The relentless borrowers

The countries involved are Austria, France, Germany, Greece, Italy, Japan, Portugal and the United States. Some of them have managed to stabilize the debt for a short period and some even to reduce it slightly for a while, but on the whole the debt has risen formidably since the early 1970s or even longer.

In France, Germany and Austria, economic growth has been much slower after 1973 than before. All three began to accumulate debt after 1973 and have continued to do so ever since (see Figure 1.1). In Austria the debt accumulation slowed down for a few years after 1988, and from the mid-1990s the debt fell slightly, but resumed its growth after the financial crisis in 2008. The growth in public expenditure was not reversed, except temporarily, until the mid-1990s, when the debt began to fall slightly. Public consumption has followed a rising trend since 1950. In France public expenditure has grown, with some reversals, ever since 1950. By contrast, public consumption has remained virtually the same since the mid-1980s, so the increase in expenditure is mainly because of increased transfers. In Germany there has been much less growth in government expenditure than in France since 1975, and public consumption has been fairly flat. It is a bit strange, therefore, that Germany has managed to accumulate almost as much public debt as France; for Germany the explanation seems to lie on the revenue side rather than on the spending side.

In Italy economic growth has been lower since 1973, but it had begun to sag earlier, or in the late 1960s. Italy began to accumulate debt already

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in the 1960s, earlier than the aforementioned three. Italy managed to reverse the accumulation of debt in the years 1994–2004, but even before the financial crisis in 2008 the debt had begun to grow again. Italy did not manage to reverse the growth of its government expenditure until 1993, after which it fell and then became stable until 2008. Public consumption has grown since 1960 except for a few years in the first half of the 1990s when it declined. Before the financial crisis of 2008 Italy was well under way in winding down its debt, but the following recession has turned that upside down. Italy's high debt legacy has added stones to the burden; government debt reached a preliminary peak of 120 percent of GDP in 1994 and never fell below 100 percent thereafter, and again came to exceed 120 percent in 2012.

In Japan economic growth has fallen in two steps, from a high level in 1950–1970 to a lower one in the mid-1970s–1990, and then virtual stagnation after 1990. The debt began to increase in 1974, declined in the latter half of the 1980s and increased again from 1990. Government expenditure varied without a trend from 1950 to the early 1970s, but rose quickly after that. It declined in the 1980s, then increased as the Japanese economy stagnated, remained fairly steady in 2000–2008 and finally increased again after the financial crisis. Public consumption remained fairly flat in 1975–1991 but increased after the economy stagnated. The buildup of debt is clearly associated with increase both in public expenditure and consumption.

In Greece economic growth fell in the latter half of the 1970s, and it has not been as high in subsequent years as in the 1960s and early 1970s. Greece began to build up debt in the late 1970s. Government expenditure and public consumption began to rise earlier, or in the early 1970s. The increase in expenditure became more moderate after a while and expenditure was fairly stable from the mid-1990s to 2006, when it rose again steeply. Public consumption rose from 1973 to the mid-1980s and has since waxed and waned, but has on the whole been on a slightly rising trend. The phases of the Greek debt buildup are clearly associated with increases in expenditure that have been out of step with revenues.

In Portugal the economy grew at a somewhat higher rate before 1973 than after. Portugal does not fit the typical scenario where public expenditure and consumption grew rapidly before 1973 and then eventually adjusted to a lower rate of growth. There was a rapid growth in public expenditure in the 1970s, and it has been on a rising trend after that. Public consumption has been on a rising trend since 1987, except

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for the years after 2008. Debt began to be accumulated in the late 1970s and has continued in that vein after that, with few exceptions. The debt buildup accelerated after the financial crisis in 2008.

The United States also departs from the typical rich country scenario. Economic growth was not much higher in the 1950s and 1960s than in later years. Government expenditure has increased substantially since 1950, from about 20 percent of GDP to more than 40 percent in recent years, even if it has fallen in some subperiods. Curiously, public consumption has fallen slightly since 1970, despite increasing expenditure. Hence the buildup of debt in the United States is due to increased transfer payments rather than increased public consumption. The American public debt began to rise after 1980 under President Reagan. That development was temporarily reversed under President Clinton in the 1990s, but resumed again after 2000 under President Bush and has continued under President Obama whose election coincided with the financial crisis.

The repentant borrowers

These countries are Belgium, Canada, Denmark, Finland, the Netherlands, New Zealand, Sweden and Switzerland. They all follow the typical path of rapid economic growth before 1973, then a rapid increase in government debt as the new reality of slower growth affected government revenues while expenditures were maintained or increased and finally stabilization or decline in public expenditure and, up to 2008, some winding down of government debt.

The two Scandinavian countries, Denmark and Sweden, have in many ways followed a similar development. In both countries economic growth was higher before 1973 than later, although not much higher. In both countries, government expenditure and public consumption continued to grow until the early 1980s. Government debt grew rapidly from 1973 until the early 1980s. Both countries managed to reverse expenditure growth and debt accumulation in the early 1980s, only to see expenditure and debt increase again to a new and higher peak in the early 1990s, after a banking crisis occurred in both countries. Both countries managed to reduce the debt after the mid-1990s by reducing expenditure, while public consumption has stayed fairly flat. Sweden has even managed to avoid building up debt after the financial crisis. A decline in transfer payments is the main reason for the debt reduction.

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Finland has traits in common with its Nordic neighbors, but is in some ways quite different. Economic growth was only slightly higher before 1973 than later, but there was a dip after 1973 and an even bigger one around 1990 related to the downfall of the Soviet Union. Public expenditure and consumption have both risen in Finland since 1950, but with some, and for expenditure major, variability; the increase in consumption has in fact been fairly even, except for a bulge around 1990 caused by the economic contraction at that time (remember we are measuring consumption and expenditure in relation to GDP). Government debt rose extremely fast in the early 1990s, from less than 15 percent of GDP in 1991 to more than 50 percent in 1993 (see Figure 1.1). The Finns managed to reduce this to a little over 30 percent in 2008, but have seen it rise again in the wake of the financial crisis.

In Belgium economic growth was appreciably higher in the 1960s than after the energy crisis of 1973. Public expenditure and consumption both continued to increase until the early 1980s, but after that expenditures declined while consumption stagnated. Government debt was built up rapidly from the 1970s to a very high level: 120–130 percent of GDP in 1994; the data sources do not quite agree. After that it was wound down, but has increased somewhat after the financial crisis.

The development in the Netherlands is quite similar to neighboring Belgium. Economic growth in the 1950s and 1960s was appreciably higher than later, but the decline in growth came around 1980, several years after the first energy crisis. That the Netherlands are a major producer and exporter of natural gas is a likely explanation for this delay. Government expenditure and public consumption grew until the early 1980s when GDP growth declined. After that government expenditure fell while public consumption stayed approximately constant, but the latter picked up again after the turn of the century. Debt was built up from the late 1970s to the late 1980s, but began to be wound down in the mid-1990s. Since the financial crisis it has increased again.

In Switzerland the growth rate was higher before 1973 than it has been later. Public expenditure rose particularly rapidly in the wake of the first energy crisis until the end of the 1970s. After that it stayed fairly flat until 1990 and then rose again. Public consumption increased until 1990, but has been fairly steady after that. Public consumption in Switzerland is among the lowest in the OECD countries, about 11 percent of GDP according to the OECD figures; the United Nations figures are higher, but show a similar trend (see the Appendix on data sources). Public debt

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rose somewhat in the wake of the energy crisis in 1973, shot up particularly from 1988 to 2005, but came down after that. Given that public consumption was fairly steady over this period, the increase in debt was apparently caused by increased transfer payments.

Canada is a bit like the United States in that economic growth was only slightly higher before the first energy crisis than it has been since then. It is also similar to the United States in that public consumption has not increased much since 1970 (in the United States it has fallen slightly). Nevertheless, government expenditure grew, by variations, until the early 1990s, but has since come down substantially. Government debt increased from 1980 to the mid-1990s, but declined again until 2007. The debt buildup is clearly related to increased transfer payments and the decline to a decrease of the same.

New Zealand is yet another country that has managed to reverse its accumulation of government debt. Economic growth was high in the 1950s and 1960s, and again and quite comparable from the early 1990s up to the financial crisis, but in between growth was appreciably lower, which prompted New Zealand to undertake radical economic reforms in the 1980s. Public consumption has been on an increasing trend in New Zealand since 1950, but government expenditure has come down from a peak around 1990.

As noted in Chapter 1, all the countries that have succeeded in reversing their accumulation of debt are relatively small. It was argued that small countries might be more vulnerable to lenders' loss of confidence than large countries. Government debt reached a level of 70–140 percent of GDP before it fell (the data on Belgium and Switzerland show a wide discrepancy between different sources; see Figure 1.1).

The victims of the financial crisis

These are Iceland, Ireland, Spain and the United Kingdom. The development in the United Kingdom is in many ways different from other OECD countries. Economic growth was not higher in the 1950s and 1960s than it has been later, but it slowed down after the first energy crisis, as in most other OECD countries. Government expenditure did not change much from 1950 to the early 1960s, but rose after that to the early 1980s. Then it was on a declining trend until 2000, when it began to rise again. Public consumption has been fairly flat for most of the time after the

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mid-1970s; it was no higher in 2013 than it was in the mid-1970s. The United Kingdom accumulated a large public debt during the Second World War, but managed to reduce it in the first two to three decades after the war (some of that was because of economic growth, as we are looking at debt in percent of GDP). The debt stopped declining in 1973, but did not really rise much until after 2007.

In Ireland and Iceland, economic growth was not higher in the 1960s than it turned out later. In Ireland the economy took a dip in the late 1970s, a few years after the energy crisis, but the country experienced a burst of growth in the 1990s and early this century, which earned it the label "The Celtic Tiger." Government expenditure rose to a peak in 1985, associated with the dip in the economy, but fell quickly after that. It shot up mightily after the financial crisis of 2008, but has since come down. Public consumption increased until 1980 and has been on a declining trend after that. Government debt increased until the mid-1980s, associated with the rise in government expenditure, but fell after that until the eve of the financial crisis, associated with a fall in and then stabilization of public expenditure. The financial crisis and the fall of the Irish banks sharply reversed that development; in 2013, the Irish government debt was nearly 120 percent of GDP.

In Iceland there was no recession associated with the first energy crisis. The economy took a dip in the early 1980s and a deeper and longer one in the late 1980s and early 1990s. Government expenditure has varied, but has been on a strongly rising trend since 1950, as has public consumption. Government debt increased from the mid-1960s to the mid-1990s and then fell until the financial crisis, after which it rose sharply as a result of the collapse of the Icelandic banks.

Spain experienced a long and deep decline in the growth rate in the 1970s and early 1980s, and the growth rate after that has been appreciably lower than in the 1960s. Government expenditure and public consumption nevertheless increased until the early 1990s. Debt was accumulated rapidly in the 1980s, but from a very low level, and, less rapidly, onward to the mid-1990s. After that the debt declined, until it rose rapidly after 2008 to the unprecedented high of more than 90 percent of GDP in 2013.

Avoidance

The countries that have avoided to accumulate debt over the past two to three decades are Australia and Norway. These two are somewhat

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special cases. Both are rich in natural resources, and their economies are to a high degree based on resource wealth, which these countries have managed well enough to avoid the resource curse. In Australia, economic growth was somewhat higher in the 1960s than later, but fell after the first energy crisis. Government expenditure continued to increase until the mid-1980s, but has varied without trend after that. The same is true of public consumption. Like the United Kingdom, Australia and New Zealand accumulated a large debt during the Second World War, but have managed to pay much of it off since then, Australia more successfully.

In Norway, economic growth was not much higher in the 1960s than it has been later. Economic growth slowed down in the early 1980s and again in the late 1980s and early 1990s, the latter episode associated with a fall in the oil price and a banking crisis, and slowed yet again in the years after the financial crisis. Nevertheless, Norway's economic growth has been high for the entire period since 1950. Government expenditure increased until the late 1970s, but has varied without trend after that. Public consumption was on an increasing trend until the early 1990s, but has since varied without trend. Gross public debt has varied without much trend, but because of its petroleum wealth, Norway had net government assets of twice its GDP in 2013.

Debt: result of overambition or inability to raise taxes?

What we have seen so far is that, in most rich countries, economic growth has been slower after the energy crisis of 1973. Also, in most rich countries public consumption and total government expenditure have grown more slowly as a result, even if this adjustment to leaner times has taken longer in some countries than others. More importantly, in many rich countries this adjustment has clearly been insufficient to halt, let alone reverse the buildup of government debt.

Trivially, accumulation of debt is due to expenditures exceeding revenues. More fundamentally, one must ask why does this happen? Do the ambitions behind the expenditures outpace the ability to raise revenues? Does this happen because expenditures are exceedingly high, or could countries, at least some of them, run into problems with raising revenues to finance even modest expenditures? As we shall see,

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there is some truth in this latter explanation. And why do expenditures rise? Is it because of a need to finance the production of services provided by government (public consumption), or is it because of a rising need, or ambition, to transfer money to firms and households, the latter presumably for redistributing purchasing power to those who otherwise would be disadvantaged? As we have seen, both of these are involved, but to different degrees in different countries, although increased transfers seem to be more important in this regard than increased public services.

In Table 2.1 the 22 countries have been ranked according to (1) debt in 2012; (2) expenditure and (3) public consumption over ten years (2003–2012), all in percent of GDP; and (4) GDP per capita over five years (2008–2012) measured in purchasing power parity international dollars. A quick glance at the table leaves the impression that the countries with the largest debt are not the ones with the highest public expenditure or the largest public consumption, nor are they the most affluent ones. The rank correlation between debt and the other three measures are 0.06 (expenditure), – 0.16 (public consumption) and – 0.4 (GDP per capita). To the extent public debt has been accumulated because of extravagant public expenditure and consumption it appears to have more to do with extravagance in relation to the ability to finance such expenditures than the size of these expenditures expressed as percentages of GDP. There is a certain tendency for the poorest among the countries considered (all of which must be considered rich) to have the heaviest debt burden. Note that this does not necessarily mean that these countries are poorer than the rest because they have a large public debt. Such causal relationship is difficult to prove and requires in any case quite sophisticated analysis (Reinhart and Rogoff identify a critical threshold for debt beyond which debt has a negative effect on economic growth[1]). A more likely explanation is that these countries are overambitious in relation to their ability to raise tax revenues. We should not exclude the possibility that the richer a country is the more able it is to collect taxes. Countries that are well ordered and with little corruption can raise tax revenues more easily than those with a large underground economy and unreliable administration. It would, however, be prudent to recognize that even rich and well-ordered countries could tax themselves to poverty.

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TABLE 2.1 *Ranking of countries according to debt (2012), public expenditure (average 2003–2012), public consumption (average 2003–2012), and GDP per capita (2012)*

Rank	Gross debt 2012 percent of GDP		Expenditure 2003–2012 percent of GDP		Consumption 2003–2012, percent of GDP		GDP per capita 2008–2012 '000 int'l dollars	
1	Japan	230	Denmark	54.9	Denmark	27.3	Norway	52,502
2	Greece	157	France	54.5	Sweden	26.5	United States	49,002
3	Italy	127	Sweden	53.0	The Netherlands	26.2	Switzerland	42,786
4	Portugal	124	Finland	52.0	Iceland	25.2	The Netherlands	40,823
5	Ireland	117	Belgium	51.3	France	24.0	Canada	40,447
6	United States	103	Austria	51.0	Belgium	23.4	Austria	40,030
7	Belgium	100	Italy	49.1	Finland	23.3	Ireland	39,924
8	Iceland	99	Greece	49.0	United Kingdom	21.5	Australia	39,692
9	France	90	The Netherlands	47.8	Norway	20.8	Iceland	38,683
10	United Kingdom	89	Iceland	47.1	Portugal	20.4	Sweden	38,129
11	Spain	86	Portugal	46.9	Canada	20.25	Belgium	36,579
12	Canada	85	Germany	46.1	Italy	20.18	Denmark	36,543
13	Germany	82	United Kingdom	45.8	Spain	19.3	Germany	36,328
14	Austria	74	Norway	43.4	New Zealand	19.05	United Kingdom	35,475
15	The Netherlands	71	Spain	42.1	Japan	19.03	Finland	34,825
16	Finland	54	Ireland	41.8	Germany	18.9	France	34,114
17	Switzerland	49	Canada	41.1	Austria	18.8	Japan	34,019
18	Denmark	46	United States	38.8	Greece	18.2	Spain	29,874
19	Sweden	38.3	Japan	38.5	Ireland	17.8	Italy	29,767
20	New Zealand	37.8	New Zealand	35.8	Australia	17.6	New Zealand	28,089
21	Norway	34	Australia	35.2	United States	15.8	Greece	26,679
22	Australia	28	Switzerland	34.1	Switzerland	11.2	Portugal	23,001

Note

1 Carmen M. Reinhart and Kenneth S. Rogoff (2010), *This Time Is Different*.

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3

The Cost Disease of Public Services

Abstract: *The cost-disease model explains why the public sector expands in an economy with rising productivity. Because of the nature of most public services, the scope for increased productivity is limited. Therefore, if both public and private consumption are to expand at similar rates, labor will have to be transferred from the private sector to the public sector and taxes will have to increase. Raising public pensions on par with incomes in the private sector will have a similar effect, and a rising share of retirees will further strengthen this effect.*

Hannesson, Rögnvaldur. *Debt, Democracy and the Welfare State: Are Modern Democracies Living on Borrowed Time and Money?* Basingstoke: Palgrave Macmillan, 2015.
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As we saw in the previous chapter, government expenditure expanded rapidly in the first two decades after the Second World War in the 20-plus countries we are looking at. This expansion was fueled by the high rate of economic growth in this period, which slowed down after the energy crisis of 1973. This high rate of growth made it possible to simultaneously increase public and private consumption. In most countries public consumption stagnated after the energy crisis while in some countries government transfers increased so that government expenditures nevertheless continued to rise. Some of the increase in transfers was because of the support of ailing industries expected to be in temporary difficulties. This was prominent in Sweden, to be discussed in greater detail in Chapter 7.

The growth of the public sector in the postwar years is, needless to say, synonymous with the expansion of the welfare state, to be further discussed in the next chapter. This growth is in part because of increased expenditure on education and health services, the primary components in what is called public consumption in the national accounts. In addition, the welfare state comprises things such as unemployment benefits, pensions and disability payments and other social support payments. These are not classified as public consumption but as transfers and, together with interest on outstanding debt, amount to the difference between government expenditure and public (government-financed) consumption.

There is no law of nature that says that all, or indeed any of this, should be provided by governments. In fact, before the late 1800s, governments were hardly involved in this at all. Nevertheless, governments in the most advanced countries in Europe and elsewhere were at that time increasingly getting involved in providing elementary education. But otherwise, individuals and households had to pay their doctors and the cost of the schooling of their children beyond the elementary level as well as provide for their old age. Things could have continued on that path. In fact, in some countries, most notably the United States, individuals and households have to pay for health services and the education of their offspring to a much greater extent than in Europe where these services are provided by governments for little or no direct charge. The high European taxes drive home the point that these services do not come for free, even if individuals do not pay for them directly. As we shall see, however, the government of the United States is indirectly quite heavily involved in financing health care and education through tax relief.

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Many reasons can be advanced for why governments should be involved in the provision of education and health services to the extent they are in Europe. An educated workforce is more productive than an uneducated one and thus a benefit for society at large and not just for the individuals involved. More importantly, making education and health services universally available ensures that those who cannot afford them, or are insufficiently aware of their merits, also get them. But how far should we push this argument? Should any esoteric training that in due course will more than pay for itself by a higher salary be paid for by the general taxpayer? Should a facelift be a government-financed health service? The welfare state should not be seen as a question of either or, but a question of how and how much. More to the point, it needs to be seen in relation to the ability and the willingness of the general public to pay for these things with their taxes. In the previous chapter we saw that the governments with the greatest problems to balance their books are not necessarily the most ambitious ones when it comes to welfare state provisions, but the ones with the greatest mismatch between their ambitions and ability to collect tax revenues.

But the emergence of the welfare state is unlikely to be due only to calm deliberations of these persuasive arguments; politics is governed by rawer nerves than that. The main factor behind the expansion of the welfare state during the past century is the widening of the right to vote, from men of wealth in the nineteenth century to the common man and woman in the twentieth. To be elected, politicians catered to their voters, and the voters increasingly wanted "free" education and health services as well as social security. The impressive economic growth, despite temporary setbacks, over the past century made this possible. Furthermore, and related to this, there was the increasing power of the working class. The factories that turned out the marvelous products of the industrial revolution were manned by an army of workers without whom little would be accomplished. Their political power first found an outlet in the labor movement. In a way their strategic economic role franchised them; getting the right to vote can be seen as a recognition of this. The working class and its trade unions came to use their influence in government for having government work for them by providing education and health services and social security that many would not be individually able to afford. In the next chapter we further discuss the development of the welfare state.

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The cost-disease model

As already argued, the expansion of the public sector in the latter half of the previous century can be seen as the result of a relentless political pressure to use more and more of society's resources to provide education, health services and various social security payments. But it can also be seen as a result of what has come to be known as the "cost-disease," the tendency of the said services to become more and more expensive as the economy grows. These are not mutually exclusive explanations; there is validity in both. Let us look, therefore, at the cost-disease model, first developed by the American economist William Baumol.[1] Why is it that haircuts, theater tickets and education have become so expensive in rich countries? It follows from two premises: (1) productivity gains happen primarily in manufacturing, but are difficult to accomplish in services like the ones already mentioned and (2) people working in manufacturing and in services must be offered comparable wages; otherwise no one would be interested in providing services.

These premises sound plausible. We all know how the products offered by the manufacturing industries have become cheap relative to services of various kinds; in some cases, such as in the electronic "gadget" industry, the prices have dropped spectacularly over short periods of time, because of technical progress. New gadgets retain their novelty for only short periods during which the manufacturers can make handsome temporary profits, but as competition brings similar gadgets on the market, the price drops. New production equipment makes it possible to produce things with much less labor, bringing the costs down. New technologies increase the usefulness (speed and versatility) of the gadgets, bringing down the cost of the services they provide. Lest it not be forgotten, competition in the marketplace is the necessary mechanism to bring these gains to the final user. In any case, examples of technological progress of various kinds bringing down the price of various manufactured goods, or the cost per unit of the service they provide, are easily thought of.

Such examples do not come as easily to mind with respect to services provided by people and not just gadgets. There are limits to how much faster and sharper haircutters increase the productivity of hairdressers and barbers. Reciting Macbeth's monologue too quickly leads to incomprehension, not to enhanced enjoyment. Playing Beethoven's fifth symphony twice as fast as Karajan had the Berlin Philharmonic do

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it would not be applauded, and neither would the performance of the choral part of the ninth symphony with just a quartet. Television and film of course reduce the cost of disseminating these things, but that is a different kind of service; there are still people who prefer the theater and the concert hall.

Actors and musicians undoubtedly enjoy what they are doing in a way those with manufacturing and clerical jobs do not, but also artists have material needs and must keep body and soul together and feed their families. If the difference between wages in manufacturing industries and the incomes of actors and musicians becomes too great in the disfavor of the latter, no one will perform on the stages of theaters and concert halls. So, despite the absence of productivity gains among actors and musicians, their wages will nevertheless have to rise roughly in tandem with the rise in wages in manufacturing caused by productivity gains in manufacturing. The superstars among the performers do get an income many times that of workers and clerks, but we are talking here of the more ordinary ones who might contemplate whether it is at all worthwhile to engage in the performing arts for a living.

Some of the services mentioned are offered in the market place. Barber shops and hairdressing saloons are operated by private firms. No one presumably goes into these businesses unless expecting to earn what it would be possible to earn in an alternative occupation. Theaters and concert halls are often owned and operated by private firms, but the high and rising cost of the performances typically brings forward government support of various kinds, without which these institutions would likely wither and die. Maybe we can do without actors and musicians on stage (after all, we have television and video), but what about education and health services? In most rich countries these are provided by government, sometimes virtually exclusively and usually predominantly. The nature of these services, as far as productivity gains are concerned, is not entirely unlike haircuts and artistic performances. Teaching still depends critically on teacher-student interaction, and there is a limit to how many more students or pupils each teacher can handle without diluting the learning effect. Mass distribution of lectures or instruction given by star performers over the internet may help, but the learning effect, particularly at the elementary level, is still likely to depend on person-to-person interaction. Nursing and other medical services are undoubtedly made easier by various technical devices that get better and better, but they are unlikely to increase much the number of patients that can be

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taken care of by a single nurse or a single doctor. Giving a surgeon two knives instead of one would not increase the number of patients he can operate on.

The salaries of teachers, doctors and nurses and others who work for the government are mainly paid for by taxes; the public usually pays only a small fee or no fee at all for using these services. But as already argued, despite little rise in productivity in public services, the salaries paid to people providing them will have to rise in parallel with wages in the private sector where productivity gains are much greater and give rise to increasing wages. Note that this has nothing to do with a possible absence of incentives in the public sector to increase productivity. These incentives may well be weak, but what the argument is all about is that the scope for increasing productivity in what usually are public services, and many other services as well, is limited by their very nature.

As people get richer, they are likely to demand an increase in the volume of public services such as health services and education on par with the increase in the consumption of manufactured goods. From this follow two implications. First, the tax burden will have to rise relentlessly. Second, more and more of the work force will be employed by the government. The formal details of this can be found in an appendix to this chapter, but Figure 3.1 shows what happens over time in this scenario. In the beginning, public goods, financed by taxes, amount to 20 percent of the economy, and 20 percent of the labor force works in the public sector (this is not far from the situation in many rich countries in the early 1950s, as can be seen from Figure 2.1). Productivity grows at a rate of 5 percent per year in manufacturing (the market sector), and production in both sectors grows at the same rate as a matter of public policy. Whether or not this is because of a "demand" from the public need not detain us here; it is the government that decides public policy, but presumably the actions of democratic governments reflect the will of the electorate that stands behind them, and expansion of public services is, to say the least, a matter of fact for the years after 1950. Even if people had to pay for health services and education out of their own pockets their demand is likely to rise in any case as they become better off, but it would not be accompanied by a rise in taxes.

Since the productivity in the market sector of the economy grows while it does not grow at all in public services, it is necessary to transfer some of the labor out of the market sector and into the public sector in order to achieve the desired growth in public services. Over time, more

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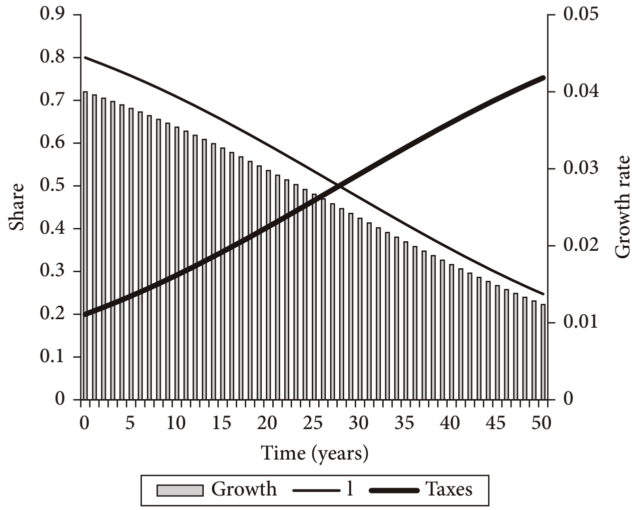

FIGURE 3.1 *Share of labor employed in the market sector, share of taxes in GDP and the rate of growth*

and more of the labor force will be working in the public sector. Since public services are paid for by taxes, the share of taxes in the economy will increase relentlessly. Over time, the share of labor employed in the public sector will approach 100 percent and so will taxes as a share of total national income. Furthermore, economic growth will decline and finally come to a standstill. With no labor left in the market sector there is no "base" as it were for technical progress to act upon. As to the public sector, its source of growth is transfer of labor from the market sector to the public sector, and with no labor left in the market sector no further transfers are possible. In Figure 3.1, over 50 years the share of labor working in the market sector has fallen from 80 percent to 25 percent, the share of taxes has increased from 20 percent to 75 percent and economic growth has declined from 4 percent to 1 percent per year, despite an assumed 5-percent annual increase in productivity in the manufacturing (private) sector. The cost-disease mechanism certainly accords with what has happened in the rich countries of the world since the early postwar years; falling rate of growth, rising taxes and an expanding public sector, but it certainly need not be the only explanation.

But what about a tax rate of 75 percent, let alone more if things continue to evolve in the same way? The public at large has indeed become richer (total production of both types of goods has more than trebled), but the problem is that the public often does not perceive a connection between public services that they get in any case and taxes that they pay irrespective of what they use of public services. A tax rate of 100 percent, toward which things are evolving, is pretty absurd, no matter how much we get of seemingly free public services. Furthermore, at that point no further growth is possible; the source of growth, the labor that technological progress makes redundant in the market sector, has dried up.

When simple models based on the prolongation of plausible trends produce absurd results, we need to consider what might happen along the way that could modify these trends and turn them into something less at odds with common sense. Indeed, we have already seen a number of such developments over the years. The electorate has revolted against taxes and voted into office parties ostentatiously committed to reducing the tax burden. They have not always delivered what they promised – public expenditure in the United Kingdom did not fall under Margaret Thatcher – but there is little doubt that they have modified, if not necessarily reversed the development we have been talking about. Public services have been privatized to some extent; the share people pay of the cost of these services as they use them has gone up. Both of these retard the expansion of the tax burden while allowing for expansion of public services, or what used to be public services. And the expansion of these services, whether paid for through taxes or partly through user fees, has probably fallen behind growth in manufactured goods.

And then there is a problem not at all considered by the cost-disease model: are people willing to work at tax rates that confiscate most of their income? No less importantly, how willing are investors and entrepreneurs to invest money in new equipment which increases productivity if most of the return disappears into the treasury? Such investment dearth would not only put paid to the productivity increase in the market sector, but would also halt the expansion of the public services, because that expansion requires transfer of labor to the public sector and from the market sector where it is no longer needed because of the technical progress. That source of growth dries up if technical progress in the market sector stops because investment comes to a halt. The reluctance to raise taxes from an already high level is likely to be one factor behind the slowdown in the expansion of public consumption and government expenditure that we have seen in most rich countries since the mid-1970s. This does not necessarily mean a slowdown in the provision of education and health services; more of the cost is being borne directly by those who

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demand them. Indeed, this seems to be the only possible solution of the dilemma of ever-increasing volume of services that people demand of their governments, but which get more and more expensive as productivity in manufacturing grows.

There are, however, other plausible possibilities. People are no strangers to demanding increased public services and at the same time oppose paying for them by higher taxes. Politicians in democratic countries ignore the wishes of the electorate at their peril. A solution to the dilemma of increasing public services without raising the necessary tax revenues to pay for them is to borrow money. In countries with their own currency politicians can use their central banks for this purpose. Alternatively, they can borrow money from private lenders. They find the necessary intellectual alibi in economists who tell them that government finances are something entirely different from the finances of private households, an illusion we discussed in an earlier chapter. These dynamics are likely to be among the causes behind the increase in government debt since the mid-1970s.

Pensions

In the foregoing we have been discussing government services; health services, education and much else. But governments pay for more than that. In many countries they also provide a large part of pensions, not just for their previous employees, but also for those who were employed in the private sector. This is not a part of the cost-disease model, but it strengthens its outcome in many ways. If retirees are to have a standard of living comparable to the working population, the income of retirees must rise in tandem with the wages in the private sector, which in terms of the tax burden is similar to the rising salaries of government employees without a corresponding increase in productivity. One could think of government-financed retirees as providing the service of just being around and smiling at us. Some evil tongues would say that the service provided by some government employees is of a similar nature, but without the smile. The problem becomes even greater if retirees are an increasing share of the population, as the case is in many rich countries.

It may be noted at this point that the retirement burden is not necessarily made any worse by the so-called underfunding, alias pay-as-you-go financing. Retirees consume goods and services that are currently

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produced; they do not subsist on money that has been stowed away for their maintenance or goods that have been stored up for their use, or live in houses of cards made of the paper wealth that pension funds have accumulated. Numbers in bank accounts are useless for providing the health services retirees and others need; for that we need people of flesh and blood. The only thing a retirement fund accomplishes is to turn retirees into claimants of capital income. The main argument for pension funds is that they restore the savings motive that government-financed retirement schemes remove; with such schemes the individual does not have to save for his or her own retirement, which is likely to reduce savings and hence productive investment in the economy. It is that productive investment that in reality pays for the expenses of retirees. This is true even for a small economy, such as Norway, which has built up a fund of foreign assets ostensibly earmarked for financing future pensions. This arrangement transfers the Norwegian retirement burden to workers in foreign countries who generate the return on wealth claimed by capital owners in their own country or abroad, even if it relieves the Norwegian workers of the burden of supporting their own retirees.

Productivity and growth

As discussed in the previous chapter, the "golden decades" after the Second World War were characterized by rapid economic growth and a simultaneous expansion of the public sector. There are two sources of economic growth: (1) increased use of labor and (2) increased productivity, which means that each unit of labor can produce more. Needless to say, it is the latter that is the source of an overall higher standard of living; economic growth because of increased labor use with an unchanged production per capita only spreads a given standard of living to more people, which would be fine for those who are recruited into the labor force but does little for the rest. The source of higher productivity per capita is usually better technology, which in turn is usually incorporated into the new production equipment and thus requires investment in such equipment.

As already explained, the scope for productivity increase is very limited in public services. In fact, an expansion of public services on par with manufacturing acts as a drag on economic growth and ultimately brings it to a standstill. That does not mean that expansion of public

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services is necessarily a bad thing, just that the scope of increasing them and paying for them is constrained.

But there is more to it than that. Much of the expansion of public services, especially care for children and the aged, was accompanied by an exodus of women from their homes and into the labor market. Such services used to be provided outside of the formal economy, but became increasingly provided by government and financed by taxation. This may have improved the quality of such services, but apart from that it did not represent any real economic growth, just a transfer from the informal economy into the formal economy. Hence, some of the economic growth because of the expansion of the public sector was simply illusory.

A simple example may illustrate this. Suppose there are a thousand families. Each has only one "breadwinner," a male. Each produces manufacturing goods worth 100,000 dollars. Ignoring the role of capital, the GDP is the sum of wages, 100 million dollars. There are no taxes. The wives of these breadwinners stay at home and take care of their children and their grandparents and in-laws.

Now suppose the government enters the scene and builds kindergartens and old peoples' homes. These institutions are staffed with the former housewives. They are paid one half of their husbands' gross wage, which would amount to 50 million dollars. This is financed by a 33-percent tax on their husbands' wages. How so? If the former housewives also pay a 33-percent tax, their take home pay would be two-thirds of 50 million, or 33.3 million. This is what the government needs to finance and is able to finance by a 33-percent tax on the husbands. The husbands' contribution to the GDP is equivalent to their gross wage, which still would be 100 million dollars, assuming that no technological progress has occurred in the meantime. Their wives' contribution is also equal to their gross wage (that's how it is measured in the national accounts), 50 million dollars. As if by magic, the GDP has been increased by 50 percent by just circulating money around and moving the housewives into the formal economy; if all of this happened in the short timespan of one year we would have a 50 percent rate of growth over that year. This, however, would not be sustainable; the housewives can enter the labor market only once, unless they leave, and then the economic growth would be reversed. Some of the economic growth after the Second World War was because of this removal of services from the informal, household economy into the formal one of which we have some if problematic statistics,[2] but no one has found it rewarding to investigate how much.

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It may well be that institutional child care and care for the aged is better and more professionally provided than at home, but that is a separate issue and the national accounts have no way of measuring that.

Low productivity

One worry of the critiques of the welfare state has been that it will stifle economic growth. There are several ways in which this could happen. High tax rates on capital income could blunt the interest in investing in new and more productive equipment. High tax rates on labor income could similarly reduce people's willingness to work. Income support to individuals with low incomes could make it more attractive to live on such income support than to work for a low wage. Yet it has turned out to be difficult to prove that a large public sector has a negative effect on economic growth.[3] As government expenditure in Sweden broke all records in the 1980s and early 1990s many Swedish economists pointed to a falling rate of growth in Sweden, while others argued that this malaise was shared with many other rich countries.[4]

Welfare state enthusiasts, such as Peter Lindert, have pointed out that one reason why an ambitious welfare state seems to have a limited effect on economic growth is that it mainly affects people with low productivity. Income support usually is not overly generous, so those who would be enticed to withdraw from the labor market and rather live on such handouts would not be well paid in the first place. They would be poorly paid because they are not very productive; their employment could not possibly justify a high wage and so their absence from the labor market does not amount to a great loss. But how strongly does this argument count in favor of welfare handouts instead of low paid employment? Work opportunities with low productivity can nevertheless be quite useful. Some individuals are more productive than others because they have special skills that are costly to acquire and in high demand; some have been trained in using intricate machines that enable them to produce high values per hour. Low productivity comes from limited willingness to pay for some labor services that require little skill, such as domestic help or flipping hamburgers, but are we not better off with such services than none at all? And then there is the question: what best promotes individual self-respect, living on welfare handouts or earning one's own living even at low pay?

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Appendix: the cost-disease model

Normalize the labor force to 1 and assume that it remains constant over time. There are two classes of goods in the economy, market goods (x) and public goods (y). Both are produced with labor. Let l denote the amount of labor employed in the market sector. Then, $1 - l$ is the labor employed in the public sector.

Ignore explicit modeling of investment, but assume that the productivity of labor increases at a constant rate of g (presumably through investment in new equipment), while productivity in the government sector does not increase at all. The production of market versus public goods at time t can then be written as

$$x_t = a l_t e^{gt} \tag{1}$$

$$y_t = b\,(1 - l_t) \tag{2}$$

Put the price of market goods equal to one. Since the role of capital is ignored, all the value produced in the market sector is equal to labor income in that sector. The wage rate (w) in the market sector at time t therefore is

$$w_t = a e^{gt} \tag{3}$$

which increases at the same rate as productivity. If those who work in the government sector are paid the same wages and have to be financed by tax revenues (T), taxes at time t will be

$$T_t = w_t(1 - l_t) = a(1 - l_t)e^{gt} \tag{4}$$

Now let both the market sector and the government sector expand at the same rate so that

$$\frac{x_t}{y_t} = k \tag{5}$$

where k is a constant. From (1) and (2) we get

$$l_t = \frac{1}{\frac{a}{kb}e^{gt} + 1} \tag{6}$$

Hence, as t increases, l_t approaches zero, so over time more and more people will be employed in the public sector, and taxes will rise toward absorbing the entire national income. This will also stop the growth in

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the economy. More generally, economic growth will decline over time. From (1) and (2), we get

$$\frac{\dot{x}}{x} = g + \frac{\dot{l}}{l} \tag{7}$$

$$\frac{\dot{y}}{y} = -\frac{\dot{l}}{l}\frac{l}{1-l} \tag{8}$$

If both sectors grow at the same rate, we get

$$\frac{\dot{l}}{l} = -g(1-l) \tag{9}$$

Hence, the growth rate declines as the labor in the market sector declines and becomes zero as all labor has been transferred to the public sector.

Notes

1 William Baumol originally put forward his "cost disease model" in a paper entitled "Macroeconomics of Unbalanced Growth: the Anatomy of Urban Crisis," *American Economic Review* 57(3):415–426, June 1967, but not under that name. It gave rise to a number of comments, and his reasoning later became known as the cost disease model. It has been elaborated upon by various authors in a multitude of papers. In 2012, he revisited the subject with the book *The Cost Disease*.

2 These statistics are problematic because there are no market prices available to evaluate the services provided. Instead, they are simply set equal to the cost of providing them.

3 See Peter Lindert (2004), *Growing Public*.

4 This debate raged over several volumes of the Swedish economic journal *Ekonomisk debatt* in the 1970s–1990s, with Walther Korpi as a prominent skeptic that Sweden was in any way exceptional.

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4

The Welfare State: Insurance or Redistribution?

Abstract: *The beginnings of the welfare state are usually traced to the social legislation initiated by Chancellor Bismarck of Imperial Germany in the late 1800s. Social reformist politicians in the United Kingdom around 1900, such as Winston Churchill and Lloyd George, were in part inspired by Bismarck. The growth of the welfare state is traced to the widening of the franchise, the growing power of the labor movement, shortage of labor after the two world wars and the increased administrative capabilities of the state following the war effort. The welfare state is not just social insurance, but involves redistribution of income, bound to be popular with voters. Gross social expenditures vary greatly among countries, while the difference is much less when measuring net social expenditures.*

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Individual versus the collective. Selfishness versus compassion. These are dimensions often supposed to divide left from right in politics and market enthusiasts from planners and government enthusiasts. But things are less straightforward and more complicated and dependent on circumstances. "You must rank me and my colleagues as strong partisans of national compulsory insurance for all classes for all purposes from the cradle to the grave." These are the words of Winston Churchill, from a broadcast in March 1943.[1] In the beginning of the past century Churchill was one of the leading social reformers in the British Liberal Party.

No type of society, no matter how primitive, is entirely devoid of compassion and mutual assistance. Without them we would not exist. Genetically, we are programmed to take care of our young, and we are not the only animal of that kind. But there are limits to how far we go, and those limits to our generosity are contingent on what we can afford. Primitive tribes of Indians and Eskimos left their old to die when they were no longer able to follow their kinsfolk on its seasonal migrations. They had no value for the tribe's survival whereas the newborns had. There are stories of a similar practice that cut closer to home. Destitute Norwegians would push their old and infirm off a cliff with a stick held by all descendants so that they would be collectively guilty of the murder.[2] In pre-Christian times, unwanted children were put out to die. Societies living on the edge of starvation have to economize on their compassion.

The welfare state is, in a historical perspective, a very recent phenomenon. In the traditional agrarian society assistance was provided within the family. The "state," if we can speak of such for preindustrial societies, was mainly predatory; those who lived under a victorious king or emperor might get some of the loot. In feudal societies, some crumbs might perhaps fall from the lord's table, and the church was a provider of alms. In the towns members of guilds engaged in mutual assistance or even mutual insurance. Industrialization broke up these mechanisms; the guilds were abolished, and people migrated from the country to the towns, living from selling their labor. The industrial worker who lost his job had no piece of land to go to in order to eke out a living.

Over time, governments stepped into this void and began to provide the help to the destitute that earlier had been provided by guilds or within the extended family. They did so at various times and in various ways. Imperial Germany is often credited with the beginnings of the welfare state. The legendary chancellor Otto von Bismarck initiated old

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age and disability pensions in the 1880s. He did this partly to undermine the socialist movement, but also to anchor the newly established German *Reich* in people's conscience. The more the state does for the common man, the greater, presumably, is its legitimacy.

Other countries in Western Europe soon followed. The German example aroused much interest and was much studied by social reformers in Great Britain. Two prominent ones in the early 1900s were Winston Churchill and David Lloyd George. Churchill, in a letter to Prime Minister Asquith (at the end of 1908), put it this way: "The Minister who will apply to this country the successful experiences of Germany in Social Organization may or may not be supported at the polls, but he will at least have left a memorial which time will not deface of his administration...I say – thrust a big slice of Bismarckianism over the whole underside of our industrial system, and await the consequences, whatever they may be, with a good conscience".[3] Lloyd George, then chancellor of the exchequer, traveled to Germany in the summer of 1908 to study the German social insurance system.

There is little doubt that British politicians and industrialists promoted social insurance in the Bismarckian fashion in response to the challenge arising from the general enfranchising of men in 1885 and the rise of the labor movement. According to the historian Bentley B. Gilbert, "[S]ome manufacturers...had for many years been suggesting government-sponsored welfare legislation as a way of breaking the labor leaders' hold over union members provided by the organizational welfare programs".[4] "National insurance was the Liberal response to the threat of socialism. This had been inevitable since the enactment of household franchise in 1885, when the poor, for whom parochial relief was supposed to be a salutary and disciplining force, obtained the vote".[5] The term "welfare state" is believed to have first appeared in the 1930s, but the British Liberal Party's 1909 budget was called the "Welfare Budget". The Germans used the term *Wohlfahrtsstaat* of Bismarck's social insurance legislation in the 1880s.[6]

The history of the beginnings of the British welfare state in the early 1900s is a fascinating one and with many ingredients other than pressure from the newly enfranchised working class. It was sold to the public partly as a means of increasing "national efficiency," that is, the health and prowess of the Briton in general. The empire demanded men (and women) of the highest fitness. Everything was not well in that regard. Of 3,600 recruits who had applied in 1897–1900 at York, Leeds and Sheffield army depots, 26.5 percent were rejected as unfit and further 29 percent provisionally accepted as "specials".[7] The learning of many schoolchildren was hampered because of hunger.[8]

Many of the political activists promoting the welfare state did so for reasons of compassion and a desire for building a better and happier race, but even if the political enfranchisement of the working class provided the wind necessary for their sails, these activists did not fully trust the working people to take care of their own affairs; there was a good portion of benevolent authoritarianism involved. The social activist Beatrice Webb was critical about Churchill's and Lloyd George's social insurance plans of 1909: "The *unconditionality* of all payments under insurance schemes constitutes a grave defect. The State gets nothing for its money in the way of conduct, and it may even encourage malingerers".[9] That attitude was not necessarily ill taken. The historian Bentley Gilbert tells of a school in South London in the early 1900s where 90 percent of the children were hindered in their learning because they did not get enough to eat:

> They got bread and tea for breakfast, bread and margarine for lunch, and about a penny's worth of food, usually fish fried in cottonseed oil, for supper. This fare might occasionally be supplemented by vegetables picked up under a barrow. Eichholz (Medical Inspector for Schools) estimated that not more than twelve of some 200 of the students' parents he knew did not drink.[10]

There were many other paternalistic and even authoritarian social reformers in the early twentieth century. Alva and Gunnar Myrdal, for decades leading social reformers in the Swedish Social Democratic Party, wrote in their book on what they called "the population crisis" that what people spend their money on will in future be a matter of social policy; what standard of dwelling they choose, what kind of food and clothing and, above all, what standard they choose for their children.[11] The book discusses at some length how the spread of inheritable diseases and intellectual defects could be avoided by sterilization, voluntary or otherwise, of individuals carrying the bad genes. The phrase "prophylactic social policy" pops up in several places. They were certainly not alone among social reformers to harbor such thoughts. Perhaps it is time to blow the dust of such ideas again, now that we know so much more than we did then about genetics and inheritance.

And then there were the entrenched interests of organizations that had provided market-based insurance solutions to health and other social risks. These organizations vigorously opposed government-operated universal solutions to such problems out of fear that it would

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harm their interests and were bought off by co-opting them into the government-sponsored solutions. Promoters of President Obama's health care law would probably feel familiarity with the early history of the British social insurance legislation, with all its shenanigans. There were two types of organizations involved in social insurance in Britain in the early 1900s, the so-called Friendly Societies that sold health insurance to their members, and the industrial insurance companies that sold so-called life assurance, which in reality was a payment at death to defray funeral expenses. The latter bears some resemblance to the modern subprime mortgages, clever schemes sold by clever salesmen to people who could not afford them and would have been better off without them. The market was based on the apparently strong desire of not having to bury one's breadwinner as a pauper. "I put him away splendid," said one widow who had given the funeral party sandwiches. "I buried him with ham," said another.[12] These insurances typically cost a penny a week, but even so, poor families could hardly afford them. The lapse rate was high; for every ten new insurance policies there were nine lapses. Still, at the end of 1919 there were 28.5 million policies in effect. The industry was big, employing 100,000 men, of whom 70,000 were insurance agents.[13] About a half of the premia went to paying for administration and commissions for the insurance agents. It would have been a better deal for the housewives who saved their pennies for these insurance policies to walk to the nearest post office and put them away in a savings account. If the insurance policy was forfeited, as it would be after a few arrears, the entire value was lost. The industrial insurance industry vigorously opposed the old age and widows' benefits of Lloyd George's proposed insurance scheme because they realized that it would enable the widows to avoid the pauper's funeral.

Sometimes the death benefit insurance would have more sinister consequences:

> Charles Booth (President of the Royal Statistical Society 1892–4 and later Privy Councillor) testified concerning the common working-class accident of smothering infants while asleep, "overlaying" it was usually called. Booth argued that in too many cases these tragedies, usually assumed to be the result of drunken parents sleeping with their children, were actually homicide. Infants were murdered for their insurance, which was sold to their parents by zealous industrial insurance salesmen who visited the home after the report of the birth of a child.[14]

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Insurance or redistribution – or both?

The generosity of the early welfare arrangements may seem meager to the modern observer, but what is important is the principle. No civilized society leaves the destitute entirely to their own devices, but what they do for them depends critically on how rich these societies are. The welfare state has come a long way since Bismarck and Lloyd George, but we are not necessarily much more compassionate, only immensely richer.

The beginnings of the welfare state, both in Germany and elsewhere in Europe, preceded national accounting by several decades, so there are no reliable statistics relating welfare expenditures to what could have been the GDP of those times (the concept had not yet been invented), but it is safe to say that it was almost miniscule compared to what it is in our day and age. Why did it grow so much? It would be unremarkable if welfare expenditure grew in proportion to how rich we become, but why does it grow disproportionately rapidly? Do the problems the welfare state is meant to solve grow disproportionately rapidly as we become richer? Do we become more compassionate? Is it the cost disease discussed in the previous chapter? Or what?

It is possible to distinguish between two major motives for the welfare state: the insurance motive and the redistribution motive. The insurance motive is straightforward. Anyone can be hit by an accident or disease that for a longer or shorter period destroys his or her ability to earn a living. Moderate risk aversion and a wage above subsistence are sufficient to generate self-supporting demand for such insurance. Much the same can be said about adverse economic circumstances throwing people out of work through no fault of their own. It is possible in principle to insure against such events with regular payments into an insurance fund to guard against such events. Such insurance can be organized by private firms or by a collective where people insure one another. This is what the medieval guilds did. In their early days, workers' associations did the same. In some countries unemployment insurance is administered by labor organizations. Government interference is not needed to satisfy such insurance demands, but one may argue that it provides for a better pooling of risk and solvency in adverse times. It brings "the magic of averages to the rescue of the millions," as Winston Churchill, then a leading social reformer in the British Liberal Party, put it in 1911.[15] Such services may even be vehicles for governing elites to seek support and legitimacy among the voters, as they undoubtedly were for the British

Liberal Party in the early 1900s. These risks do not necessarily become any greater as economies grow, except that rich and technologically developed economies might rely more on specialized skills, making it more difficult for people to be reemployed if their skills become obsolete and they lose their jobs.

But much welfare expenditure cannot be said to be motivated by insurance against unforeseen events. Even some of Bismarck's welfare reforms were of this kind. Old age is a certainty, provided we do not die early. It sounds a bit weird to regard old age pensions as an insurance against the misfortune of not dying early enough. It could possibly be regarded as an insurance against the misfortune of not having provided for one's old age while there was still time, or against the "misfortune" of living much longer than expected. But there are other and more credible "misfortunes" involved. There were those who, in high-inflation countries, lived to see the paper wealth they had built up for their old age destroyed, partly or even entirely. Some might simply have got only subsistence wage in their working life and thus unable to provide for their old age. Old age pensions that are not financed by the pensioners' own savings are a redistribution to low-income earners from those with higher incomes. Another example of such redistribution is government child support. There are such things as unwanted pregnancies, but a general subsidy for having children is a very imprecise instrument if it is meant to be an insurance against unforeseen calamities; rather it is a redistribution of income to those who are deemed more needy than others and even so a rather imprecise instrument for that purpose.

The emergence of the welfare state roughly coincides with the enfranchisement of the general public. The idea that the welfare state arose in response to a demand by the general public is not far-fetched; their elected representatives were largely the ones who erected it. That does not include Bismarck, but it was the threat from the socialist party that prompted him to introduce his social insurance laws, so ultimately it was public demand for social expenditures by the government that lay behind these reforms. In the beginning social insurance was a central purpose of the welfare expenditures; they compensated for sickness, disability and old age, but there was a redistributive element as well, to the extent the expenditures were financed from general taxes (in the early days it was not uncommon to finance compulsory sickness insurance by premia paid by the insured themselves).

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The social reform activist Sidney Webb was in no doubt about what general enfranchising would lead to:

> It appears to me that if you allow the tramway conductor to vote he will not forever be satisfied with exercising that vote over such matters as the appointment of the Ambassador to Paris ... he will realize that the forces that keep him at work for sixteen hours a day for three shillings a day are not the forces of hostile kings, of nobles, of priests ... he will more and more seek to convert his political democracy into what one may roughly term an industrial democracy, so that he may obtain some kind of control as a voter over the conditions under which he lives.[16]

Enfranchisement gave the general public influence over what governments did, even if countries are governed by elites, as discussed in the next chapter. And the general public demanded social security and redistribution. Sickness, disability and unemployment were disasters, and so was old age for many; those who had to live from hand to mouth had little ability to save for their old age. With increasing wealth, it became less and less acceptable that the disadvantaged should live in squalor. Social insurance and redistribution of income were intertwined; those with higher income were seen as legitimate financiers of social security, although it was often financed, at least in part, by premia paid by those who were collectively insured. Medical expenses were often covered in this way.

William Beveridge, in his influential report[17] on social insurance in Britain, emphasized the insurance character of compensations for unemployment, sickness and disability. Contributions and payouts were to be the same for everyone, although with exceptions for large families. The government's contribution to this compensation scheme nevertheless implied some degree of redistribution, being financed out of ordinary taxes. It was not an insurance scheme in an actuarial sense and not a voluntary one, it was a compulsory insurance for all citizens to obtain the best pooling of risk; some would call it compulsory solidarity. But Beveridge made two important points: "The state in organizing security should not stifle incentive, opportunity, responsibility; in establishing a national minimum, it should leave room and encouragement for voluntary action by each individual to provide more than that minimum for himself and his family".[18] Second, "the insured persons should not feel that income for idleness, however caused, can come from a bottomless purse".[19]

The two world wars probably contributed greatly to the development of the welfare state, for several reasons. For one thing, they made manpower scarce and hence strengthened the working class, particularly after the Second World War when the postwar reconstruction was not punctuated by a depression but morphed smoothly into a long period of strong growth. Furthermore, the wars immensely strengthened the administrative capability of governments, not just of those that were involved in the war effort itself, but also of those that had to stretch their capabilities to avoid getting involved in them. Both belligerent and nonbelligerent countries demanded of their citizens that they mobilize in order to defend their home country. Should not a state that demanded that its citizenry sacrifice itself in the pursuit of war be a provider of welfare in times of peace? “If for warfare, why not for welfare?”[20] Once the war was over citizens demanded that the much-strengthened government apparatus be turned to peaceful purposes of interest to the general public, meaning welfare payments and provision of social services in kind (health and education). In the 1930s, the world depression made heavy demands on social expenditure. Its depth may have been unprecedented, but depressions were not unknown from before in industrial society. What was new were the general suffrage, a greater affluence and stronger government apparatus.

Yet another factor contributing to the growth of the welfare state is the break-up of the multigenerational family and even the nuclear family itself. In the old agrarian economy all generations lived on the farm and got their wherewithal from what it could provide. “Social security” was a family affair. After the industrial revolution father and son could work in different places and in different trades and live under different roofs, and so did after a while mother and daughter. But individual freedom and absence of obligations means that somebody else will have to take care of grandma and grandpa and maybe the babies as well. In the most ambitious welfare states, that “somebody else” usually is government-provided care for the aged, infirm and the offspring. We thus have the paradoxical situation that individual freedom is based on a wide-ranging welfare state, a collective institution requiring collective financial support. All these factors contribute to the strong undercurrent supporting and expanding the welfare state, particularly in the years after the Second World War.

As argued earlier, the generally high economic growth in the first 30 years after the Second World War (the French call them *les trente glorieuses*) much facilitated a further expansion of the welfare state. Over the past 50 years or so, the redistributive element has grown in strength,

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while the social insurance coverage has become more generous. There are strong reasons why redistribution of incomes can be expected to be a strong element of government policy in a democratic society. Redistribution of income is, needless to say, something that is unlikely to be forthcoming voluntarily. High-income earners who in principle might agree to share their income with low-income earners whose identity they do not know and with whom they have no social relations are unlikely to do so on their own initiative, knowing that they would be fairly alone in their endeavors. To achieve income redistribution on any appreciable scale, government coercion is needed. Such schemes are sure vote winners. The income distribution is always skewed in favor of the rich, so the majority of voters always have less than the average income. A redistribution that makes incomes more equal is therefore a sure vote winner. One may wonder why there is not more of it, and the answer probably is that the governing elites realize that the incentives to generate the income to be redistributed would be weakened, possibly to the point where the firms and individuals to be used as cash cows will migrate somewhere else.

The political advantage of distributing income from relatively few high-income earners to more numerous low-income earners probably explains much of the growth of the welfare state. Note that such redistribution does not only involve a transfer of money from high-income earners to low-income earners such as pensioners, single mothers or whatever. Financing government services such as health and education with general tax payments also involves transfer from the rich to the poor by making such services accessible to the general public. This is, needless to say, popular not only among the poor, however defined, but with the public at large with or below-average income. Furthermore, there is a social insurance element in this, particularly with respect to health services.

It may also be noted that transfers that do not necessarily increase the equality of incomes can be sure vote winners. It is possible to obtain political payoffs by targeting transfers to well-defined groups and pay for them through general tax revenue. The benefits of such transfers are easily perceived by the group to which they are targeted – farmers unable to compete in the international market, the disabled and the unemployed, single mothers and many more. Taxpayers may protest about the tax burden being too heavy, but they are unlikely to be upset about some particular type of transfer such as the ones mentioned. The

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political payoff from effecting such targeted transfers is ensured until the taxpayers at large become too disaffected. Not all transfers to selected industrial or occupational groups that are perceived to be targeted at the disadvantaged, or presented as such, could be characterized as welfare transfers, but they account in any case for some of the expansion of government expenditure.

The welfare state is, naturally enough, seen as a collective solution to individual problems. We get our medical care from government-operated hospitals and doctors employed by governments; care for our children is provided by public institutions or possibly private ones subsidized by governments; our children are educated in government-financed schools, sometimes even to the level of postgraduate university education; our infirm parents are taken care of in public institutions. Much of this is wholly or partly free of charge in advanced welfare states. The ability to choose among doctors, hospitals, schools, kindergartens and old people's homes is often limited; he who pays the piper calls the tune, as the saying goes. As noted earlier, there is an interesting duality between this subordination to the collective solution and the freedom of the individual. Not having to take care of one's aging parents opens up choices otherwise unavailable. Being able to rely on day care and care of children of school age even during after-school hours makes it possible for both spouses to participate in the labor market and engage in other types of self-realization. This individual dimension of what otherwise is understood to be collective solutions very likely accounts for some of the support voters give to the welfare state. Einhorn and Logue, in their discussion of the Scandinavian welfare states, make the point very well: "It is ironic that the collectivist means that conservatives always feared would destroy individualism have, in fact, encouraged it".[21]

How, and how large?

So, how far have we come? It makes sense to measure the size of the welfare state in relation to our riches, which in practice means expressing it as a percent of GDP or some related measure. Doing so for the time of Bismarck and his contemporaries is a risky undertaking; as already noted this was long before the compilation of national accounts and the invention of the GDP concept. In the late 1800s, welfare expenditure was only a small share of government expenditure and the latter, it is safe to

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say, was a much smaller part than now of whatever the GDP might have been in those days. But even for our modern period, measuring public welfare expenditures in relation to GDP is not entirely straightforward. It is straightforward to compile numbers on government expenditures on health care, education, pensions and other welfare transfers, but the problem is that some transfers are partially clawed back by being subject to taxation. Furthermore, individuals often get tax relief for expenditures on their own health care and education, and tax relief contributes to the deficits of governments just as much as direct outlays. There are thus two ways of expressing government contribution to welfare: (1) measuring gross expenditure and (2) accounting for the said tax relief and all clawbacks of transfers. The latter method, measuring net expenditure, is immensely more difficult, as it requires detailed data and even some good judgment and is thus more open to criticism. In the OECD much work in this vein has been done by Willem Adema and his collaborators to measure net welfare expenditure.[22] The results are indeed surprising. Figure 4.1 shows gross and net social expenditure in 2007 for seven OECD countries. With reference to gross expenditure, the United States ranks the lowest, with only 16 percent of GDP, while France and Sweden

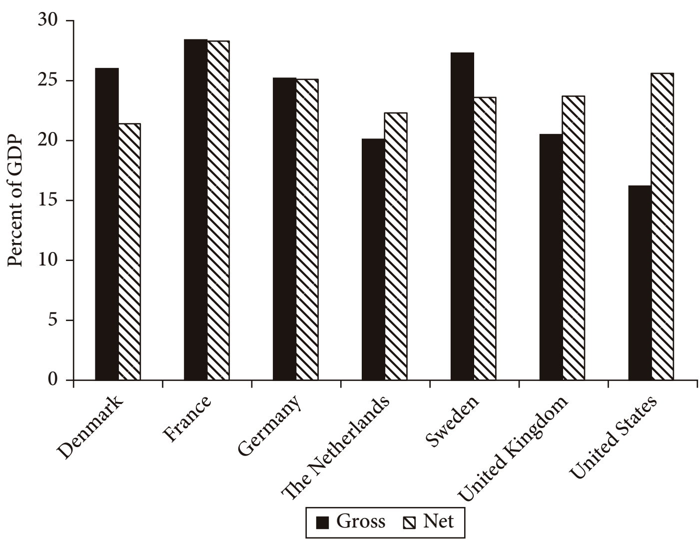

FIGURE 4.1 *Gross and net social expenditure as percent of GDP in seven OECD countries*

Source: Adema, Fron and Ladaique (2011).

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spend almost twice as much, 28 and 27 percent, respectively. With reference to net expenditure the United States is ahead of Sweden, with 26 percent compared to 24, but France is still on top with 28. Curiously, Denmark is the most parsimonious of the seven countries shown in the figure when we look at net social expenditures, with 21 percent of GDP.

In general there is much less difference between rich countries when one looks at net social expenditures instead of gross expenditures. This tells us that there is less difference between the welfare ambitions of rich countries than meets the eye when we look at their gross expenditures, but a considerable difference in how they choose to realize these ambitions. Some target their transfers to those who need them by means testing; others, the Scandinavian countries in particular, use universal but taxable transfers, where the needy keep their full transfer while others lose some through taxation. There are deadweight losses associated with both methods; means testing requires resources for monitoring; those who do not need transfers nevertheless keep some of them as long as the marginal tax rate is less than 100 percent. Some, and indeed most, governments prefer to provide health care through government-operated systems; others, the US government in particular, prefer to subsidize private health insurance through tax relief. Some of the latter is in fact facilitated through employer-sponsored health care, since this is a cost for private firms and deductible for tax purposes. There are arguments for both. The European health care system ensures a fairly equal treatment of all citizens, but typically at the expense of waiting lists even for serious illnesses. The notoriously expensive American system provides better for medical innovations, which initially can be afforded only by the wealthy and well insured but later become available to the common man and woman through learning by doing. In this sense the egalitarian Europeans can be said to be free riders on the American health care system that caters to the wealthy.

* * *

The reasons why the welfare state has become so large are complex, but all grounded in the enfranchised citizens' demand on those who govern them. One thing we demand is security; security from losing our jobs, from being in ill health and from not being able to support ourselves in old age. But we also like to have a share of the income others have earned and to have others pay for public services we use and for our children's education and for the care of our parents. Social insurance could in

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principle be self-financing, even if using the state as an intermediary is probably wise. But social insurance involved some redistribution even from its beginnings, and over time it has become abundantly clear that the state can be used to redistribute income. And so, not surprisingly, a demand for redistribution has developed, and the governing elites have been willing to do so for their own political survival. Living on welfare has become a way of life for many people in the most advanced welfare states. Such "lifestyle" becomes a poverty trap, because welfare handouts are not overly generous; those who live off welfare payments from an early age never make it into the labor market and never acquire the elementary discipline and skills associated with being employed. This lack of training and absence of participation in the labor market is a waste of human resources and a drag on the generosity of the welfare state itself; after all it is work in the market sector of the economy that ultimately finances all the welfare handouts. But it is more serious than that; the high taxes that are needed to finance all this are a drag on other people's willingness to work and, more seriously probably, the willingness to invest. If worst comes to worst, the welfare state's generosity could be self-defeating.

And then there is the deadweight loss involved in cheating: people who are neither sick nor unable to work but still claiming sickness or unemployment benefits. Some think that this is an acquired behavior; virtuous people accustomed to fend for themselves see such schemes as a last resort while a younger generation growing up with them takes them for granted and even counts "unused" self-reported sickness days as extra vacation days. But abusing welfare arrangements has been with us from the beginning, and both administrators in Lloyd George's time and he himself were aware of it and concerned about it. This was in fact an argument for entrusting the allegedly club-like Friendly Societies with the administration of sickness and unemployment benefits in the first comprehensive social insurance scheme in Britain. From the Swiss canton of St Gallen we have a discouraging early example. A compulsory unemployment insurance scheme was put in place in 1895. Some workmen neglected to pay the fee (it was not collected from employers). Then, when they lost their job, they would pay the arrears in one installment. The supervision was ineffective. Payments amounted to 93 percent of payouts the first year and 41 percent the second year. After two years the system was bankrupt.[23]

Is redistribution of income defensible and how much of it do we demand? John Rawls' theories of maximizing the welfare of the most

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disadvantaged, supposed to be achieved among our souls negotiating behind a veil of ignorance with respect to what body they will end up in, appeal to many and would seem to prescribe complete equality.[24] Elections may be decided behind a veil of ignorance on behalf of the voters, but not with respect to what body their souls occupy; electoral outcomes are decided by people of flesh and blood. Many people have found it difficult to understand why even the right of center political parties in most rich countries support a large government sector, despite their political rhetoric and sometimes outspoken aims of cutting government expenditure. The main difference between political parties seems to lie in their emphasis on the orientation of government expenditure rather than its total amount. As is convincingly demonstrated by the political scientist Carsten Jensen, right of center parties favor expenditures on health and education, which appeals to all voters, while left of center parties are more favorably disposed to support unemployment compensation, which to a greater extent appeals to their voters.[25] In few countries have we seen the public sector decline in the past decades. But irrespective of the orientation of government expenditure, it needs to be financed by commensurate taxes if economies are not to be crushed under mountains of debt. What supports our welfare superstructure are the individual incomes that are generated by people's work and investment in productive capital. Overambitious taxation can reduce both of these. And then we are back where we started this chapter, generosity is something that must be on par with what we can afford. Choices must be made and priorities set. No government can afford all things great and good.

Notes

1 Quoted in Maurice Bruce (1961), *The Coming of the Welfare State*, p. 311.

2 This practice is mentioned in the book *Lille land – hva nå?* by a previous foreign minister of Norway, Knut Frydenlund (p. 76). One of Frydenlund's advisers in negotiations about the fisheries zone around the island of Jan Mayen, a fisherman from western Norway, used the phrase "we'll hold the stick together with you" to indicate support for Frydenlund's position. He correctly interpreted this cryptic expression as indication of support and only later learnt of its origins.

3 Quoted in Bentley B. Gilbert (1966), *The Evolution of National Insurance in Great Britain*, pp. 252–253.

4 Gilbert (1966), p. 254, n. 42.

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5 Gilbert (1966), p. 448.
6 On this see Bruce (1961), p. 31.
7 Gilbert (1966), p. 83.
8 Gilbert (1966), p. 89.
9 Quoted in Gilbert (1966), p. 278, n. 95.
10 Gilbert (1966), p. 89.
11 Alva and Gunnar Myrdal (1934), *Kris i befolkningsfrågan*, p. 203.
12 Gilbert (1966), p. 321, n. 56. Bruce (1961) also briefly describes the industrial insurance companies and the "death benefits" (pp. 112–113).
13 Gilbert (1966), p. 319. The industrial insurance companies survived the social insurance reforms of Lloyd George and the life assurance business was still alive and thriving at the beginning of the Second World War. There is an Appendix in the Beveridge Report (Beveridge, 1942, Appendix D) dealing with the life assurance industry. At that time the lapse rate was lower, 50–60 percent, and the administrative expenses also lower, about 40 percent of the premia.
14 Gilbert (1966), p. 90.
15 Quoted in Bruce (1961), p. 311.
16 Quoted in Gilbert (1966), pp. 25–26.
17 William Beveridge (1942), *Social Insurance and Allied Services*. This report was in many ways the foundation for the welfare reforms that the postwar British Labour government of Clement Attlee implemented.
18 Beveridge (1942), pp. 6–7.
19 Beveridge (1942), p. 12.
20 See Bruce (1961), p. 305.
21 Eric S. Einhorn and John Logue (2003), *Modern Welfare States. Scandinavian Politics and Policy in the Global Age*, p. 311.
22 The methodology is documented in Willem Adema (2001), "Net Social Expenditure."
23 Described in Gilbert (1966), pp. 265–266.
24 See John Rawls (1971), *A Theory of Justice*.
25 See Carsten Jensen (2014), *The Right and the Welfare State*.

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5
Democracy and Enlightened Authoritarianism

Abstract: *Modern democracies are very different from the city-state democracy in ancient Greece, being ruled by competing elites, assisted by professional, permanent bureaucracies. To secure reelection, ruling elites have to pander to often ill-informed and disinterested voters. This is a formidable barrier to necessary reforms that in the short run are likely to be unpopular. Governing elites are tolerated and rewarded in good times and punished in bad times, even if they have limited control over events. Is democracy a way of governing in good times? Recent history shows examples of democratic elites pushed aside in times of economic difficulties by usurpers in waiting. Democracy is good at distributing the fruits of economic growth more evenly, possibly to the point of hampering or even reversing economic growth. Contrary to conventional wisdom, the roots of the industrial revolution lie in societies where only a fraction of the relevant age group had the right to vote. Recent economic miracles of East Asia all happened under enlightened authoritarianism, which in some countries has morphed into democratic government.*

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Some authors are convinced that the debt problem we have been talking about has been caused by democracy;[1] the voters behind elected politicians demand more government services, but do not want to pay for them with higher taxes. Elected politicians indulge both demands and run up debts. As we have argued, this is not unlikely. If continued, such attempts will end in tears and in hyperinflation and loss of confidence in governing elites when they are no longer able to "deliver" the fantasy world of ever-expanding public services and government transfers without an accompanying rise in taxes. But can and will governing elites mend their ways before passing a point of no return? Perhaps yes; we have already seen that some countries have been able to reverse the accumulation of public debt, even if it may be argued that a lot more is needed. In Chapter 7 we take a closer look at one country, Sweden, which has succeeded in doing this, but first a few words on modern democracy, how it works, its strengths and weaknesses.

Modern democracies are very different from the democracies in ancient Greece from which this label is derived. Democracy in ancient Greece was practiced in small city-states and meant that policy matters were decided by a general assembly where one man had one vote (yes, it was men who voted, and only free men at that; slaves had no vote, and they were many). Whatever may be said about the success or otherwise of democracies in ancient Greece we can quickly dismiss this method of governing as a relevant alternative for the contemporary modern state. This entity is immensely larger and more complicated than the city-state in ancient Greece. The modern rich-country state is governable only by a cadre specifically trained for this purpose. There are many reasons for that. One is the degree of complication. There are many decisions on matters large and small that must continuously be taken, and they must be based on knowledge of and experience with the matter at hand. An assembly of citizens in a continuous session would bring the economy to a halt.

A second argument is one of consistency. Effective governing requires that interrelated issues be decided jointly, or at the very least that the repercussions of decisions on individual issues be taken into account. For this knowledge and overview are needed. Such knowledge and overview comes from experience and study of the issues at hand. Each individual voter could be presumed to have the necessary overview for the highest-level issues, but the problem is that decisions taken by majority vote among many individuals could easily produce inconsistent results.

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It might be possible to live with them, but such inconsistencies should preferably be avoided. As a case in point, consider a separate vote on the amount of public services and tax rates. Chances are that the outcome would be a deficit, and who would cover it?

Here are some interesting numbers from the United States.[2] In January 2011, no less than 84 percent of Americans thought that it was either "extremely important" or "very important" that the president and Congress deal with the budget deficit. Incidentally, a similarly high percentage seems to have held this opinion in all years, even back in the 1930s. So what expenditures would they like to see cut? There was a solid majority for cutting foreign aid, but, alas, this would not go very far; foreign aid is a small part of the US government budget. Of items that make a difference, a majority was opposed to cutting aid to farmers, national defense, antipoverty programs, medicare and social security. Raising taxes is not popular either. So here we have goals that, unfortunately, are incompatible.

Informed decision making requires two things: access to information and ability to process it. To be informed as needed for the many decisions that in principle one might say should be taken democratically takes time at the very least and possibly other resources as well. One could easily envisage each individual spending most of his or her time on being as well informed as possible. Not much else would get done. A reasonable solution is specialization; some individuals specialize in acquiring the information necessary to take political decisions while others use their time for other productive efforts. Needless to say, such division of labor is as wealth-enhancing as distribution of labor in general. Then there is the ability to act wisely on the information. The ability to do so is as variable as the distribution of intelligence. People should refrain from decisions on matters that they do not understand, no matter how well informed. Unfortunately, they do not always do so voluntarily. A true definition of stupidity is not understanding that one does not understand. It is not an uncommon affliction.

It is not surprising, therefore, that the democracy we know is government by competing elites. The elites specialize in decision making on matters of policy. The elites are responsible for deciding both public revenues and expenditure and thus are empowered to keep them reasonably balanced – how well they succeed and their incentives to do so is another matter. In addition to the political elites we have the cadre of civil servants who make decisions on the nitty-gritty day-to-day matters

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that need to be decided to run the government efficiently. They can be seen as technicians with the necessary training and experience who stay on their posts even if the governing elite changes. They are supposed to be subordinate to elected politicians and to make their decisions on technical matters in accordance with the latter's priorities. But the distinction is often blurred, as Sir Humphrey has so well demonstrated in that unforgettable television series "Yes, Minister." Often, policy emerges from interaction between elected officials and permanent civil servants, and the influence of the latter probably more often than not is for the better. After all, it is the senior civil servants who have the requisite knowledge and experience. Ministers come and go, as they say.

An interesting and, one is tempted to say, benevolent case of a civil servant with his own agenda is reported by the historian Bentley Gilbert.[3] Robert Morant, a British civil servant in the early twentieth century, persuaded his minister to introduce a superficially uncontroversial bill about health inspection of schoolchildren, expecting that it would reveal such alarming facts that it would necessitate a government-sponsored (and expensive) remedy.

But elites tend to be corrupt and self-serving. This is where the competitive element comes in. Competition, by itself, does not solve that problem; in fact, competition among elites often ends in a civil war with one elite outdoing another until it is the only one left standing. This is, in fact, the traditional story; European history is a long tale of civil wars among competing kings and warlords. Competition among elites results in a reasonably honest and effective government when the elites accept the rule of law, compete by nonviolent and reasonably honest means and respect one another and the outcome that one of them has won. The latter is probably contingent on the near-certainty that within a reasonable time frame there will be another contest with a fair chance of reversal.

The reason why we pin the label of democracy on this governing by competing elites is that the selection of elites is done by voting by the general public. The appropriateness of this process may be debated, and much depends on how it is organized. Taking their cue from democracy in ancient Greece, many commentators seem to be under the illusion that the distribution of votes and the distribution of members of parliament among political parties should be as close as possible. This is an illusion because, for effective government, we need effective elites. This is most easily accomplished where there are only two competing

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political parties, which in turn is best ensured by what has become known as the first past the post system. Under this system the chance for small parties to get elected is small and they become marginalized. Under proportional representation a plethora of small parties will thrive, no single party will have a majority and building a governing elite will require horse trading among the parties. Each party will devote much time and skill to improve its parochial position, and small "tippers of the scales" may attain undue influence. With two dominant parties the differences of opinion that small parties represent will be incorporated into the dominant parties, but the fighting over different points of view within one party is less likely to mean inefficient government than if it takes place among different individual parties, each with its own parliamentary representation.

Referenda are seen by some as a valuable democratic supplement to governing by elites, and indeed they involve the electorate more directly in governing, but is that all for the better? John Micklethwait and Adrian Wooldridge argue in their book *The Fourth Revolution* that referenda have made California nearly ungovernable. That seems an overstatement, but even so referenda are mainly a source of trouble and not wisdom; the result from one referendum can easily strike down the result of another and not necessarily because facts have changed in the meantime. Interestingly enough, governing elites have resorted to a referendum when they have been unable to reach a consensus among themselves about a controversial issue. The Danish, Norwegian and British Labour Parties all resorted to a referendum about their respective countries' membership in what was then the European Common Market. By doing so they avoided a serious split in their own ranks, but the Norwegians are still struggling with the legacy of two divisive referenda that have gotten in the way of their membership in the European Union.

Selecting among competing elites by popular vote has two advantages: (1) it ensures governing in the interest of the general public rather than just in the interest of the elite itself and (2) it provides a certain guarantee against corruption among the elite. But more is needed than just a popular voting procedure to ensure this. Popular votes were organized in the Soviet Union and its satellites and resulted in a resounding near-100-percent support of the candidates, for whom there were no alternatives. And more than just alternative candidates is needed for this mechanism to work. The electorate must be reasonably well informed, so that it is aware of ineptitude and corruption among the elite. For this, newspapers

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and other media that are both honest, competent and independent of the ruling elite are needed. And not only that; independent judges are needed to punish corrupt elite members. Contemporary Russia is a good example of what happens without strong independent and critical media and with a corrupt judiciary. Some trappings of democracy are in place, but that is all.

But the ability of the electorate to serve its own best interest has its limits. To put that in perspective, let us draw on what has come to be known as the Glorious Revolution when William of Orange was forced to agree to share his power with the English Parliament. As Acemoglu and Robinson put it in their book *Why Nations Fail*, this transformed the English monarchy from a predatory institution to one that became interested in governing by law and sharing in the spoils of the emerging capitalism. Describing England under King William as a democracy in the modern sense of the word is a stretch, however. Probably no more than 5 percent of the relevant age group had the right to vote, but this was a strategic group, namely merchants, industrialists and landowners. The voters of course supported policies that were in their interest, and these were policies that promoted industry and trade. It is tempting to see this as a precondition for the industrial revolution, and at the very least it must have promoted that process. So the new order was wealth-generating and benefited not just the tiny 5 percent that had the vote but also the public at large. Landowners are not usually credited with playing a positive role in the development of industry, but the historian Barrington Moore has argued convincingly that the English landowners were oriented toward business and markets and played a decisive role in making possible the development of English industry under parliamentary government that later evolved to what we recognize as modern democracy.[4] The contrast is Prussia and Imperial Germany, where landowners supported an authoritarian government that promoted industrial development.

Since the Glorious Revolution the right to vote in England and elsewhere in democratic countries has been extended to all people older than some minimum age. Not surprisingly, the goals of policy changed in response to the interests of the new voters. The industrial revolution gave rise to a class of wage laborers who made up a large part of the population well into the post–Second World War period, but has since receded somewhat. In many countries political parties based on the working class rose to prominence and became one of the main competing

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elites in politics. The welfare state is to a large extent the work of these political parties, as is various legislation strengthening workers' rights. The capitalists were disgruntled, but for a long time the welfare state did not seem to interfere with the growth and productivity of the economies of what we call rich, democratic countries.

The rich, democratic countries of the world may now well be in a position where the common right to vote has counterproductive effects, especially in countries with a large public sector. As discussed earlier, an expanding public sector draws an increasing share of people of working age into that sector. This has primarily to do with the nature of public services; there is very limited scope for productivity gains, to which is added that the incentives to realize such gains are often weak in the public sector. But people are likely to vote for what they see in their best interest. How will those who are employed in the public sector perceive their interests? Will they be voting for tax increases to finance their wages without paying much attention to the effect on investment and productivity in the market sector? Much the same can be said for the army of retirees who are supported by government. Will these voters realize that the expanding public services and rising standards of living in general depend on growth and productivity in the private sector of the economy and that both of these are likely to be adversely affected by high taxes? These questions are highly pertinent, and disturbing, given that the majority of the electorate in many rich countries is public employees and retirees. These are not the wealth-creating voters of the Glorious Revolution, nor are they the workers toiling on the shop floor of private firms and who were the backbone of the parties auguring in the welfare state, the foremost of which were the British Labour Party and the Swedish Social Democrats.

Authoritarianism versus democracy

Is democracy as we know it in the modern state beyond dispute? To some people the contest was over with the fall of the iron curtain. The main challenge to democracy in those days was communism, and its bankruptcy at that time was total. The ultimate cause of the fall of communism was its failure to deliver a standard of living to its subjects that came anywhere near living standards in rich, democratic countries, despite its claim to be acting in the best interest of "the people." This was

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recognized in the highest of places. Michael Gorbachev is reported to have said to his wife, after one of their official trips to the West: "Raisa, we cannot go on living like this." Alas, the attempts to reform the Soviet economy came to little, and it got worse under the fledgling Russian democracy. The reason the dictatorial Putin is popular in wide circles in Russia is that he brought some order to chaos and under him the Russian economy began to revive.

While superiority of living standards in the West compared with Soviet communism is beyond dispute, it is anything but clear that Western democracy is always and indisputably the only road to affluence. A few years before Gorbachev initiated his economic and political reforms in the Soviet Union, Deng Xiaoping kicked off the economic reforms in China. Essentially, they amounted to the introduction of a capitalistic market economy, but they contained little of democratic reform. The Chinese communist party still jealously guards its hold on power and there is no sign that it is going to reverse that policy any time soon. Nevertheless, the Chinese economy has grown at an unprecedented rate since capitalism was brought in to the rescue, and hundreds of millions have been lifted out of poverty. All this has happened without an inkling of democracy and with a good portion of corruption, but despite the warts the improvement of living standards in China is beyond any doubt.

Nor is China the only example of a country lifting itself out of poverty in the absence of democracy and under, shall we say, enlightened authoritarianism. The economic development in South Korea is probably even more impressive than in China, but it took off under, some would say, notorious authoritarians; the Korean democracy came of age in the late 1980s. Singapore is another country that in a few decades has grown from abject poverty to one of the richest countries in the world. This has happened under a one-party rule perhaps best characterized as enlightened authoritarianism. There is a democratic varnish over the whole thing; there are elections, there is another political party which has a few representatives in parliament, but this opposition is marginalized and without any influence. Lee Kuan Yew, the first prime minister of Singapore, had for many years an official status as an elder statesman and his son is now prime minister. There are reports of somewhat crude methods applied by the dominant party for keeping the opposition down, but it is quite possible that the Singaporeans like it this way; the "People's Action Party" has undoubtedly delivered, so why try something new and untested? "If it ain't broke, don't fix it."

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In his memoirs, Lee provides a clue to his success in Singapore. He describes a visit to St Peter's Church, on a stopover in Rome in May 1958 on the way from London to Singapore. The pope was saying mass, there was much excitement, the nuns were crying out "*Vive il Papa*" in ecstasy as the pope strode down the aisle. But Lee had been long enough in politics to know all there is to know about the spontaneity of crowds. He asked himself "who is directing this?" and began to look around and saw choir boys on balconies placed around the pillars of the church gesticulating to the nuns. Lee thought of how the Roman Catholic Church had been able to survive for almost 2,000 years. How do they do it? And he remembered reading about popes being elected by cardinals appointed by other popes. "That recollection was to serve the PAP (People's Action Party) well".[5]

Japan is another success story. Isn't Japan a democratic country? Well, the Democratic Party has been dominant ever since the Japanese got back their sovereignty after the Second World War. The opposition has been in power for short periods, but has not been very successful. The first "benevolent dictator" of Japan was General McArthur, who governed Japan for a few years after the war with Japan was over. He laid the foundations of what later became known as the Japanese economic miracle. The Meiji Restoration of 1868, which laid the foundations for Japan's industrialization, is best characterized as enlightened authoritarianism. Then there is Taiwan, which began its economic development under the authoritarian Chiang Kai-shek, and after him came his son. And there is Hong Kong, a city-state with miraculous growth from very modest beginnings, much like Singapore. The Swedish economics professor Bo Södersten has described a conversation with a Hong Kong official, a few years before the takeover by China.[6] Södersten was impressed by the development of Hong Kong, and the official explained the secret to him; capitalism and the rule of law, few economic regulations and the sanctity of contracts. "We're much like the western countries," he said, and added almost like an afterthought of little relevance, "well, we don't have the right to vote." The British rule over the crown colony of Hong Kong can be described as a benevolent authoritarianism light; there was no parliament, no government needing popular support, but there was the rule of law, there was the sanctity of contracts, there was absence of economic regulations. This, and the industry and entrepreneurial spirit of the Chinese, brought about the economic miracle of Hong Kong.

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The history of the West itself offers some hints that democracy is not a necessary requirement for economic development. The Glorious Revolution that some people see as decisive for the English economic development was a democracy of the 5 percent, as already mentioned. But it was the decisive 5 percent. The industrialization of Germany in the late 1800s took place under an authoritarian government, and the same must be said of the industrialization of Japan in that same era.

Our experience of democracy with universal voting rights is about a 100 years old. Much of that period was characterized by an unprecedented economic growth, the benefits of which democracy undoubtedly helped spread more widely than otherwise would have occurred. It is easy to divide a growing pie in such a way that everyone will be happy, but what if the pie is shrinking? Worse, what if the pie shrinks because its allegedly just distribution makes the baker disinterested? Is democracy a way of sailing in fair weather? Will it weather a storm of economic stagnation that may be brought on by democracy itself? There are signs that we are now getting into that kind of situation. And we have been there before. A number of undemocratic governments saw the light of day as a result of the economic depression of the 1930s, the Nazi regime in Germany being the most notorious. Not that in the end it brought prosperity to the German people.

This brings us to the point that disastrous dictatorships exist, just as the enlightened ones, and are probably much more numerous. Not only that, it is indeed likely that enlightened dictatorships end up that way. Without the threat to be removed from power in case of failure, any ruling elite is likely to become corrupt and self-serving, and most of them are that way from the beginning.

The most glaring example of a self-serving and incompetent dictatorship is North Korea. It is hardly possible to imagine a better demonstration of the importance of economic institutions than the two Koreas. There are ethnic Koreans on both sides of the border, with the same language and culture, but the contrast between the two Koreas is one of light and darkness – literally. There is a famous picture taken from a satellite showing the two Koreas at night. In the South there is much light; it is a rich country, the cities are illuminated at night. In the North there is darkness. The country is too poor to have enough electricity to illuminate its cities, and besides, at night everyone is probably supposed to be indoors watching communist party propaganda on the single television channel available (many, perhaps most people probably

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cannot afford television, but for them there is a single channel radio). And then there are the less evil ones: Castro's Cuba, Belorussia, Zaire under Mobutu. Venezuela doesn't quite qualify, but Hugo Chavez and his successor tried their best.

Winston Churchill is supposed to have said that one only needed to talk for five minutes to the average voter to lose faith in democracy. Today the anonymous commentaries on internet media reveal the average voter's ignorance and lack of civility. But he added that democracy was the worst system of government except for those other systems that had been tried. By and large, probably, but there are cases where democracy has failed utterly and generated chaos. Yugoslavia fell apart after democracy was introduced. What often happens when democracy is let loose on ethnically divided societies is that political parties are formed on either side of an ethnic dividing line. To breed loyalty into their supporters ethnic divisions are exaggerated instead of played down. This makes it more difficult for different ethnic groups to coexist and often results in a civil war where one group tries to dominate the other. When the groups live together in the same city or area, ethnic "cleansing" becomes "necessary." This is often surprisingly easy to do even when different ethnic groups have been living together peacefully for generations, even to the point of interethnic marriages not being uncommon. We do not need to go to Africa for examples, which provides many. The fate of Yugoslavia is a sad one. Northern Ireland is another, even if "ethnic" may seem a misnomer. Majority rule was explicitly rejected for Northern Ireland because of its divisive role; a shotgun marriage (power sharing) seems to have worked so far.

This brings us back to the point that democracy works when the competing elites play by the rule of law, respect one another sufficiently and accept the outcome of a vote. One may wonder about the wisdom of having the contest among the elites decided by uninformed, apathetic and outrightly stupid voters; the election campaigns do not breed confidence in that process; it is hardly an intellectual debate; rather it is sloganeering, deliberate distortion and disinformation, and an attempt to engage the uninformed and the disinterested. Advertising and public relations agencies are enlisted for these campaigns, outfits that are not known for balanced, informed and disinterested presentation of issues, but for dishonest persuasion and deception. It may be just fortuitous that the outcome is not worse than it in fact is. For one thing, many voters are much better informed and intelligent than assumed by the advertising agencies. For another, in mature democracies there normally is not

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much difference between the competing elites despite their rhetoric. But sometimes things go badly wrong. Those who initiated the civil war in Yugoslavia, Slobodan Milosevic of Serbia and Franjo Tudjman of Croatia, were voted into office by solid majorities. Hitler came to power by parliamentary means, even if the Nazis never got a majority of votes while elections were still practiced.

Sometimes democracy either withers under stress or dissolves in chaos. General de Gaulle was called upon in 1958 when the Fourth French Republic lay in tatters, but he was incorruptible enough to put together a fifth one much in his own image. In 1973, Augusto Pinochet overthrew a democratic regime in Chile, which had brought chaos to the economy. He put together an economic system that still stands and set Chile on a more fortunate path of development than other Latin American countries. Like other coup makers Pinochet got blood on his hands, but he is probably the only dictator who took the risk of being voted out of office and stuck with the result even as it went against him. And then there is the Russian experiment with democracy that resulted in the collapse of the Soviet Union. The chaos and overall decline in living standards that resulted and lasted for many years is too well known to need much elaboration. James Baker, secretary of state under George H. W. Bush, wrote the following in his diary after a visit to the Soviet Union in September 1991:

> The [Russian] democrats' failure would produce a world that is far more threatening and dangerous, and I have little doubt that if they are unable to begin to deliver the goods, they will be supplanted by an authoritarian leader of the xenophobic right wing.[7]

Prophetic words indeed.

Perhaps, well-functioning democracies are less different from enlightened authoritarianism than many people think. Stein Ringen, himself no spokesman for authoritarian governments, says the following in his book *Nation of Devils*:

> Participation ... is a slippery idea. If it means giving citizens a share in day-to-day decision making, for example through intensive use of referendums and the like, then, sad as it may be, participation from below is not conducive to good government. It gives leaders too little power to dominate followers and others too much power to subvert governors. Hard libertarians and soft advocates of participatory democracy have in common that they believe people to be instinctively of sound and rational character and judgement. But they are not, which is why leadership from above is the essence. Citizens are best

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> served by delegating decision making to representatives. On the other hand, if governors are to get their doings accepted, they need to involve citizens so that they feel they are not being treated arbitrarily or in a dictatorial manner. This is a different form of participation – I prefer to think about it as deliberation – in which governors pull citizens into their orbit, or co-opt them. Needless to say, participation in this meaning is separated from manipulation by a very thin line. (p. 10)

Just so. Thin indeed. Is the difference between authoritarianism and well-functioning democracy that in the latter the citizens do not "feel" being treated arbitrarily?

Money also votes

It is well known that running for office in a democracy costs a lot of money, nowhere more so than in the United States. Arousing apathetic voters and feeding them with suitably biased "information" takes a lot of costly meetings, travels and professional advice from people experienced in these arts. Nobody can run for office successfully without accumulating the funds necessary for such activities. This gives money a strong influence on who runs for office, and probably also on who gets elected; it is not unreasonable to expect that those with the largest "war chests" have the best chance to get elected. Viewed from this angle, it is less the voters than the donors behind the candidates who decide who are elected and which elite forms the government. The donors may be expected to support those who in turn promote their interests. Perhaps the money does not do all the talk; voters have a say also, but there can be no doubt that money matters.

Many commentators view this with apprehension and regard the influence of money as an undue intrusion. Is that so certain? People with money can, of course, be expected to support candidates who promote their interests, but need that be all for the worse? No presidential candidate or governing elite will depend on the donations of a single person or company or even corporation, so all that these donors can reasonably expect is that "their" candidate, if elected, supports business interests in some general sense. Perhaps that is a welcome corrective to the influence of voters. Voters can be expected to demand increased welfare provisions, be it services or transfers. But the ability to provide these things depends on a vibrant market-oriented economy.

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That is what the business interests are presumably trying to promote. Recall how the very small segment of the English public had the vote in the days of the Glorious Revolution and how they most likely promoted their business interests, which in turn led to the rapid development of the British economy. Perhaps the business-friendly politics that governing elites may be expected to follow in return for their support from business in fact promotes the ability of the economy to provide the welfare services the ordinary voters crave.

The fact that some large corporations pay little or no tax, despite donating to political candidates, irks many commentators. Some even maintain that such corporations contribute nothing to the common good. This is jumping to conclusions. Those who work for corporations pay taxes. It can be argued that taxing the employees of corporations is the best way to have them contribute financially to the welfare state. The reason why labor typically is taxed fairly heavily is that they have nowhere to go. Emigration could be contemplated, but would that be to another high tax economy? And how easy would it be to find work there? By contrast, corporations, in today's globalized world, can go somewhere else easily. One way of keeping them where they are is to tax them lightly. That, in turn, could entice them to invest and so broaden the productive base on which all welfare state benefits are founded.

Market failure versus government failure

Our societies are governed not by the decisions taken by the governing elite alone. In fact, most decisions are taken by individuals; alone, in the family, and in companies and organizations. Most of them apparently have a small impact, affecting only the individual or the organizations where they are taken. But that appearance can be deceiving; the sum of impacts of decisions taken by individuals concerning only themselves, their families or the companies and organizations where they work can have a wide impact on society at large.

This raises the question of which decisions should be left to individuals for their own good, or acting within their families or entities where they work, and which should be taken by the governing elite. We have some experience of governing elites having wide powers for making decisions on economic matters. It was at one time formulated as plan

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versus market, and planning failed miserably; it ended in the fall of the iron curtain and the disintegration of the Soviet Union and its empire.

But even in market economies, governments do not abstain from interfering in economic matters. That interference is not necessarily to be avoided; some problems are not well dealt with by markets alone. The question is, how far should governments go in interfering with markets; what decisions had better be left to markets alone to deal with and which had better be reserved for governments?

If we think democratic procedures solve these matters well we are in for a disappointment. Many government interventions are for subsidizing unprofitable industries or imposing regulations that are ill taken even on their alleged merit, such as the US regulations to put a minimum of ethanol into gasoline. Why do democratically elected governments persist in such things that apparently go against the interests of the majority who has elected them?

The answer to this riddle has long been known and was eloquently expressed by the late Mancur Olson in *The Logic of Collective Action*. It lies in the concentration of special interests and fragmentation of general interest. The cost of supporting American farmers is not very noticeable for the American consumer, but matters a lot to the farmers themselves. The farmers, and other special interest groups gaining from some policy favorable for them, will use their power to influence the governing elite to come up with subsidies or regulations in their favor, while the public at large will not find it worthwhile to spend time and money on fighting it. This is how democracies tend to become ruled by special interests, to the detriment of general interest. This makes the economy less efficient and has a harmful effect on living standards overall. The worst effect could possibly be on the introduction of new technology and thereby on economic growth. New technology does not have powerful vested interests behind it, but the technology that it threatens has. One would have expected the established telephone companies to put up a fight against the mobile phone, or the producers of mechanical typewriters and calculators to do so against the personal computer. They would have argued that jobs and important skills were at stake. Apparently, they did not. Perhaps these technologies began as a niche not seen at all as a threat, and then, suddenly, their force became overwhelming. But typesetters put up fierce resistance against electronic typesetting that made them redundant and their skills obsolete, and their industrial actions nearly

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ruined the newspapers they worked for, but they never got the backing even of governments with labor sympathies. The most picturesque example perhaps is the British Parliament's support of self-proclaimed "friends of railways" who, in the early days of the automobile, required that it should not run at a higher speed than ten miles an hour, with someone with a red flag running in front of it. Apparently that regulation did not last long.

Democracy: a guarded optimism

To conclude this discussion, modern democracy is not quite what many seem to believe, a government of the people, by the people, for the people. It is certainly government in the name of the people, but to what extent it is able to serve the interests of the people at large is an open question. Modern democratic processes are biased in favor of special interests at the expense of general interest. The selection process for governing elites leaves much to be desired. Some authoritarian governments have been enlightened enough to serve the interests of the common man and woman better than many a democratic government. The inherent superiority of democracy should not be taken for granted, but it is nice to have when it works. Will it be able to withstand the strain when economic growth stops and is perhaps reversed, when debts can no longer be further accumulated and have to be paid back either by hyperinflation, which is apt to tear societies apart, or by severe cuts in benefits and a raise in taxes? The risk is that the established elites will get the blame, even if deserving only a part of it, and that unenlightened and self-serving populists will have their day, because people would want to test the untried when all else has been tried and failed. This is how Adolf Hitler became the chancellor of Germany 80 years ago, and he quickly eliminated all competitors. Eighty years may seem like a long time, but human desires, judgment and abilities are unlikely to change much over that period of time, so what happened 80 years ago may well happen again, but not necessarily in the same place.

But there are some reasons for optimism, one of which is how Sweden dealt with its debt trap. We look at that in Chapter 7, but first, a few words about the European Union, some of whose member states seem to be in a hopeless debt trap.

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Notes

1 See David Roch and Bob McKee (2012), *Democrisis: Democracy Caused the Debt Crisis; Will It Survive*?
2 Quoted in Alan S. Blinder (2013), *After the Music Stopped*, chapter 15.
3 Bentley B. Gilbert (1966), *The Evolution of National Insurance in Great Britain*, p 125.
4 See Barrington Moore, Jr (1966), *Social Origins of Democracy and Dictatorship*.
5 Lee Kuan Yew (1998), *The Singapore Story*, pp. 285–286.
6 Bo Södersten (1991), *Kapitalismen byggde landet*.
7 James Baker (1995), *The Politics of Diplomacy*, pp. 526–539.

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6
The European Union: A Viable Colossus?

Abstract: *The European Union is a term way ahead of its time. Instead of a union, we have a half-way house between an international organization and a confederation. The EU is sometimes presented as a peace project, but a more sober analysis would look at its beginnings as a cooperation among previous enemies necessitated by new superpowers that had totally sidelined them as world powers. The current problems of the EU are often ascribed to a "democratic deficit," but they are more likely due to the absence of a common European identity and little delegation of power that matters from its still sovereign member states. The debt accumulation problem of the euro countries, although no greater than that of the United States and Japan, is often ascribed to the absence of national currencies in the member countries of the Eurozone. The euro was, however, adopted in large measure to get away from the classical problems of devaluations used to bridge the gap between wages and productivity.*

Hannesson, Rögnvaldur. *Debt, Democracy and the Welfare State: Are Modern Democracies Living on Borrowed Time and Money?* Basingstoke: Palgrave Macmillan, 2015.
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The doubts about sustainability of government debt have been greatest with respect to some member countries of the European Union that use the euro as a currency: Greece, Cyprus, Italy, Spain and Portugal. All of these have a high level of debt, although some not much higher than Germany and France (Spain's debt was 94 percent of GDP in 2013 while Germany's and France's were 79 and 92, respectively). Suddenly, in 2011, lenders began to doubt the ability of these countries to pay them back. Returns on government bonds in these countries rose way above the return on government bonds in France and Germany. These doubts arose from two circumstances. First, lenders doubted the ability of the governments of these countries to cut expenditures or increase taxes sufficiently to eliminate their deficit and thereby the need to continue taking up new loans. Second, these countries have no central bank of their own to buy government bonds; on the contrary, the European central bank, which is responsible for the euro, is explicitly forbidden to finance government deficits.

There has not been any dearth of advice from some economists to the effect that these countries should abandon the euro and reintroduce their own currencies, which then could be devalued so that their economies could be "stimulated" by a lower exchange rate and thereby lower real wages, and thereby having their resurrected central banks finance the deficits of their governments. The practical difficulties of that kind of policy are obvious; who is going to willingly transform the euro-denominated assets into assets denominated in liras or drachmas that are explicitly destined to fall in value? Borrowers would, of course, be commensurately elated. Policies such as these would have to be accompanied by "financial repression" if ever there was one. We have in fact got a foretaste of that; when the banks in Cyprus faced bankruptcy, the Cypriot bank accounts were frozen and the euros in Cyprus essentially made inconvertible as if they were a domestic currency. It was not well received by the common Cypriot.

It is worthwhile remembering that at least some of these countries, Italy and Greece in particular, converted to the euro explicitly in order to move away from the inflationary circus that had characterized their economies. In these countries, as in so many others, wages and salaries used to rise more rapidly than productivity. This eroded their competitiveness in international markets, and to avoid unsustainable trade deficits the value of their currencies was repeatedly adjusted downward. This worked as long as there were restrictions on capital movements across

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borders, and even so it was not always fully effective; Italians would smuggle their liras across the Swiss border and convert them to Swiss francs in order to avoid the attrition of their bank accounts back in Italy.

The authorities in these countries had had enough of this and looked with envy on the stability of the German currency. The purpose of their adopting the euro, modeled on the German mark, was to get a currency that was stable and would permit free capital movements across borders. But there were strings attached. At German insistence the European central bank was expressly forbidden to finance government deficits; the German hyperinflation of the 1920s still casts long shadows over German politics. This made the individual euro countries responsible for following policies that are consistent with a stable value of the currency. This implies two things: first, governments must keep their deficits within the limits of what they can finance in the capital markets; second, wage and salary increases must be limited to increases in productivity. The option of paying higher money wages that are brought into line with a stagnant productivity by eroding the value of the currency is no longer available. These problems were foreseen at the outset; in the so-called stability pact, government debt was limited to 60 percent of GDP and deficits to 3 percent. Both rules have long since been broken, ironically first by none other than Germany itself.

One could say that the preconditions for the euro project have been proven not to be in place and that it should therefore be abandoned. But that abandonment would have its own problems, as already explained. Furthermore, the alternative inflationary way has proven to be a bumpy one; it was one that countries wished to abandon when they introduced the euro. In fact, one could say that even the euro itself has an inflationary bias built into it, albeit a weak one. The European central bank is supposed to follow a policy that keeps the rate of inflation at or below 2 percent. Lately, journalists and other pundits have been worried that the rate of inflation is close to zero and perhaps moving into negative territory. But why 2 percent? Why not aim for zero and price stability? Inflation or its opposite, deflation, is about who loses, borrowers or lenders. With inflation, lenders lose some of the money they have lent, because they will be paid back with money worth less than what they lent. An interest sufficiently in excess of the rate of inflation could compensate for that, however. With deflation, borrowers pay back with money worth more than they borrowed. Perhaps the effects of deflation and the accompanying risk of insolvencies and bankruptcies are seen as

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a more serious disturbance than losses of wealthy lenders. Furthermore, the lenders can be compensated with a high enough rate of interest, while negative rates of interest would be needed to compensate borrowers in deflation, and these are difficult to implement.

This inflationary bias in monetary policy is a recent invention in a historical perspective. Back in the days of the gold standard, the value of money was equal to its gold content, while the prices of other things could go up and down and periods of sustained price declines were not unknown. Before the First World War people could write about monetary values that made sense across the generations; a pound sterling was the same pound sterling for dad, his son and the grandpa. Money values that old people of today remember from their youth make no sense to their teenage offsprings. Inflationary bias has become the way the modern economy works, even if it is a moderate one. Still, an inflation of 2 percent will reduce the value of money by about a half over 30 years.

A way out of the problems afflicting the southern members of the European Union would be to change the rules of the European central bank and allow it to buy government bonds, just as the central bank of any country with its own currency can be used to finance the debt of its government (this is what the Japanese central bank is now [late 2014] doing with a vengeance). This is unlikely to happen; it would be opposed by Germany and would in fact contradict its constitution. German taxpayers are in no mood to pay for the profligacy, real or imagined, of countries with lots of sunshine like Italy and Greece. And it is doubtful that they would be much more positively disposed even if they were told that ultimately this would be for the benefit of German banks that in a perhaps unguarded moment lent money to these countries.

More fundamentally this unwillingness of having the European central bank bail out Eurozone governments is a reflection of a much deeper malaise of the European Union. The label “union” is way ahead of its time and its time may never come. What we have is an amalgamation of different countries somewhere between an international organization of sovereign states and a confederation. The member countries have given up some of their sovereign prerogatives, but not much. They still have their own armies and foreign policies; the most radical abrogation of sovereignty is the euro currency union, and not all member countries are a part of that. The problem is that there is no such thing as a European identity among the peoples of Europe; they still regard themselves as French, English, Danish or whatever. People

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are willing to have themselves governed by elites of their own ethnicity but not others. Recently, we have discovered that nearly half of all Scots consider themselves different enough from the English to warrant a governing elite of their own, and then we have the Catalans and the Basks. Belgium is a federal state despite its smallness and sometimes without a federal government for long periods because of interethnic rivalry. Cosmopolitans of a broad mind may find this atavistic, but it is a fact nonetheless. Culture changes very slowly; technology, not least in moving people rapidly over long distances, has in recent times progressed at a rapid clip. There is a wide gap between our ability to move around and our inclination to identify with people from different cultures, even those that are as close as European national cultures.

In fact, we are dealing here with a very old cultural tradition. People have always preferred to move among those of a shared ethnicity. There have always been exceptions; interethnic marriages and friendships across ethnic differences, but these relationships have often proved to be surprisingly fragile once ethnic strife breaks out. Migrations into alien territory have occurred, but migrants have preferred to settle among their ethnic brethren if possible, as the settlement of the United States and Canada amply proves. In the multiethnic empires of the past, such as the Tsarist and the Habsburg empires, people were ruled by elites who had nothing to do with their ethnicity, but they lived in ethnic clusters: parts of towns or stretches of land that were ethnically fairly homogeneous. With democracy these empires broke up; people could accept to be ruled by elites of their own but not elites of a totally different breed.

Some people might argue that the experience of "new" countries such as the United States and Canada contradicts this. However, that is not the case; there is such a thing as a national American culture. One finds greater cultural differences even within a moderately sized European state than over the vast territory of the United States. Those who migrated to the United States came with a one-way ticket and had no intention to go back, some even came there forcibly. Various European ethnic groups such as the Swedes and the Norwegians tried to maintain their language and culture, but it was all over after a generation. The second generation realized that if they were to get anywhere they had better integrate with the rest of Americans. Some settlers actively discouraged their children from retaining any traces of their traditional culture. One achievement of the United States is that they have in fact succeeded in making *ex pluribus unum*, a national culture out of a hodgepodge of different ethnic groups.

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This was possible because those who came burned their bridges, or others burned them, and they came to an almost empty territory. These so disparate groups have contributed in various ways to what we now recognize as an American culture: the English their language and law, and without the Africans there would not have been any jazz. We are not going to see anything similar happening in Europe, and if a proof is needed we need go no further than to the problems of integrating recent immigrants into European societies, especially immigrants of Muslim faith, even the second generation. The problem does not lie singularly with the receiving country; integration requires willingness to be integrated, which always implies abandonment of some cultural inheritance.

Will the EU fall apart?

The malaise of the EU is sometimes ascribed to a "democratic deficit," that the European voters have insufficient influence on the governing institutions of the EU. This is probably mistaken; the problem is the absence of a European identity. There have been some attempts at addressing the democratic deficit; there is a European parliament, known also as the flying circus, which is constantly on the move between Brussels and Strasbourg for political reasons, despite all the costs and inconveniences. It is not held in high esteem by European voters; the turnout for European elections is much lower than in national elections, and members of the European parliament do not have a high profile in the countries they represent. The problem, rather, is that the EU governing elite has too little power and too few things to decide, at least important ones. This is so because the member states are unwilling to give it that power, and that again is because the "Union" has little legitimacy among the citizenry of the member countries. Matters are not made any better by the tendency of national politicians to blame "directives from Brussels" for unpopular decisions, even those that the same politicians welcome and are happy to see the Brussels bureaucrats "force" upon them.

The convulsions in the euro currency union could possibly cause the union to fall apart. And there are other signs of that happening as well; at the time of writing (late 2014) there are strong indications that Britain will withdraw. But there are other weaknesses; the union has probably overextended itself by expanding into the sphere of influence of the former Soviet Union. This has brought millions of poor people into the union and under

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its umbrella of free movement of people across boundaries. Not surprisingly, people move where the money is, be it job opportunities, welfare handouts or even begging in the streets. This has caused considerable strain in the union and is one reason why the British might leave.

Officials at the union level even entertain the ambition of a further expansion; bringing the Ukraine into the anteroom of the union sparked the troubles in the Ukraine in 2014. The union has probably bitten off a bigger piece than it can chew; we are not living in a world where every single country under the sun can in a democratic manner and as a sovereign state decide where it belongs. Less has changed in the hundred years since the First World War than we like to think, and as a commemoration of that great war the troubles in the Ukraine were well timed. Russia clearly has imperial ambitions and is no stranger to the use of force to make them come true. The countries that used to be in the Soviet sphere of influence, or even members of it like the Baltic states, were eager to become members of the European Union, both to ensure a better economic future for themselves and probably also to guard against sliding back into a Russian sphere of influence. It is true that NATO and not the EU takes care of security, but EU and NATO membership largely overlap. One may, however, reasonably doubt both the preparedness and the willingness of other EU and NATO member countries to defend these more exposed members. If your adversary has imperial designs and plays by the rules of conventional power politics you had better adopt some of the same if you don't want to be eaten off at the fringes. We have all heard the phrase of 1938: "Czechoslovakia is a small country very far away," uttered when the British prime minister Neville Chamberlain had made a concession to Hitler in order to ensure "peace in our time". We might hear something similar again, and soon. One consequence of the buildup of government debt is that EU governments are in that much worse shape to build up their armed forces as necessary to deter Russia from eating away at its fringes. That had better be thought through with due care before the union decides to take on new members. Even the anteroom might be too close for comfort.

The European Union as a peace project

In one of its many bizarre awards, the Norwegian Nobel committee in 2012 awarded the Nobel Peace Prize to the European Union. It is touching

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that some people see the European Union as a wonderful example of peaceful cooperation between two earlier enemies, Germany and France, and indeed as the very substitute for their earlier armed conflicts, but it is a shallow analysis. The enmity of Germany and France was ended by the emergence of two much more powerful states after the Second World War. These two superpowers, as they used to be called, divided the world between them into spheres of influence. Rivalry or peaceful cooperation among nations has always been determined by relative strength; the strongest have been rivals, with the weaker cooperating with the stronger without unduly challenging them. German-French enmity was a post-Napoleonic phenomenon; before that the main rivals used to be France and England, because those two were comparable in strength, with France mostly stronger. After the Second World War, West Germany and France found it in their interest to cooperate, and to cooperate with others, in order to avoid being sucked into the sphere of influence of the Soviet Union. Besides, Germany was divided and in ruins after the Second World War and in no position to expand at the expense of any of its neighbors. But West Germany soon enough regained its industrial prowess, and for many years it bankrolled what was then the Common Market while France provided *la gloire*. Those days are now long gone.

Even if characterizing the EU as a peace project is hardly a serious proposition, this in no way detracts from its usefulness as a cooperative organization for similar and like-minded states for their mutual interest. The world has shrunk and in many ways made the small nation-state obsolete. We need larger markets: as much mobility of labor as is compatible with cultural and institutional stability, common money with a stable value, standardization in rule making and design, a common language, the list is long. The technological imperative for all these things is strong; the lack of European identity is the main obstacle, and there is no sign that it will be emerging soon. On the contrary, there is reason to expect that it will take a long time to emerge, not least if we look at the history of the European nation-state. The national languages and cultures that so many Europeans now cherish and identify with are not in fact all that old and emerged not only from the pressure of technological revolution in communications but also and possibly more importantly from a good portion of enlightened authoritarianism and centralized administration. Many European national languages, English and French in particular, simply were the dialect spoken in and around the national capital, conquering the rest of the country because it was used by the ruling elite

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and its administrators, enforced country-wide in the schools, and used by the newspapers and magazines spread by the railways. Later radio and television spread the standard national language with unprecedented effectiveness. A well-known adage has it like this: a language is a dialect with an army and a navy. The European Union lacks both.

German is the surprising exception; *Hochdeutsch* as a standard written and spoken common language was adopted by many states large and small long before the emergence of the German *Reich*, despite being quite different from the local dialect (Switzerland was never a part of the *Reich* and Austria only briefly). This is an interesting contrast with Scandinavia where we are still living with four varieties of essentially the same language (two of them in Norway) and where, as in many other places, the dialect of the capital essentially became the national language. In today's shrunken world the usefulness of these languages is decidedly limited, even for the native speakers themselves. Maybe the difference was because of population density – Scandinavia's population was and still is scattered over a large area, while distances in the German-speaking world were smaller. And then there was German high culture; a common language vastly increased the market for writers and actors and must have been helpful even for composers, singers and tradesmen. Scandinavia was culturally underdeveloped by comparison. For reasons of expediency English is well under way of becoming the language of Europe, a process not entirely unlike how *Hochdeutsch* conquered the German-speaking world. Adopting it formally would free up much expense now wasted by the European Union on translation, simultaneous and other, for better purposes. The reader may imagine the hue and cry a proposal to make English the common language of Europe would generate. Ironically, the usefulness and versatility of the English language would not be anything like what it is without the economic prowess of the United States.

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7

How Sweden Got Out of the Debt Trap

Abstract: *Sweden is one of the most successful countries in the world and one of the pioneers in building the welfare state. The welfare state was built on 100 years of virtually uninterrupted economic progress, which came to a halt in the 1970s. Sweden tried to cope with its rising unemployment and financing of an ever more ambitious welfare state by borrowing. Gross public expenditure and government debt both reached 70 percent of GDP in the early 1990s. Both welfare expenditures and government pensions were cut in the 1990s, and the accumulation of debt was reversed. Sweden is now one of the EU countries with the lowest debt ratio and has been able to avoid its rising again after the financial crisis of 2008. There appears to have been a wide consensus about what needed to be done among Swedish governing elites; economic reforms legislated by one elite were often prepared by expert groups commissioned by the other.*

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Sweden is an interesting case of how the problem of expanding public sector and declining productivity has been dealt with. Sweden is one of the most successful countries in the world. It was dirt poor back in the early 1800s and, later in that century, one of the countries with the highest rate of emigration, mainly to the United States. The Swedish industrial revolution is usually dated to the latter half of the nineteenth century; exactly when it began has preoccupied economic historians and is not likely to be precisely answered ever. The period 1870–1970 has been described as the golden 100 years of uninterrupted economic growth.[1]

What accounted for the industrial revolution in Sweden? Undoubtedly, it piggybacked on the English industrial revolution and the openness of the expanding markets of the British Empire, but the necessary conditions were in place on the Swedish side. One was entrepreneurship; Swedish inventors made several world-class inventions, and entrepreneurs – not necessarily the same individuals – turned them into exportable products. The Swedish economy was open, property rights were respected and the country was generally peaceful. Hordes of Swedes emigrated, relieving the pressure on the country's limited ability to feed itself, but there were more than enough left to man the new workshops and factories that sprouted, and they were reasonably well educated – most Swedes at that time could read and write, and they were able-bodied and willing to work. Myhrman, in particular, emphasizes the role of stable institutions and rules from the early 1800s as essential for economic growth.[2] It is noteworthy that Sweden at that time was not a democracy; ultimate power resided with the king, and the parliament had only an advisory role. Voting rights were restricted to men who owned property, and parliament was organized along class lines: nobility, clergy, urban propertied and peasants. As late as 1900, only about 10 percent of males in the relevant age group voted in an election.[3] Sweden (in union with Norway) and Denmark did not become democracies until late in the nineteenth century. Why was this restricted coterie of decision makers conducive to economic development? Probably because it contained a good portion of propertied individuals who gained from a free market economy open to foreign trade. There is a parallel with the Glorious Revolution, discussed earlier.

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The welfare state after the Second World War: from moderation to excesses

In the 1950s and 1960s, the growth rate of the Swedish GDP was high, although not higher than in other rich countries at the time. Sweden was, however, in a favorable position, not having been involved in the Second World War. Public expenditure and public consumption increased rapidly and more so than in most other rich countries. The welfare state was expanded in many directions. One of these was public pensions, to be further discussed in the next section.

Even if Sweden acquired the reputation early as the most advanced welfare state in the world, the Swedish public sector was at that time not particularly large. As late as 1960, taxes as share of GDP were about the same in Sweden as in the United States.[4] Government expenditure as percent of GDP was 22 in 1950 and 27 in 1960, but 18 and 23, respectively, in the United States.[5] Later the gap widened rapidly. At its height in the early 1990s, government expenditure in Sweden briefly exceeded 70 percent of GDP while in recent years, after the financial crisis, the US government expenditure has reached 40 percent of GDP.[6]

Two factors mainly account for the enormous rise in Swedish government expenditure from the late 1960s onward: rising welfare state ambitions and slower growth of the Swedish economy. The rising ambitions are illustrated by what happened to labor taxes designed to finance various welfare programs for wage earners (childbirth leave, education, retirement, and more). They were 12.5 percent of wages in 1970, 32.7 percent in 1976 and 36.7 in 1979.[7] This, together with high taxes on profits, reduced investment in Swedish industry. Tellingly, large Swedish companies increased their investments abroad while they reduced them at home. Shortly after 1970, the Swedish economic growth declined. Sweden was, however, not alone in this regard; in most rich countries a similar decline occurred, most likely because of the quadrupling of the oil price in the wake of the energy crisis of 1973. There was, in the 1980s and 1990s, a lively and somewhat inconclusive debate on whether Sweden had fallen behind other countries. Yes, it had indeed fallen behind, but the gap was not great, and some other rich countries, Switzerland in particular, seemed to have suffered a similar fate. Some tried to explain this by reference to the relative ease of catching up, but then, why at this time? Nevertheless, being caught up with is less serious than being left behind.

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Despite slower growth, Swedish government expenditure and public consumption continued to expand. Tax revenues did not keep pace, because of slower economic growth, and Sweden accumulated public debt rapidly, from 20 percent of GDP in 1976 to over 60 percent in 1985. It is noteworthy that this development partly took place under a center-right government. The Social Democrats lost the election in 1976 and were in opposition until 1982. But Social Democratic ideas (or was it just ideas shaped by virtually uninterrupted good times?) still ruled the roost; the center-right parties did not take a fundamentally different approach to governing. It was on their watch that government debt ballooned, and no serious attempt was made to reduce public expenditure, neither transfers nor the provision of public services. As noted earlier, the welfare-financing labor tax increased substantially during the first center-right government 1976–1979.

The expansion of the public sector under the center-right government was driven not only by a welfare ideology that had penetrated into the center-right parties, but also by the notion that the economic recession that came in the wake of the energy crisis of 1973 was of a transient nature and that it would be possible to bridge the gap over the present recession and to the good times to come. One could, of course, argue that this reflects an ideology of government intervention; that it is the responsibility of governments to even out fluctuations in the business cycle. This bridging was expensive: companies were subsidized to produce for inventories; even the building of large tankers and freighters was supported in this way; and support to the unemployed also became expensive. A large part of government expenses in the late 1970s were due to various support programs to ailing industries, particularly shipbuilding and textiles; this support increased sixfold under the center-right government, from 8.8 million 1971/1972–1975/1976 to 51.8 million in 1976/1977–1980/1981.[8] Government expenditure outpaced revenue and, as we have just seen, debt was accumulated.

When the good old times did not reappear this policy lost credibility, and in 1982 the Social Democrats were back. It was on their watch that the debt buildup was reversed and the expansion of public expenditure and consumption was brought to a halt. The debt ratio reached its high point in 1985 (64 percent of GDP) and then began to decline slowly.

But more trouble was in store. Economic growth was almost as high in the 1980s as in the 1950s and 1960s, but reverted to a deep recession in the early 1990s. Government expenditure and debt rose to new heights:

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expenditure to almost 70 percent of GDP in 1993 and debt to over 70 percent of GDP in 1996. Even if insufficient to cover expenditure, government revenue was 65 percent of GDP around 1990. It was difficult to avoid the conclusion that the Swedes were at the end of the road and would have to do something decisive to reverse this development.

So they did. The growth of the welfare state was halted and some winding down took place, mainly by reducing transfers such as pensions and payments for sickness leave (the pension issue is addressed in the following section). There was not much curtailment of publicly provided services such as health care and education, but a certain degree of privatization was introduced: privately owned and operated schools and clinics, for the purpose of increasing efficiency in these sectors even if the government mostly paid for them. The conditions for sickness leave, disability payments and pensions were made less generous. Since the early 1990s, those who report in sick on the job have to bear the cost of the first day themselves, which has significantly improved people's health on Mondays and Fridays and reduced government expenditure on sickness leave; from 1989 to 1995 the average number of days each year that people reported sick fell from 24 to 11.[9] The pensions have been made much less generous, as is discussed later on.

These changes were preceded by a report from a group of economists who analyzed Sweden's problems and came up with specific proposals for policy changes. The English version was called, tellingly, *Turning Sweden Around*. One of the arguments for the proposed changes was that Sweden had fallen behind in the league of rich nations because of its large public sector and high level of taxation. While Sweden's GDP per capita over the years fell behind that of many other rich nations it has been pointed out that the difference between these is small and that Sweden's economic growth over time did not diverge widely from that of other rich nations. That notwithstanding it seems clear that Sweden's public sector, measured as revenues in percent of GDP, could not continue growing much further. Neither could expenditure; a widening gap between expenditure and revenues would have resulted in an unending accumulation of debt, which is not possible. The arguments for a policy change therefore seemed unassailable, and a policy change was indeed implemented in the 1990s, interestingly enough under a Social Democratic government, but with a wide consensus and support from the center-right opposition.

Even if expenditures have been wound down and brought into balance with government revenues the Swedish welfare state is still alive and

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well. Sweden is still among the countries with the highest government consumption and expenditure, measured as a share of GDP. In 2013 public consumption in Sweden was 26 percent of GDP. Only Denmark was slightly ahead, with 27. That same year Sweden's government expenditure was slightly above 50 percent of GDP. A few of the other traditional OECD countries (Italy, France, Belgium, Finland, Austria and Denmark) had expenditures that exceeded 50 percent of GDP and some more so than Sweden.

It is probably true that without some perception of a crisis the said policy changes would not have been implemented. Not only is it difficult to foresee the long-term implications of policy, but there is also the common-sense approach summed up by the old adage "if it ain't broke, why fix it?" An electorate that has gotten accustomed to a long period of virtually uninterrupted economic growth and expansion of the welfare state will take some convincing that things have indeed changed for good.

After the policy changes of the 1990s Sweden did turn around. Economic growth was robust from the mid-1990s until the financial crisis of 2008. Government debt has come down to about 40 percent of GDP and has not increased after the financial crisis. Sweden's experience provides reasons for optimism about how elected politicians will be able to deal with unsustainable growth of the welfare state; they managed to turn Sweden around and stop an ongoing rise in government expenditure and debt. Hopefully, this is not a uniquely Swedish trait; but skeptics would point out the considerable homogeneity and smallness of Swedish society, despite decades of significant immigration that seems to be causing increasing discord in Swedish society. Some other relatively small countries have also managed to reverse the accumulation of debt, as already discussed, although somewhat less successfully.

It is noteworthy that what has gone wrong and what has gone right in Swedish economic policy is not clearly identifiable with one particular party or coalition of parties. One may argue that the excessive welfare ambitions of the Social Democrats drove the Swedish economy into the morass in the early 1970s. But the center-right parties made little attempt to rectify it. When the Social Democrats came back in 1982 they began with a substantial devaluation of the Swedish currency, in order to restore the profitability of Swedish industry, and they wound down much of the support to industry that the center-right government had put in place. But their reforms turned out to be too timid; they ended in a crash in the early 1990s that amounted to the biggest contraction in the

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Swedish economy since the 1930s. They changed course, curtailed some welfare excesses such as disability and sickness payments and initiated a study of how the pension system could be reformed.

It has been pointed out that the reforms carried out by a center-right coalition often have been prepared by a study initiated by the Social Democrats and vice versa, which could account for the continuity of economic policy across party lines and governments, all rhetoric to the contrary. It appears that the Swedish governing elites have a wide-ranging common understanding of problems and of how to deal with them. They do err, as we all do, but err in common, and also develop a common understanding of how to put things right when the errors of their ways have become obvious. They are probably much helped by a cadre of civil servants who accumulate insights and knowledge irrespective of who is in power, engaging in some adult education when a new and inexperienced government comes along. This arrangement bears more than a superficial resemblance to enlightened autocracy; the competing political elites happen to have much in common in their understanding of economic processes and political goals and rely on the same groups of experts for advice.

The pension system

The story of the public pensions in Sweden is a good example of how the provision of public goods – in this case, transfers – is expanded in good times thought to last forever, and then having to be wound down as the burden on public finances becomes less and less bearable. It also has some elements of politicians making promises that fall due in the future, long after the next parliamentary period is over. By the 1950s, several occupational groups had negotiated pension rights with their employers that supplemented or even exceeded the old age pensions that they got from the state. Ordinary wage earners, the backbone of the Social Democratic Party, did not have any such rights, and there was pressure on the government, Social Democrats in a coalition with the farmers' party, to legislate a general scheme for pensions related to previous earnings. A number of government papers and political negotiations preceded the concrete proposals put forward in the late 1950s. There were three proposals, but really two alternatives, a benefit scheme financed from current payments, often called pay-as-you-go system, and

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a funded system where the payouts would be financed by the return on the pension fund.

As discussed in Chapter 3, the difference between these systems is less than meets the eye. Pensioners no less than others consume goods and services that are produced in real time; they are not subsisting on money that has been stashed away or on goods that have been stored up for them for decades. The smoke and mirrors surrounding what we might call the legitimacy of these payments are quite different, however. In a funded system, pensioners have in effect been turned into capitalists, or perhaps rather rentiers; they claim their income in the capacity of capital owners (pension funds are invested in stocks and bonds and real estate). In a pay-as-you-go system the pensioners simply receive transfers from those still of working age. Lest there be no misunderstanding, people who still work are, of course, also producing the values that pensioners might claim as capital income.

There is another potential difference as well. In a funded system with individual accounts, the pensions received must be related to the amount each pensioner has paid into the system, which in turn is bound to be closely related to his or her income while working. In a pay-as-you-go system the individual pensions need not have any relationship to the amounts each person paid into the system in the past; they are in effect financed by taxing the working population.

The system proposed by the Social Democrats did relate pensions to previous income. The benefit payments were related to the best 15 years of income, but with an upper limit, and full rights were obtained after 30 years of work. The retirement age was set at 65. The "tax and transfer" character of the system increased over time, as the ceiling on pensions sank in real terms but payments into the system were assessed on all income, also the part above the ceiling.

It was recognized at the time that the public pension system would remove an important motive for private savings. To compensate for this public saving was increased. The pension payments were financed by what essentially was a tax on wages and salaries, and payments into the system were in the beginning much higher than the benefit payments. The difference was saved in what came to be called pension funds. Interestingly enough, an argument at the time about not choosing a funded pension system was that the funds built up in this way would become inordinately large and inflate values on the Stockholm stock exchange. Needless to say, this was long before Sweden opened up to a globalized financial market.

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The political disagreements about the pension system made the pensions the main issue of the parliamentary election of 1958 when the Social Democrats won their biggest victory ever. Their unfunded alternative clearly appealed to the voters. One reason may have been that this alternative provided for early payouts; in a funded system it would have taken a generation to acquire full pensions, unless some bridging provisions had been provided, while in a pay-as-you-go system the payments could begin immediately. The pension system was voted into law in 1960 with some drama – one of the fund supporters essentially defected – and the first payouts were made in 1963.

One of the proponents of the funded system, the famous economics professor Bertil Ohlin, took a beating from the election. His party suffered a severe electoral setback. Ohlin predicted that the pay-as-you-go system would go broke some time in the 2000s. In an irony of history, he turned out to be right, but did not live to see himself vindicated, while his daughter was the minister of finance at the time when the need to revise the system had become widely recognized. The actual reform of the system did not take place on her watch, however; it was the same Social Democratic Party that originally put the system in place that implemented the change. It did not go down well with some of those who were old enough to remember the debates of the 1950s and the promises given at the time. In 2008, one 82-year-old pensioner put it this way: "[A]s Tage Erlander (the prime minister at the time) put it, even we workers should get a little golden edge in late life. And that's what everyone believed ... But the dream about the workers' pension fund remained just that, a dream ... The pension fund was liquidated and the government walked away with hundreds of millions of kronor. The money was used to pay down the public debt and to enter the rich man's club, the EU".[10]

But times were no longer what they used to be. Economic growth in the 1970s and 1980s was not as high as in the 1950s and 1960s. Furthermore, there were much fewer people of working age per pensioner than there had been back in the 1950s. The actual retirement age had edged down, the retired lived longer and the birth rate in Sweden had fallen. Earlier promises, based in reality at that time, could not easily be kept. To their credit, the Social Democrats were realistic enough to adjust their policy to the new reality, even if one could say it took some time for it to sink in.

In the new Swedish pension system, payments are conditional on the life-expectancy of each cohort of pensioners. People have been

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given incentives to continue working beyond the age of 65. A part of the pensions is funded, with payments depending on the return on the pension fund. There are several of these, and individuals can decide for themselves how a part of their pension is invested. If there is a discrepancy between the return on these funds and the expected payouts for pensions a braking mechanism sets in and reduces the pension payouts.

Notes

1 See Bo Södersten (1991), *Kapitalismen byggde landet*, and Johan Myhrman (2003), *Hur Sverige blev rikt*.
2 Myhrman (2003).
3 Peter Lindert (2004), *Growing Public,* figure 7.2.
4 See Andreas Bergh (2013), *Den kapitalistiska välfärdsstaten.*
5 United Nations: Yearbook of National Accounts.
6 IMF (International Monetary Fund). Note that these are gross figures; because some transfers are clawed back through taxes, the net expenditure is less.
7 Myhrman (2003), p. 189.
8 Myhrman (2003), p. 194.
9 Assar Lindbeck (1997), *The Swedish Experiment.*
10 Published in the Swedish newspaper *Dagbladet*, July 29, 2008.

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8
Conclusion

Abstract: *The welfare state is a nice thing to have, but we must be prepared to pay for it. The welfare state is built on the private sector producing the necessary material goods and the taxes used to pay for it. A too ambitious welfare state with its concomitant taxes may in fact hinder the growth of the private sector on which the welfare state is built. The accumulation of public debt in almost all rich countries is due to a rising gap between welfare ambitions of governments and their willingness or ability to let their citizens pay for them. Unfortunately, funds for a further increase in debt often dry up suddenly, with governments facing sudden problems in financing their ongoing deficits and renewal of existing debt. Sudden and deep cuts in expenditures or increases in revenue may then be necessary. The understanding among the electorate may lag far behind events, governing elites may suddenly lose their electoral support and usurpers or incompetent populists in waiting could be voted into office as untainted and worth a try. This is how the Nazis came to power in Germany about 80 years ago. The accumulation of public debt in rich countries will have to end, but whether it can be reversed in a timely fashion or will result in a political crisis and hyperinflation as in the interwar years is anybody's guess.*

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The welfare state is a nice thing to have, but no one should be under any delusion about what it is built on. Without thriving agriculture and manufacturing industry the material wherewithal that keeps the armies of pensioners, teachers, doctors and nurses going would not exist and we would be without their wonderful services. Looking at things from the financial perspective, we realize that it is from the private, market-driven sectors that governments get the tax income that enables them to defray the expenses for all the services and hand-outs they provide.

We can disagree about how much of services and how generous pensions governments should provide, but what we should not waste our time on debating is that we have to pay for it. Arguing for a generous welfare state is the same thing as arguing for high taxes. The problem is that high taxes erode the material basis for welfare generosity by discouraging work effort and investment. But exactly how much is not easy to pin down with precision; the high tax countries in Europe such as Scandinavia, the Netherlands and France are doing quite well; their GDP per capita and their living standard, however measured, are not far behind the United States, a country with decidedly lower taxes. Some would even argue, and not entirely implausibly, that their living standard is higher. But there is some evidence, rather stronger than circumstantial, that these countries have approached and possibly gone beyond the critical level where taxes seriously affect investment. Swedish industry reduced its investments in its home country in the 1970s and the Swedes found it necessary to reduce the tax on companies and the marginal tax rates on individuals. It seems to have paid off.

But there are other things to consider. One characteristic of the relatively low-tax US economy is its vitality. Nowhere else is innovation more rapid. Many other countries are good at imitating these innovations and producing the new gadgets they give rise to at a lower cost, but most new products see the light of day in the United States. Is this because of lower taxes? Possibly. It is probably not so much because of the higher remuneration that successful entrepreneurs can expect in a low-tax country, but more because of the greater wealth that lower taxes leave in private hands. The owners of this wealth are prepared to take risk and to finance innovations that without capital would never get anywhere. Wealth in the hands of governments does not work the same miracle; governments have never been good at picking winners in the economic sphere.

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Since the Second World War, governments in the rich countries of the world have increased their welfare services and transfers enormously. This was easy during the high-growth decades up to the mid-1970s. After that virtually all the rich countries in the world have taken an easy way out and financed their generosity with borrowing. They have raised taxes as well, but not sufficiently to cover their expenditure. Borrowing has typically increased in response to economic adversities that have reduced tax income and raised expenditures for the unemployed, for maintaining employment in companies that otherwise would have gone bankrupt or for rescuing failed banks. But the debt so incurred has not been wound down sufficiently after the crisis was over, so over time the debt has increased formidably. This makes it all the more difficult to deal with the next crisis, which always comes sooner or later.

How long will it be possible to increase government debt before increasing it further becomes impossible? No one knows, but it would be wise not to try to find out. The limits to further borrowing have the habit of making themselves known suddenly and further increasing the difficulties the debtor country had from before. An indebted government trying to sell its bonds may suddenly find that bondholders have lost confidence and are unwilling to take on more except at a formidable discount. This hits not just the financing of an ongoing deficit; at any given time some old bonds fall due and need to be replaced with new ones, which then must be sold at a discount, further adding to the outstanding debt. The buildup to a debt crisis is slow, almost unnoticeable, at any rate for the nonspecialist citizen. Then, suddenly, the debt problem becomes acute and hits the front page news. Dealing with it, on the contrary, is not easily done in a moment; cutting government expenditure and raising taxes is a longer slog and an unpopular one at that. It can be done only by a governing elite with a solid support, some of which it can afford to lose, or by a consensus among the competing elites.

It is tempting to see democracy as a cause of the debt problem. Raising taxes and cutting welfare expenditure are both unpopular and can be done only when there is a perception of crisis. At that point things have proceeded too far; the problems may not be insurmountable, but certainly more difficult to deal with than if they had been tackled earlier. It is not because of a lack of foresight, but because of the ability to act. The governing elite needs to convince not just itself but an unwilling and ignorant electorate.

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Is democracy a way of governing in happy times? There is some indication that it is. Most rich countries had gone through the critical, initial phase of economic development while they were governed by authoritarian elites chosen by a small part of the citizenry. General franchise and what we call the democratic way of governing came later, and it is tempting to see it as a result and not the cause of industrial development. Democracy is better at spreading society's wealth widely than at generating it. The problem is that spreading wealth too widely is likely to hamper its generation. Democracy works well in good times when things improve from one year to the next, but it is less good at dealing with challenges such as the economic depression of the 1930s, which saw the emergence of not so enlightened and usurping authoritarian governments. The great stagnation in the wake of the financial crisis of 2008 has brought its own political challenges the end of which we have not seen yet.

Where are we headed?

So how will the debt crisis end? That is anybody's guess, and anyone pretending to know risks exposing himself to ridicule as time passes; economic forecasts have earned a bad reputation that is well deserved. But that does not preclude being mentally prepared for various plausible scenarios, trying to avoid the worst ones. That the debt level will have to come down in most of the countries we are talking about seems a foregone conclusion, the question is how. In simple terms, either the value of the debt will have to be eroded through inflation, or government revenues must be brought to exceed expenditures to generate the savings necessary to reduce the debt to a sustainable level. It has been argued that, in the financially integrated world of the present, the inflation solution is impossible, except perhaps for the United States and Japan. Moderate inflation like the one after the Second World War, which lasted into the 1980s, takes a long time to work; hyperinflations of the interwar (or Latin American) type create their own problems.

But what about default or debt restructuring? None of the rich countries we are talking about is likely to go for the first option. Debt default shuts governments out of credit markets for a long time. Debt restructuring may perhaps be taken as a polite word for "managed default"; lenders accept new bonds for the old ones that have fallen due, or accept that

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their bonds are redeemed with less than their face value. Lenders accept this reluctantly and only as a substitute for something even worse. This was a part of the response to the Greek debt crisis, which has not yet been resolved; the Greek debt ratio is still increasing.

Ignoring default or restructuring, which in any case would only be a partial solution to the debt problem, leaves us with raising revenue or cutting expenditure, or both. That is the most likely way, but unlikely to be popular. Most of the government expenditure in rich countries is expenditure on welfare; on public consumption such as health services and education; and transfers such as old age and disability pensions and handouts of various kinds. Some transfers, and by no means insignificant, are support to ailing industries such as uncompetitive agriculture. Some government expenditure will have to be cut and some services now provided "for free" by governments will have to be partly or wholly privatized; in fact, in most countries people are already paying some of the costs of their health care and of educating their children. Rich countries will have to travel further down this road.

Raising taxes will also be unpopular and could create further problems. Taxes reduce the rewards from work and investment and could therefore reduce economic growth. In the present globalized world, taxes on capital income are most likely to have this effect; corporations move their activities to other countries if they are taxed too heavily in one place, putting high tax countries at the risk of stagnation. Labor, on the contrary, is less able to flee from countries with high taxes; prospective emigrants will wonder whether they will find a job in another country, or one that pays as well as the one they are used to. The skills most in demand and transferable across national boundaries are the most productive and mobile ones, which is also bad news for the high tax countries; they risk chasing away the most productive of their labor and thereby retard their own economies. It would not be surprising to see the emergence of economic nationalism where countries fence themselves in with high tariff walls and controls of foreign investment, with democratically elected governments regaining their decision-making power from international corporations over vital issues, as some demagogues would put it. "Reemergence" would be the appropriate word; these methods were tried in the 1930s and accomplished nothing but losses of the gains from trade and spreading those losses more widely.

The need for increased government savings is hardly in question, but the fact that reputable economists keep giving contradictory advice will

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not speed up the adjustment. Some ask: "What is the remedy for taking an overdose of opium? More of the same?" Others argue that governments need to stimulate their economies to increase their growth and make it easier to pay down on the debt. In doing so governments would continue their deficit financing for a while and further increase their debt burden. To some this sounds like St Augustine's prayer: "Lord, make me chaste, but not just yet." These differences in advice are surprising, coming from a profession that prides itself on scientific method and outlook.

Will the debt reduction be accomplished and what will happen on the way? Established elites will be reluctant to introduce the necessary measures, for fear of losing their electoral support. The most likely circumstances in which this will happen are when there is common understanding among the competing elites about what needs to be done and cooperation in doing it. This seems in fact to have happened in at least some countries that have dealt with their debt problem in the recent past; we have discussed in some detail the case of Sweden. The longer the necessary adjustment is delayed, the greater it will have to be. Accumulating debt means that the interest payments go up and eat up more and more of the government revenue. Not only that; countries that have a high debt are likely suddenly to meet demands for a higher interest on any new debt, because of lenders' fear that they will not be able to pay back. Unfortunately, things are not unlikely to have to go that far, because the governing elite will hardly make much of an adjustment unless there is a sense of an urgent crisis, both among the elite itself and no less among the electorate at large whose support the elite needs. The Swedish experience certainly points that way. Countries with a large debt accumulated in good times are vulnerable. Suddenly, lenders may lose confidence and demand a substantial increase in interest to cover a higher perceived risk of default; suddenly a country may sink into a recession that reduces tax revenues and widens the gap between revenue and expenditure and sparks off a loss of confidence among lenders. How quickly this can happen is well illustrated in Figure 1.1; just look at how rapidly the government debt in Finland, Sweden, Denmark, Iceland and Ireland rose over a very short time when these countries experienced economic problems. Some had to do with crisis in their banks, but the rapid buildup of government debt in Sweden and Denmark in the late 1970s was because of a classic Keynesian response to a recession, increasing public expenditure despite a falling tax revenue. Countries

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with a high debt ratio to GDP from before are in a poor shape to tackle such events.

Will we see the established ruling elites in rich democratic countries getting their act together and taking the necessary steps to increase government savings to reverse the buildup of government debt? Hopefully, but these testing times could also be the time of the incompetent populists and usurpers in waiting, cashing in on the evident failure of existing elites to deliver what they have promised, of avoiding economic stagnation, rising unemployment and falling standards of living. The Third Reich was established less than 100 years ago under somewhat similar circumstances in what arguably was the most advanced country in the world at the time, culturally and scientifically. It took the Nazis less than ten years to rise from a fringe group to inhabiting the German Chancellery, and they did so by following the democratic script until they had gotten into a position to do away with it. A repetition seems unlikely to happen on German soil, but what about French, British or Italian? We see some highly alarming tendencies in all three places as well as elsewhere. France, Britain and Italy are large and powerful enough to cause a major disruption, while unenlightened populism in small countries will do only local damage that can be contained.

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Appendix: Data Sources

Government debt

R&R: Database on government debt, compiled by Carmen Reinhart and Kenneth Rogoff (R&R).

IMF: Online database, World Economic Outlook 2013, updated with World Economic Outlook 2014.

The IMF data begin for the most part in 1980, while the R&R data go much further back. There is in general good agreement between the two data sets. In some cases R&R report two or more series for government debt, with one or possibly even more differing from the IMF data. When there is discrepancy between the IMF and R&R the diagrams in Chapter 1 show both gross and net government debt figures from the IMF.

Government expenditure, public consumption and economic growth rate

UN: Yearbook of National Account Statistics (1950–1981); National Accounts Statistics (1982–1997).

OECD: Aggregate National Accounts and Government Expenditure (OECD e–library).

OECD (M): Main Economic Indicators.

OECD (H): Historical Statistics.

IMF: Online database (World Economic Outlook).

Maddison: Monitoring the World Economy 1820–1992. OECD, Paris, 1995.

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Government expenditure and public consumption have been divided by GDP, as reported in the same sources, except for IMF, which shows government expenditure in percent of GDP. The UN series go back furthest, while the OECD series usually begin in 1960 and the IMF series in 1980. There are some discrepancies among the IMF, UN and OECD series, but they generally show the same tendencies. The UN and OECD or IMF series have been patched together in the years where the discrepancy is the least, as reported in the section that follows. In a few cases the UN and OECD or IMF series are distinctly different, and in those cases both are shown in Figure 2.1.

Sources used for individual countries

Australia

Expenditure: 1950–1996: UN; 1997: OECD; 1998–2013: IMF.
Public consumption: 1950–1986: UN; 1987–2013: OECD.
Growth: 1950–1960: Maddison; 1961–1979: OECD (M); 1980–2013: IMF.

Austria

Expenditure: 1950–1987: UN; 1988–2013: IMF.
Public consumption: 1950–1974: UN; 1975–2013: OECD.
Growth: 1950–1969: Maddison; 1970–1979: OECD (H); 1980–2013: IMF.

Belgium

Expenditure: 1951–1979: UN; 1980–2013: IMF.
Public consumption: The UN Yearbook and the OECD show somewhat divergent data so both are shown.
Growth: 1950–1969: Maddison; 1970–1979: OECD (H); 1980–2013: IMF.

Canada

Expenditure: 1950–1996: UN; 1980–2013: IMF.
Comment: There is a discrepancy of a few percent points between the UN data and the IMF data, so both are shown.
Public consumption: 1950–1993: UN; 1994–2013: OECD.
Growth: 1950–1961: Maddison; 1962–1979: OECD (M); 1980–2013: IMF.

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Denmark

Expenditure: 1951–1982: UN; 1983–2013: IMF.
Public consumption: 1950–1968: UN; 1969–2013: OECD.
Growth: 1950–1969: Maddison; 1970–1979: OECD (H); 1980–2013: IMF.

Finland

Expenditure: 1953–1996: UN; 1997–2013: IMF.
Public consumption: 1950–1988: UN; 1989–2013: OECD.
Growth: 1950–1969: Maddison; 1970–1979: OECD (H); 1980–2013: IMF.

France

Expenditure: 1950–1985: UN; 1986–1013: IMF.
Public consumption: 1950–2013: OECD.
Comment: There is considerable and widening disagreement between the UN series and the OECD series, from 3 percentage points in 1950 to 6 in 1985.
Growth: 1950–1960: Maddison; 1961–1979: OECD (M); 1980–2013: IMF.

Germany

Expenditure: 1950–1985: UN; 1986–1999: OECD (H); 2000–2013: IMF.
Public consumption: 1950–1974: UN; 1975–2013: OECD.
Growth: 1951–1969: Maddison; 1970–1979: OECD (H); 1980–2013: IMF.

Greece

Expenditure: 1950–1980: UN; 1981–2013: IMF.
Public consumption: 1950–1963: UN; 1964–2013: OECD.
Growth: 1950–1969: Maddison; 1970–1979: OECD (H); 1980–2013: IMF.

Iceland

Expenditure: 1950–1996: Statistics Iceland (Sögulegt yfirlit hagtalna); 1997–2013: IMF.
Public consumption: 1950–1979: Statistics Iceland (Sögulegt yfirlit hagtalna); 1980–2013: OECD.

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Comment: The consumption in 1970 is about 3 percentage points higher, according to the OECD, but the gap narrows over time and in 1985 the two sources virtually agree.
Growth: 1950–1979: Statistics Iceland (Sögulegt yfirlit hagtalna); 1980–2013: IMF.

Ireland

Expenditure: 1950–1980: UN; 1981–2013: IMF.
Public consumption: 1950–1976: UN; 1977–2013: OECD.
Growth: 1950–1969: Maddison; 1970–1979: OECD (H); 1980–2013: IMF.

Italy

Expenditure: 1955–1979: UN; 1979–1987: OECD; 1988–2013: IMF.
Public consumption: 1950–1979: UN; 1980–2013: OECD.
Growth: 1950–1969: Maddison; 1970–1979: OECD (H); 1980–2013: IMF.

Japan

For Japan there are major and persistent differences in levels between the expenditure and consumption series and so both series are shown. The trends are similar, however.
Growth: 1950–1969: Maddison; 1970–1979: OECD (H); 1980–2013: IMF.

The Netherlands

Expenditure: 1950–1976: UN; 1977–1994: OECD; 1995–2013: IMF.
Public consumption: 1950–1968: UN; 1969–2013: OECD.
Comment: In 1969 the consumption is 2 percentage points higher according to the OECD and the difference widens over time.
Growth: 1950–1969: Maddison; 1970–1980: OECD (H); 1981–2013: IMF.

New Zealand

Expenditure: 1960–1977: New Zealand Statistics, Historical Tables; 1985–2013: IMF.
UN Statistical Yearbook has data for 1950–1968, but these are about 10 percent points lower than the data from New Zealand Statistics. The latter seem more comparable to the IMF data, even if there is a gap of about ten years.
Public consumption: 1950–1969: UN; 1970–2013: OECD.

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Growth: 1950–1979: New Zealand Statistics, Historical Tables; 1980–2013: IMF.

Norway

Expenditure: 1950–1979: UN; 1980–2013: IMF.
Public consumption: 1950–1983: UN; 1984–2013: OECD.
Growth: 1950–1969: Maddison; 1970–1979: OECD (H); 1980–2013: IMF.

Portugal

Expenditure: 1952–1994: UN; 1995–2013: IMF.
Public consumption: 1952–1993: UN; 1994–2013: OECD.
Growth: 1950–1969: Maddison; 1970–1979: OECD (H); 1980–2013: IMF.

Spain

Expenditure: 1955–1984: UN; 1985–1993: OECD (H); 1994–2013: IMF.
Public consumption: 1954–1969: UN; 1970–2013: OECD.
Growth: 1950–1969: Maddison; 1970–1979: OECD (H); 1980–2013: IMF.

Sweden

Expenditure: 1950–1985: UN; 1986–2013: IMF.
Public consumption: 1950–2013: OECD.
Growth: 1950–1969: Maddison; 1970–1979: OECD (H); 1980–2013: IMF.

Switzerland

Expenditure: 1953–1985: UN; 1986–2010: IMF; 2011–2012: OECD National Accounts.
Public consumption: 1953–1996: UN; 1970–2013: OECD.
Comment: There is s persistent difference in the level of public consumption according to the two sources, but both show a similar trend. Both paths are shown in Figure 2.1.
Growth: 1950–1969: Maddison; 1970–1979: OECD (H); 1980–2013: IMF.

United Kingdom

Expenditure: 1950–1983: UN; 1984–2013: IMF.
Public consumption: 1950–1977: UN; 1978–2013: OECD.
Growth: 1950–1969: Maddison; 1970–1979: OECD (H); 1980–2013: IMF.

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United States

Expenditure: 1950–1981: UN; 1982–2013: IMF.
Comment: data 1982–2000 from the 2013 database.
Public consumption: 1950–1969: UN; 1970–2013: OECD.
Growth: 1950–1960: Maddison; 1961–1979: OECD (M); 1980–2013: IMF.

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