TRADEOFFS IN PUBLIC FINANCES:
COMPARING THE WELLBEING OF BIG SPENDERS AND LEAN SPENDERS*

by

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Abstract: Taking the Lisbon 2000 concern with social cohesion seriously and drawing on research analyzing similarities and differences among 19 rich democracies, this paper compares the economic performance of big spenders and lean spenders at a similar economic level from 1950 to the late 1990s. Going beyond aggregate public spending, it shows the contrasting effects of particular types of spending and taxing. By examining the record of the past half century I highlight the extraordinary continuity of the contrasting institutions and policy directions of these countries. The lesson of such national differences is that there is not one road to good economic performance but several. I specify five types of political economy, each with its own costs and gains. A final summary compares the confrontational "low road" pursued by the United States and the "high road" pursued by the strongest consensual democracies of Continental Europe where social partners have negotiated real reforms in expensive social policies.

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The record of the last 50 years of the 20th century offers little support for the argument that there is a sharp tradeoff between job security, social security, equality, poverty reduction, and participatory democracy, on the one hand, and worker productivity, economic growth and other measures of economic performance, on the other. What is often left out of the discussions of these alleged trade-offs are, first, systematic empirical observations of the economic performance of big spenders and lean spenders at a similar economic level; second, the contrasting economic and political effects of particular types of spending and the types of taxes used to finance public spending, and, third, analysis of the impact of various economic and social policies on consensus or political legitimacy as these in turn shape economic performance. The interplay between economic and political policies is evident in the recent history of the United States. For instance, the tax cutting mania from Reagan to Bush II ultimately paralyzed government at every level, reducing the capacity to use fiscal policy for any public purpose other than military, alienating citizens who had been educated to believe in free lunches, and putting too great a burden on monetary policy. Its radical escalation under President Bush II has resulted in an explosion of deficits and debt. It has polarized politics to its greatest intensity since the 19th century. That makes it much more difficult to take timely action to deal with the Medicare crisis and to gradually reform Social Security.

Is There a Welfare State Crisis?

The essence of the welfare state is government-protected minimum standards of income, nutrition, health and safety, education, and housing assured to every citizen as a social right, not as charity (Wilensky, 1965, p. xii). In the abstract this is an ideal embraced by both political leaders and the mass of people in every affluent country, but in practice and at high levels of development it becomes expensive enough and evokes enough ambivalence to become the center of political combat about taxes, spending, and the proper role of government in the economy. In public expenditures, the welfare state is about two-thirds to three quarters of what modern governments do. The core programs of the welfare state, often subsumed under the general heading of "social security," have taken the form of social insurance against the basic risks of modern life: job injury, sickness, unemployment, disability, old age, and income lost due to illness, shifts in family composition, or other random shocks (wars, depression, recessions). Because the welfare state is about shared risks cross-cutting generations, localities, classes, ethnic and racial groups, and educational levels it is a major source of social integration in modern society. Because it lends a measure of stability to household income, it has also been an important stabilizer of the economy in the downswings of the business cycle especially since World War II.

The welfare state is at once one of the great structural uniformities of modern society and, paradoxically, one of its most striking diversities. In the past century the 19 currently richest democracies have varied little in their general strategy for constructing a floor below which no one sinks. The richer these countries became, the more likely they were to broaden the coverage of both population and risks. At the level of economic development they achieved in the past 30 years, however, we find sharp contrasts in spending, taxing, and the organization of the welfare state and, of course, in the politics of the welfare state.

The Rhetoric of Crisis

In 1975 I wrote that “the welfare state in its wondrous diversity has proved hard to shoot down;” it marches on through thick and thin (Wilensky, 1975, p. xvii). Since then there's been recurrent talk of a "crisis of the welfare state." Politicians, finance ministers, and even some scholars complain that accelerating social spending accounts for a rising burden of debt and deficits; that public support for the welfare state has eroded, another reason for cutting it down; and that social spending is a drag on economic growth, is inflationary, or contributes to unemployment. We should put these complaints in historical perspective.

Crisis talk has been a feature of welfare-state politics for almost a century. In Germany, when Bismarck's social legislation reached a cost of 1.4 percent of GDP in 1905, it triggered heated debate over its backbreaking economic burden and threat to civic morals. By 1988 that figure (social spending/GDP) had reached about 25 percent with none of the predicted effects. In recent decades crisis-mongering has escalated, aided by the rise of the broadcast media, which amplify extreme views.

If by "crisis" we mean rapidly accelerating social spending among the 19 rich democracies, by any measure social spending as a fraction of GDP has evidenced slower growth since 1975 or 1980, in some cases leveling off. Moreover, the burden of social spending in these countries varies both in level and trend. Thus, if by "crisis" we mean accelerating social spending, there is no crisis common to all.

If the welfare-state crisis means that the social budget is heavy and growing, that the welfare state is the root of public deficits, and deficits are dangerous, then again there is no general crisis. Results are the same whether we consider total government spending or confine analysis to social spending. A thorough study of gross debt-to-GDP ratios from 1961 to 1990 among 12 EC countries shows that the ratio of government expenditures to GDP is unrelated to the gross debt ratio and that rising deficits are not the result of growing expenditures (von Hagen, 1992, pp. 12-13; cf. Cameron, 1982). For instance during 1986-90 among welfare-state leaders the average debt ratio ranged from

128 percent of GDP for Belgium and 110 percent for Italy to 44 percent for Germany and 35 percent for France while among the welfare-state laggards the ratio ranged from 110 percent for Ireland to 50 percent for the United Kingdom (the U.S. ratio in 1994 was 70 percent). Similarly, the annual net government deficit 1993-94 among big spenders ranged from Sweden's 8.3 percent of GDP (down to 5.2 percent in 1996), Belgium's 3.7 percent, Netherland's 1.2 percent and Norway's 2.4 percent surplus, while among welfare-state laggards the annual deficits ranged from Japan's 6.0 percent and the United States's 4.1 percent to Ireland's 1.6 percent (OECD National Accounts). Debt ratios depend not upon government spending but upon what else these countries do -- whether they tax enough to pay for the services their citizens demand, their economic performance, the structure of their government (e.g., the strategic dominance of the prime minister or finance or treasury minister over the spending ministers), and the structure of the budgetary process. For example, experience with budget norms in the United States shows that they are ineffective in the long run for two reasons: first, the decentralized and divided structure of government means that Congressional spending committees and government agencies can maneuver to increase spending throughout the budgetary process by a principle of reciprocity; second, when Congress adopts a spending limit or budget ceiling, the federal government dumps mandates without money on the states; third, the states, whether they have legal spending and taxing limits or not, lavishly issue long-term bonds, resort to creative accounting tricks, and conduct one-time sales of assets to meet legal requirements for a balanced budget (von Hagen, 1992, pp. 38ff.).

In short, there is such great variation in the depth and duration of fiscal stress and debt and so much evidence that the welfare state is not the culprit causing changes in debt, that it makes no sense to talk about a general welfare-state crisis.

If the meaning of the welfare-state crisis is that there has been a withdrawal of mass support for social programs, there is no evidence of it. The most remarkable and solid finding of public opinion research on taxing and spending -- both over time and across countries -- is the stability of issue-specific opinion about social programs and the taxes to finance them. Since World War II, pensions and national health insurance remain overwhelmingly popular, most family policies retain a majority, while public assistance to the non-aged, non-working poor remains stably unpopular. Similarly, consumption taxes and social-security payroll taxes evoke no sustained mass hostility, while property taxes and income taxes arouse the most persistent resentment. The rank order of enthusiasm regarding both spending and taxing is similar across countries and over time. Chapter 10 [Backlash, pp. 369-373] reviews the evidence and explains why the relative uniformity of public opinion about the welfare state cannot explain great national differences in the electoral success of sustained tax-welfare backlash movements and parties like those of Mogens Glistrup in Denmark, Ronald Reagan in the United States and Margaret Thatcher in the United Kingdom.

If the "welfare state crisis" is not an inevitably accelerating rate of social spending, not the withdrawal of mass support for social spending, and not the inevitability and dangers of public debt, then surely it means that the burdens of the welfare state universally subvert good economic performance. Chapter 12 shows that the evidence is overwhelmingly to the contrary.

Social Spending, Types of Political Economy, and Economic Performance

Let's begin with aggregate social spending, then move to types of spending and taxing. Welfare-state spending (excluding housing and education[1]) up to 1973 was a

[1] Comparable data on total housing subsidies of all kinds are very sparse. What we have on 12 of our 19 countries shows a close fit with the rest of social spending as a GNP share or per capita (2002 Appendix C, pp. 730-732). Higher education spending, however, because of its stronger meritocratic component, is generally negatively correlated with the rest of the welfare state, which is more egalitarian. Means-tested public-assistance spending has a similar pattern of negative correlations with other social

positive contribution to the combination of low-to-moderate inflation, good real GDP growth per capita, and low unemployment. Since the first oil shock, social spending has been on average neutral. Why is the welfare state as a whole <u>not</u> a drag on economic performance?

Consider three sectors of social policy: <u>medical care and health; occupational health and safety; and active labor-market policy</u>. It seems reasonable to suppose that countries that increase dignified mass access to medical care and are aggressive in diffusing information about nutrition and other good health habits through schools, clinics, and child care facilities will in the long run enhance the productivity of the labor force (see chapter 16). Similarly, insofar as the expense of job-injury insurance has inspired more preventative occupational health and safety programs in the workplace, it has enhanced productivity by reducing absenteeism and turnover and cutting costs. Finally, there is strong evidence that those countries such as Sweden, Norway, Finland, and Japan that have invested in active labor-market policies (training and retraining, rehabilitation, job creation, placement, counseling, and mobility incentives, and a strong labor-market board), and have tried to reduce their reliance on passive unemployment insurance and social assistance, have a productivity edge over their competitors (Wilensky 1985 and 1992; Wilensky and Turner 1987, pp. 3-5, 25-31; and Wilensky 2002, Figure 2.2).

Beyond these generalizations, if we compare types of political economy, we find that some rich democracies facilitate productive tradeoffs among the government, mass-based political parties, and broad-based interest groups (labor, management, professions, established churches, farmers, and other associations), while other equally

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spending (Tables 6.Dl and 5.Cl) Even per capita spending for post-secondary education shows no relationship to these other programs (Appendix D, tables 6 D.1 and 6 D.2). Social spending is defined broadly but differently by several major sources. They all yield roughly the same country rank order as what I use here (2002, p. 248 ftn. 5).

rich democracies do not. By combining the cumulative power of two mass-based political parties with long and continuous standing - - Catholic and Left - - with types of bargaining among the social partners, I generate these five types of political economy. They predict the wellbeing of nations and their people in the descending order indicated in Table 12.7 with the democratic corporatist countries at the top and the fragmented and decentralized political economies at the bottom. Table 12.5 will later show how spending and these types relate to the economic performance of the 19 countries from 1950 to 1989, taking account of differences in vulnerability to external shocks.[2]

[Table 12.7 here]

Table 12.7 from <u>Rich Democracies</u> uses these types to explain 3 outcomes. The table shows that by wide margins and for these three outcomes, the consensual corporatist democracies, especially those with strong left or competing left and Catholic parties - - all of which are big spenders - - clearly outpace the more-fragmented and decentralized political economies as well as corporatist democracies that keep labor at a distance. They shine in labor productivity growth (1980-96), real compensation growth (1989-96), and achievement of more household equality (1990).[3] A study by Mishel, Bernstein, and Schmitt (1999 Table 8.2) shows that in per capita income growth per

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[2] My model of democratic corporatism (2002,ch. 2) accents four interrelated criteria: (1) Bargaining channels for the interaction of strongly organized, usually centralized economic blocs, especially labor, employer, and professional associations with a centralized or moderately-centralized government obliged to consider their advice; (2) A blurring of old distinctions between public and private; (3) A broad scope of national bargaining going beyond labor-market issues resulting in (4) the integration of social and economic policy and a greater chance to reach consensus and implement policy. Germany is an ambiguous case of corporatism; Switzerland, a marginal case of corporatism-without labor.

[3] An update of Table 12.7 adding 1996-2002 to cover the average for the entire period 1980-2002 shows little change in relative performance, although the U.S. improved its rank to below-average productivity growth (up from 17th to 11th of 18 countries) and Italy fell from 6th to 12th. Regarding inequality, only Italy changed rank substantially: it increased its relative inequality (moving from 12th to 3rd). Compensation shifts reflect national variation in short-run recession effects and labor agreements so 6 countries changed substantially, some up, some down.

year 1989-96 (using purchasing power parities for 12 countries available) the U.S., Canada, and France were the worst performers. Of seven corporatist democracies on their list, six have relatively high income growth. Again, as I found throughout my 19-country analysis, the greater earnings and income equality, job security, welfare-state protections, and poverty reductions of the more consensual democracies have not retarded their productivity and income growth and other measures of relative economic performance either in the 40 years preceeding 1990 or even in the 1990s.

Table 12.5 contains an overview of the economic performance of various types of political economy in five periods from 1950 to 1989.

[Table 12.5 here]

The measure is a 6-point index that equally weights real GDP growth per capita, inflation, and unemployment - - scoring high to low growth from 2 to 0, high to low inflation from 0 to 2, and high to low unemployment from 0 to 2. The best performers score 6 on this index; the worst score 1. This index avoids arguments about what is most important - - the control of inflation, good growth, or low unemployment. To take account of each country's vulnerability to the oil shock of 1973-74, I examine performance in the five years 1974-79 and then consider their 1980-84 response to the worst oil shock combined with multiple shocks of 1979-81 (worldwide recession and the export by the U.S. of the self-administered Volker interest rate shock). The equally-weighted components of my index of vulnerability to energy shocks are liquid fuels (almost all oil) as a percentage of total energy consumption, and energy production as a percentage of energy consumption in 1970.[4] Think of energy vulnerability as a handicap

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[4] For sources and rationale for measures in Table 12.5 and further discussion of results see 2002 pp. 432-450 and Appendix G. In scoring the economic performance index and its components I used natural (substantial) cutting points from high to low rather than an arbitrary proportion which might yield a trivial difference of one-tenth percent on unemployment "2" and "1". An analysis of growth, unemployment, and inflation separately is also in the book.

race. If the U.S., UK, Canada, Australia, Norway, and the Netherlands do well in the years after each oil shock we should take a little credit away from them because they are least vulnereable; if the most vulnerable countries - - Japan, Switzerland, Finland, and Belgium - - score medium to high in economic performance as they do, we should be impressed that they leaped over the high hurdles with such gusto.

Using Table 12.5 and 12 other tables, including disaggregated results and explanations of deviant cases (not here reported), here is a brief summary of my conclusions (ch.12). If we bring the entire universe of rich democracies to view and examine their experience from 1950 to 1992, we find the following:

(1) Corporatist democracies -- with a couple of possible exceptions (Japan and Switzerland, both with systems that do not fully integrate labor into social and economic policy making and implementation) -- tend to devote more of their resources to the social-security package (pensions, health care, family or child allowances and related programs, job injury insurance, unemployment compensation and related labor market programs, and miscellaneous aid to the disabled and the poor) and related social spending (see ch. 5 and Appendix C for measures and elaboration). (2) Corporatist democracies pursue tax policies that strike a balance between painfully visible taxes (modest income taxes and property taxes on households), hefty social -security contributions, and heavy consumption taxes (e.g.VAT), thereby permitting high levels of taxation with minimal political uproar (chapter 10). (3) Such social spending and taxing, far from constituting a brake on good economic performance, is a positive contribution. (4) Corporatist big spenders and taxers on average had an edge in economic performance, definitely before 1975, and if we take account of differences in their exposure to the oil shock of 1973-74 and the multiple shocks of 1979-82, even up to 1992, clearly in low inflation and low unemployment, less clearly in economic growth. After the first energy shock the striking pattern is that corporatist democracies with or without labor, far from evidencing the

rigidity of "Eurosclerosis," adapted better and quicker than the more "free marketeer" democracies did. By the summary index of economic performance, the top-ranked seven includes Japan and France (clearly corporatist without labor) and Switzerland (ambiguous on this point). Three other stellar performers (Norway, Austria, and the Netherlands) are clear cases of corporatism with labor, and one (West Germany) is ambiguously corporatist. The pattern becomes stronger after the second bigger shock. By then Sweden and Finland join the ranks of relatively good performers; the rest retain their top seven standing, except for Netherlands and France, which drop substantially. The only non-corporatist country that makes the top eight in 1980-84 is the United States.

(5) From 1990 through 1996 types of political economy were unrelated to average economic performance measured by my index; but corporatist democracies, with or without labor, continued to outperform non-corporatist democracies in holding down unemployment (average for corporatism-without-labor, 5.5 percent with Japan and Switzerland leading; average for democratic corporatist countries, 7.8 percent; for least-corporatist democracies, 9.3). Least-corporatist democracies, however, had a slight edge in controlling inflation (2.6 percent vs. 2.9 percent for non-corporatist democracies, with the best performance again going to corporatism-without-labor). The real GDP per capita growth per year was 2.3 percent for least-corporatist, 2.0 for corporatist democracies; the worst performance goes to corporatism-without-labor, 0.4 percent, with Switzerland and France at the bottom and Japan with an above-average 1.5 percent. (6) For some recent years major policy mistakes in Japan, the Netherlands, and Sweden explain why Japan and the U.S. traded places as "Number One" while the economy of Sweden sputtered (mainly 1984-92) and that of the Netherlands stalled (mainly 1984-91), then both countries recovered smartly (see 2002, pp. 110-116 for explanations for Sweden and the Netherlands and for why Japan and the U.S. traded places after 1992, pp. 445-450).

Prominent in the demonology of Reaganomics and Bush II, even among some academic economists, is an imaginary vicious circle of confiscatory taxing, runaway social spending followed inevitably by inflation, declining capital investment, no growth, and unemployment, followed by more demands for welfare entitlements, and so on. In fact, what we see in the wondrous variety of real experience is a mildly benign circle: the consensus-making machinery of corporatist democracies fostered fuller utilization of human resources and high levels of taxing and social spending, which together facilitate the kind of tradeoffs between major economic actors that apparently result in better performance through thick and thin.

What Tradeoffs are Good and Bad for the Economy?

The answer to the puzzle that corporatist big spenders on average have done better or as well as the fragmented decentralized lean spenders is the tradeoffs facilitated by both social spending and the national bargaining patterns institutionalized in the more consensual democracies. (In this section I concentrate on the most common tradeoffs, with only a hint at specific economic effects. In the next section I present the quantitative results.)

[Figure 12.1 here]

Figure12.1 is the causal model I used for regression analysis of economic performance. It singles out one of the three types of bargaining arrangements among major economic and political actors without reference to the five types, using numerical scores instead. The inverse of the policies and outcomes in Figure 12.1 are typical of confrontational systems of the fragmented and decentralized political economies.

The historical sequence of sources of democratic corporatism (not indicated in the Figure) begins with various forms of proportional representation (PR) - - the root cause of the great differences between the 13 countries that adopted this electoral system between 1855 and 1920 and the six that had the British Westminster system of "majoritarian" first-past-the-post, winner-take-all elections[5] With the spread of the franchise the labor/socialist movement and Catholic challenge to incumbent conservative parties, the PR compromise facilitated the rise of parliamentary mass-based left parties and Catholic parties. Their doctrines were diverse but they were all sympathetic to corporatist bargaining arrangements among social partners; in the language of the Lisbon strategy of 2000 they valued social cohesion. Once these systems were in place - - all by 1950 or so - - the policies that shape economic performance were adopted or expanded. One other hypothetical cause of corporatism does not stand up: the idea that trade dependence inspires the government, labor, management and political parties to get their internal act together because they live or die only by agreements on ways to enhance productivity and export prowess. However, trade dependence does work as a source of corporatism at the extremes of the Netherlands and Belgium - - the two countries most dependent on trade for at least the past century.

Once these consensual bargaining arrangements were in place, center-left and center-right coalitions were inevitable. Such accomodative interaction of left power, Catholic power, and corporatism, in turn, produced scores of social, economic, and labor-market policies, some of which facilitated trade-offs favorable to good economic performance.

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[5] I explain these fateful differences in ch. 2 of Rich Democracies. Ireland is the exception, the only one among the Anglo-American democracies that had PR. Japan, Germany, and France have mixed systems.. The architects of PR modified it with several devices to discourage very minor parties and splinter movements. But nearly pure PR appears in three exceptional cases—Denmark, Netherlands, and Israel and all three evidenced political trouble along with Italy, which abandoned its pure form in 1993. Proportional representation is like patent medicine: a proper dose is good for your political health; an overdose can kill you.

To oversimplify, here are the main tradeoffs in these more-or-less centralized bargaining systems.

1. Labor restraint on nominal wages in return for social security and related programs based on social rights and modest increases in real wages. The payoff to labor is increases in the "social wage" by universal categorical benefits. Such benefits and services are a substitute for means-tested benefits like public assistance. The distinction between divisive highly-visible means testing and simple, quiet income testing is important. By "means-testing" I mean (1) noncategorical benefits targeted to the poor via a stiff income- and/or assets-test, (2) applied by welfare administrators with substantial discretion, (3) with a high probability of stigma. "Income testing" is the opposite. It is categorical as a social right with co-payments graded by income bracket and, because it is private and invisible, has no stigma. Means-testing is characteristic of Britain and other decentralized and fragmented political economies (USA, Canada, Ireland); democratic corporatist countries, especially those with cumulative left party power, avoid means-testing and rely much more on income testing. (2002, pp. 321-332.) In fact, they are alternative policy packages that are strongly and negatively correlated. Corporatist democracies have avoided the Anglo-American obsesssion wth targeting the "truly needy," which necessitates a vast apparatus of investigation and surveillance of the poor. They rely instead on universal income-tested family policies (e.g. child care, parental leave), which are also strongly and negatively correlated with means-testing (ch. 7). Heavy reliance on means-testing is one source of bureaucratic bloat and tax-welfare backlash (chs. 9 & 10) - - the visible "undeserving poor" become scapegoats for populist-right politicians. In regression analysis, means-tested benefits directly and independently increase unemployment except in one post shock

period; they are indirectly a drag on economic growth because they consistently divert resources from capital investment and subvert human resource development (pp. 455-457). Regarding the effect of wage constraint: while most corporatist democracies had higher wage increases before 1980 than their noncorporatist ccounterparts, when the shocks of 1974 and 1979-82 hit, they resisted wage pressures and did better controlling inflation in the five years after each shock

2. Job protection in return for wage restraint, labor peace, and sometimes tax concessions (e.g. lower taxes on corporations and capital gains). A high strike rate - - one of the most robust variables explaining poor economic performance -- is a proxy for poorly-managed industrial relations systems. Strikes, both official and wildcat, are related to other, more continuous forms of industrial conflict at the workplace: sabotage, slowdowns, output restriction, as well as absenteeism, tardiness, playing dumb, quits, and grievance activity. Both strikes and associated job actions create bottlenecks and other inefficiencies, forestall managerial initiatives, and thereby increase unit costs and reduce economic performance. (Flaherty 1987a,b; Norsworthy and Zabala 1985, p. 557; and Hodson, 1995, 1997.)

Systematic comparative studies for job protection are few but there are numerous case studies of management concessions either coerced by labor movements and government or voluntarily given -- ranging from accounts of lifetime employment in large firms in Japan to Western European laws and contracts that enhance job security (e.g., Emerson, 1988; ILO,1995; OECD, 1997), and several systematic coomparisons of "labor rigidities" of Europe vs. the U.S. and within Europe (Nickell, 1997). What such studies suggest is that job security facilitates the rapid introduction and effectiveness of new technology by reducing labor resistance to change and tapping the know-how of workers; it reduces the costs of turnover and encourages management to invest in on-the-job training (Ibid., p. 180 and Table 22). Like payroll taxes, job security has no effect on unemployment (Nickell, 1997, p.66). Elaboration is in my chapters 1 and 18.

Regarding tax concessions to employers as a labor/government tradeoff to compensate management, the measure is taxes on corporate income, profits, and capital gains. Unfortunately OECD data do not permit disaggregation of these 3 taxes but the aggregate yields two findings worth noting. I did not anticipate that democratic corporatist countries which include labor would go light on such taxes but that's the fact. The negative correlations between corporatist scores and corporate taxes as a percent of total revenue range from -.45 to -.55 from 1955 to 1977 but fade to insignificance thereafter. The effect of such taxes on economic performance is negligible; if we eliminate Japan from the 19 countries --it had by far the highest reliance on corporate income and profits taxes during the entire period of its excellent economic performance--then we find no relationship between these taxes and economic performance.

3. Participatory democracy in the workplace or community in return for labor peace and wage constraint. A case in point: the German local works councils and national co-determination combined with regional collective bargaining that is coordinated by centralized unions and employer associations setting a broad framework—at least until 1989 when the huge and continuing burden of

unification combined with recession and a procyclical monetary policy made Germany the "sick man of Europe." Several countries provide channels for worker and union leader participation in tripartite boards administering parts of the welfare state -- medical insurance, unemployment and accident insurance, and pensions (chapters 2 and 5). Such union participation in unemployment insurance and related labor-market policies is especially strong in Belgium, Sweden, Denmark, and Finland.

4. In return for all of the above, the government improves its tax-extraction capacity and public acceptance of taxes on consumption -- not irrelevant to reduction of inflation and budget deficits. Thus, the combination of high VAT and social-security taxes is a moderately positive contribution to high scores on my economic performance index before 1974 (although it is insignificant after).

5. In return for all the above, both labor and the government tolerate low taxes on either capital gains or profits and avoid high property taxes. Although my study shows that taxes on capital gains, corporate income, and profits have only moderately negative effects on capital investment and little effect on economic performance, property taxes may be a drag in all periods. Reliance on property taxes is characteristic of the more fragmented and decentralized democracies.

. 6. With the habit of making such tradeoffs and faced with strong labor movements, management in the more corporatist democracies tends to join labor in the implementation of a wide range of policies. The result: less intrusive regulation and more effective implementation of laws and executive orders. Thus, the complaint that Western Europe is hyperregulated and hyper-protected while America has an excellent ability to adapt ignores the evidence on types of regulation and regulatory styles. The paradox that the most decentralized political economies with the most liberal (free-market) ideologies -- e.g. the U.S. -- have the most rigid and intrusive regulations can be explained by the weakness of the structure and political power of labor and the absence of channels for collaboration among labor, management, and the state. (I return to regulatory regimes when dealing with the U.S. model at the end.)

Some students of comparative political economy strongly argue that this is all outmoded, that these advantages of the tradeoffs facilited by democratic corporatism pictured in Figure 2.1 are dinosaurs from the days before globilization and economic austerity emerged. Because of economic constraints since the early 1970s, they assert, neither the government nor employers can deliver the continual harvest of benefits (wages, job security, social security, participation in policy decisions in workplace and community) that has sustained consensus and permitted labor leaders to embrace labor peace, wage restraint and government tax policies, and to cooperate on productivity, labor flexibility, and tax breaks for management -- the tradeoffs discussed above. This inspires rank-and-file protest against the unfavorable bargains their leaders obtain. Thus, it is alleged, worker disaffection is proliferating and corporatist democracy is fast disappearing.

There are three answers to this dire picture: (1) Corporatist democracies provide stronger and more meaningful channels for participation of union members and the general citizenry than the fragmented and decentralized democracies (see data in ch. 3). Lively participation in broad-based associations provides a prop for continuity; such participation patterns do not fall off because economic constraints appear. (2) The range of economic and non-economic gains for labor is wide, the kinds of benefits numerous. Often low-cost gains (e.g. expanded participation in managerial decisions, pay-for-knowledge, flexible schedules) can be substituted for high-cost gains (big increases in wages or pensions). Facing the financial turmoil and economic constraints of recent years, the social partners also can trade wage moderation or lower payroll taxes in return for commitments to invest capital domestically, or a modest widening of skill differentials to overcome the economic drag of radical wage compression (especially prevalent in Sweden) in return for skills training, job security, and so on (2002, pp. 51-57, ch. 12 and p. 128 ftn.13). The net effect of such tradeoffs is to increase private and public savings and investment and hence real economic growth. (3) Habits of accommodation among the social partners are of long standing and have survived crises of the past. If we examine recent developments in the two cases that have evidenced most decline in the strength of bargaining arrangements -- Sweden and Netherlands -- we can see that negotiated adaptation is a better concept than collapse or even erosion. (For a full discussion of these two cases and other assertions regarding the demise of consensual bargaining, see 2002, ch. 2 pp. 110-116.)

Which of the Sources of Good Economic Performance are Most Important?

Table 12.5 gave an overview of the interplay of types of political economy and dichotomies for aggregate level of social spending/GDP and vulnerability to energy shocks, as predictors of economic performance of each country in various periods. This section presents the main conclusions from multivariate analysis including extensive multiple regression analysis testing those relationships for which we had appropriate data on almost all or all of the 19 countries; these variables appear in Figure 12.1 in the boxes on public policies and economic outcomes. We used three independent variables at a time in all possible combinations for each period. Here are the results; they are consistent with all cross-tabulations.

First, the proximate causes: strike rates, capital investment, wages, taxes, and spending:

- The most important sources of good economic performance for both economic performance index and its components are <u>corporatist bargaining arrangements</u> (with or without the full integration of labor) and related public policies that foster <u>low strike rates</u> (a clue to effective industrial relations systems), <u>a high rate of gross fixed capital investment</u> and <u>wage restraint in shock periods.</u> The two most consistently robust variables are strike rates and capital investment; either one or the other or both have major effects no matter what is added to the equation. If we ignore the causal sequence in Figure 12.1, one or the other of these powerful variables consistently predicts more of the variance in the economy than corporatism, leftism, Catholicism, spending or taxing levels or types, or external shocks. The regressions show that capital investment has a positive effect because it increases growth (1965-74, 1974-79, and 1980-84) and lowers unemployment (1965-74, 1974-79, and 1985-89 but not after the second oil shock 1980-84).[6] And high strike rates have a negative effect because they increase unemployment (1950-74, 1965-74, 1974-79, and 1980-84) and/or increase inflation (1974-79, 1980-84, 1985-89).

  The crucial importance of labor peace in this analysis is underscored by this finding: Of our significant sources of high scores on both the index and its components - - strikes, capital investment, corporatism score, Catholic party power, left party power, and social spending - - strikes explained more variance

[6] Economists studying the American slowdown in productivity experienced after 1973 attribute at least a fourth and as much as half of the slowdown to the lack of business investment (B.M. Friedman 1989, pp. 196 and citations p. 310, ftn. 11). However, they seldom consider industrial relations systems in a comparative context.

in economic performance than all others in almost all equations. Even during the period of recovery 1985-89, strikes were consistently more of a drag than capital formation was a help (2002, pp. 459-461). And labor peace is a product of the tradeoffs facilitated by consensual bargaining arrangements (above).

- Social Security spending (SS/GNP) and, to a lesser degree, social security per capita are positive forces for GDP growth 1950-74 and the general index 1950-74. Holding constant strikes and capital formation, social spending remains significant in some equations. It is irrelevant to inflation and unemployment. The growth rate of social-security spending, either nominal or real, is not significant if Japan with very high growth in both social spending and its economy is excluded.

  In no period and for no measure of performance is social-security spending a significant drag, controlling for leftism, Catholicism, corporatism, capital investment, and strikes, the major sources of economic performance. In 1980-84, both strikes and SS/GNP appear to dampen economic performance, but that is due to Japan (very low in strikes, tops in capital investment, very low in social spending); eliminating Japan, social security is reduced to no significance or marginal significance in all but one of 20 equations (17 countries).
  Where we eliminate both Japan and Switzerland (they have the same unique pattern), social security has no significant effect in any equation. This suggests two roads to good economic performance: corporatism-without-labor with lean social spending, high capital investment, and low strikes, or corporatism with full inclusion of labor with generous social spending, high capital investment, and, most important, few man-days lost from strikes.

  The literature on the impact of the welfare state confirms this conclusion. In a careful review of the mixed and weak findings of nine studies of the economic impact of social spending on economic performance -- most authored by economists -- A.B. Atkinson (1995) concludes that none of them shows that the welfare state is a drag on economic growth, employment, or productivity (cf.

Lindert, 2004a, ch. 18).

- Although total social spending SS/GNP is either slightly positive or neutral for economic performance, the structure of spending counts. As we have seen above, the Anglo-American emphasis on stiff and stigmatized means-testing of benefits and services not only increases tax-welfare backlash and makes it more difficult to finance government, it is a drag on economic performance because it increases bureaucratic bloat, drains off investment, increases unemployment, and in 1980-84 was a drag on growth. More important, both detailed examination of cases and quantitative results show that public spending and the organization and delivery of health care is positive for long-run productivity and economic performance, not to mention poverty reduction and reduced inequality (2002, ch. 16).

  Two other components of the welfare state are clearly positive tradeoffs for passive policies that emphasize public assistance and unemployment insurance: an "active labor-market policy" and a family policy. ALMP includes job creation, apprenticeship training, incentives for on-the-job training and retraining, work-study programs, remedial programs to increase basic literacy and improve work habits, a strong labor-market board to match job seekers and job -vacancies for everyone, [including compulsory notification of job vacancies or layoffs], mobility allowances, relocation assistance and rent supplements tied to mobility for workers trapped in depressed areas and industries, and more (2002, pp. 706-707 and Figure 2.2 listing 21 types of ALMP). Family policy (ch. 7) includes parental leave, paid and unpaid; childcare; before- and after-school leisure centers; family allowances; rent supplements and housing assistance. It is designed to assure the care of children, increase gender equality, and balance parental demands of work and family. Both ALMP and family policy have incidental payoffs: increase labor-force participation, avoid the feminization of poverty, reduce income inequality and, finally, increase long-run productivity. Sweden has led in both clusters of policies with good economic effects over decades.

- Wage restraint. This concession of labor is important in periods of crisis. While most corporatist democracies had higher increases before 1980 than their noncorporatist counterparts, when the shocks of 1974 and 1979-82 hit, they resisted wage pressures and did better in controlling inflation for the five years after each shock. Regression analysis confirms the findings that restraint of nominal wages strongly reduces inflation in all periods but has no effects on unemployment or GDP growth and no effects on the general index for 1950-74. In short, their accomodative bargaining gave corporatist democracies more flexibility. (See note 12 in ch. 12 for six other studies consistent with my findings.)

- <u>Taxes: level and type</u>. With one deviant case of Italy, whose spending for long periods exceeded its tax collection, taxes roughly match spending. Big spenders pay their way over the long run; or big taxers spend a lot; or both. From 1965 to 1988, the correlations between the corporatism score and total taxes/GDP range from .60 (1974) to .72 (1980 and 1988). The relationship is especially strong for corporatist democracies with strong left-party power in all periods (e.g., Denmark, Sweden, Norway are among the top 4 taxers in all periods; two countries, with both left and Catholic power, Netherlands and Austria, are among the top seven for all periods.
- <u>As a percentage of total taxes, the big taxers rely mainly on least visible and least painful, least unpopular taxes -- consumption taxes</u> (e.g., VAT) <u>and social-security taxes</u> (e.g., payroll taxes); as we have seen, they also <u>avoid heavy taxes on corporate income, profits, or capital gains</u>, although this relationship faded in the 1980s. Apparently, the tradeoffs made when labor is at the high-policy table for many years favor management; in return for payoffs in the "social wage," labor not only constrains wage demands but also supports tax breaks for management. In the absence of a steady labor influence (as in Japan, Australia,

New Zealand, Canada, and the U.K.), the government turns to business as a source of revenue.[7]

In any case, the main conclusion is that total taxes, like aggregate social spending, have little or no consistant effect on economic performance. But types of taxes, like types of social spending, are often important. Sales and value-added taxes remain significant and positive for economic growth after controlling for other variables for 1950-79, with positive impact on the index 1965-79. These consumption taxes are consistently negatively related to strikes, while they are positively related to capital formation, which may explain why they are good for growth.

There are no significant correlations between consumption taxes and inflation or unemployment, however, and no significant correlations with any performance measure in the 1980s.[8]

[7] Even after the first wave of corporate tax reform this older pattern remains: corporatist democracies still go light on business; paradoxically leftist regimes are most friendly to business. Thus, in 1989, of the top 7 in profits taxes as a percentage of total taxes, 5 are least corporatist (Japan and Italy are exceptions); of the bottom 11, all but Ireland are corporatist with or without labor (Germany, marginally corporatist, is near the median). Again this is a product of tradeoffs discussed above, especially in left corporatist regimes with a history of strong left power; among these 18 countries, Austria, Sweden, Denmark, Finland, and Norway have the least reliance on corporate taxes. Israel is excluded from this analysis. Source: Nørregaard, John and Jeffrey Owens, "Taxing Profits in a Global Economy," The OECD Observer, 175 (April-May 1992): 35-38. The United States also fits this pattern: it was above average in its reliance on corporate taxes until 1983-87, when it dropped to 13th. Corporatist democracies in Europe go even lighter on such taxes than these data show, because unlike the United States they have moved toward integration of individual and corporate taxes by lowering taxes on income from dividends and capital gains of individuals. Thus, the total burden on European corporations is less than it appears while the burden on U.S. corporations is more than appears, at least until Bush II's radical changes.

[8] My finding that consumption taxes do not set off a wage-price spiral is supported by other studies showing that in 11 of 13 OECD countries surveyed, the introduction of the VAT "either had little effect on retail prices or simply resulted in a shift of the CPI trend line (one-time effect)" (Sijbren Cnossen 1991, pp. 634 and 643). Cnossen also concludes that a VAT is superior to an income tax in promoting capital formation and economic growth, consistent with my findings. Ibid., pp. 633-634, 643-644. See the similar finding for the United States 1955-1980 in Jorgenson and Yun (1986).

In short, relative to industrial relations systems and capital formation, the structure of taxes is only moderately or weakly related to economic performance, an effect that almost disappears in the 1980s. If we are concerned only with economic impact, consumption taxes and social security taxes were benign; income taxes, property taxes, and to a much less extent, corporate taxes, were a drag. And the general level of taxes had no effect at all. The tax-cutting mania of Republican Presidents Reagan and Bush and the Republican Congress of 1994-2000 (and the echoes among conservatives in Europe) and the heated denials of their Democratic opponents that they were "tax-and-spend liberals" were, to say the least, misplaced.

Whatever their economic effects, the larger significance of these types of taxes is political: property taxes on households, as we have seen, are a root cause of tax-welfare backlash movements and parties, which can paralyze a government to the point where it cannot raise necessary revenue for schools, infrastructure, R& D, budget balancing, or meet strong electoral demands for services. Increases in payroll taxes or VAT are similarly political; they are used in the tradeoffs in agreements on welfare-state reform among the government, labor, and management. And in the history of tax strategies of consensual democracies, they arrived at an accent on payroll taxes and the VAT because their leaders understood that if they were to pay for the social and labor-market policies they favored, they needed tax balance--as a percent of total revenue, more reliance on the least painful taxes and less on income taxes and property taxes.

- <u>Least corporatist democracies have a taste for property taxes</u>. Of our l9 the seven top countries in property taxes as a percent of total revenue in all periods from

> 1965 to 1987 are the U.S., UK, New Zealand, Australia, Canada, Ireland, and the only corporatist democracy in that Anglo-American club, Denmark. Such taxes appear to be a drag on economic performance, but they are so highly correlated with the rest of our variables that also predict poor performance (2002, pp,485-489) that I leave it aside here. Its greatest importance is as a proximate cause of tax revolts. In the years when strong tax-welfare backlash movements and parties emerged (1965-75) and subsequently persisted, all the countries so afflicted ranked high in their reliance on property taxes on households (see 2002, pp. 379-385)—U.S., UK, Denmark, Switzerland.

What all these findings underscore is that aggregate public spending or social spending or total taxes or “social transfers” obscure the economic and political impact of particular sectors of spending and types of taxes as well as particular social and labor-market policies. Not only do these vary greatly among rich democracies but some are productive, others are justified on non-economic grounds (e.g.pensions greatly reduce pre-transfer poverty among the aged).

Retrenchment of the Welfare State? The Fate of “Cutback Budgeting”

I began by observing that if “crisis” talk, however misleading, is universal; if anti-taxing, anti-social spending, anti-bureaucratic themes have helped candidates to win some elections (ch. 10), has the action of governments matched the rhetoric of campaigns? What cutbacks have actually occurred in the period of austerity after 1975 or 1980 when economic growth and productivity growth slowed down? With some exceptions, the core programs of the welfare state -- pensions, disability insurance, and national health insurance, programs that have generally outpaced GDPgrowth -- have proved most resistant to real cuts in benefits per capita or even in their GDP shares (on disability insurance see chapter16, Environment). Most vulnerable to real cuts or at least spending restraint have been education, family allowances, social assistance, and unemployment compensation.

With few exceptions, there are five main reasons for this pattern of growth and restraint. First, demography, as usual, counts. Declines in education spending reflect declines in school-age populations. The "young" countries with a school-age bulge (measured by school agers per prime-age adult) cut education expenditures per child while still raising such spending as a share of GDP but as the school population declined the GDP share leveled off or declined. The older countries spent more on pensions both per capita and in GDP share but at a diminishing rate, eventually leveling off (Lindert, 1996a, pp. 14-15). Aging, as we have seen, also increased health and disability spending, especially as the "old-old" increased their share of the population. Second, after universal coverage is achieved, various measures to control costs or restructure programs had some effect, especially in health care (as in recent German reforms). Third, programs where abuses were obvious and widespread (sick pay, disability insurance) have evoked substantial government reform efforts with varying success; disability cutbacks have encountered especially fierce resistance (see the five-country comparison in 2002, chapter 15 and Table 15.3). Fourth, the rate of economic growth has an automatic effect on these numbers: below-average growth will automatically increase the expenditure ratio (SS/GDP) as the denominator levels off or decreases while social spending continues upward. Finally, the interaction of three forces -- a very large clientele (all pensioners, all the health insured), strong political organization or influence, and great mass popularity -- means that welfare-state leaders have already achieved generosity of benefits; their citizens now have entrenched interests and strong sentiments for maintaining the status quo. Conversely, if clientele is small, organization and influence is weak, and majority sentiment is hostile -- as with means-tested benefits targeted to the non-aged, non-disabled poor and to a lesser extent unemployment compensation -- real cutbacks are most likely.

I have elsewhere described many specific welfare reforms in particular countries in detail (2002, pp. 211, 221-232; 2005 forthcoming) and recent works by economist Peter Lindert (1996b, 2004a, 2004b) provide the best recent overview of patterns of growth and retrenchment for long periods from the 18th century until now. (Lindert also concludes that the net national economic costs of government social programs in modern democracies today is near zero.) I will here only briefly illustrate the intensity of mass protest against cutback budgeting, whether the reductions are initiated by the right or the left. Then I’ll describe the great contrast between the Netherlands and Sweden’s approach to disability programs and the current Finnish reform of pensions and related programs, a model achievement.

Two patterns should be noted: first the welfare state has always been about the aged, who are the heaviest users of such expensive programs as health care, pensions, and disability insurance. But do not assume that this has created some kind of war between the generations, that the aged and “gray power” are running away with the public budget at the expense of the young. The evidence both from cross-national surveys and failed government efforts to make major cuts in these benefits shows the opposite - - strong support for all three programs cross-cuts generations; it is universal. In fact the adult children of the elderly are sometimes more enthusiastic about universal pensions than their parents. They know the alternative: Without these programs much of the burden of personal support for their retired parents would fall to them at the very time when they are trying to finance their children's college education, and parental costs of the young are mounting. Some might even be faced with a 4-generation family - - their own parents and grandparents (the old-old aged) and their own children. This is only one of many sources of pro-welfare state mass support (2002, pp. 370-373, 216-221).

The second pattern is that pro-welfare state backlash appears wherever the public and its representatives perceive that the incumbent political leaders are serious about retrenchment:

- In Italy Prime Minister Romano Prodi's center-left majority coalition of 1998 split over \$14.5 billion in proposed spending cuts, specifically the \$2.9 billion reduction in pension and healthcare programs. Prodi resigned. Renegotiation led to \$291 million less in pension cuts but total spending cuts were reduced to almost one-third of those originally proposed and in return the left demand for a 35-hour workweek was accepted.
- In France in late 1995 the conservative Chirac/Juppe government proposed cuts triggered a strike movement that almost shut down the French economy for three weeks. It had a wider base of public sympathy and a less global set of issues than les grands événements of 1968. It was triggered by the so-called "plan Juppé" presented by the government with almost no consultation or participation as a non-negotiable policy package to save the French welfare state, restore French competitiveness, and meet requirements for joining the EMU (European Monetary Union). The plan proposed to overhaul pensions for all public sector employees by requiring longer service for benefits (from 37.5 years to 40 years)

and reducing their generosity; to eliminate union seats on the boards of public sector social-security funds; to control costs in the health insurance system by reducing union and employer influence in its governing bodies, capping expenditures, and instituting a new income tax targeted to health insurance and levied even on pensioners and the unemployed; and to speed up the effort begun by the Left government of 1983 to restructure and modernize the semi-commercial public sector. The changes were sudden and radical. Strikers concentrated on protecting pensions, health care, job security, traditional job rights and working conditions. The government withdrew its proposal to reform public sector pensions (and was subsequently forced to accept a full pay pension for truck drivers at age 55); but did not give up its ambition to drastically reform the entire social security system. In July of 1997 Chirac/Juppe were defeated by Lionel Jospin of the center-left (2002, pp. 265-267).

- In the mid-1990s German Chancellor Kohl proposed to reduce state-subsidized health spa vacations from the present four weeks every three years to only three weeks every four years; he proposed to increase by 75¢ the small co-payment per prescription (previously about $1.50 to $5.00). He also suggested some modest pension reforms. All this might not sound Draconian to American ears, but it provoked demonstrations, processions of cars, and brief work stoppages all across Germany; 350,000 protesters poured into Bonn in June 1996 - - a post-war record. In the late 1990s through 2003, confronting declining birthrates, longer life spans, earlier exits from work (and the consequent deterioration of the working/non working population ratio), as well as less working time, higher unemployment, and the continuing burden of reunification, German governments of both center-right and center-left continued efforts to reform the welfare state with only small results. For instance, as of 2003, the Schroeder government tightened eligibility rules for unemployment benefits. More significant potentially is that the SPD (Social Democratic Party) in 2003 accepted Schroeder's "2010 Agenda". This plan aims to cut non-labor costs by reducing benefits for the long-term unemployed, liberalize the pharmaceutical market, increase copayments by patients, and, again, calls for pension reforms. Once more massive protests greeted the proposals, which remain a hope. What is obvious is that despite three decades of bold talk about cutbacks of the big welfare-state programs, the action has been severely limited by mass resistance.

Although President <u>Reagan</u> in eight years and Prime Minister <u>Thatcher</u> in twelve years both launched verbal assaults on the welfare state, they were unable to make more than a small dent on aggregate social spending, mostly by means testing and tightening eligibility rules for the most vulnerable population - - the poor (2002, pp. 223-224). As his first act in this area Reagan proposed to reduce the minimum guaranteed pension in social security (2002, pp. 223-224). Immediately 100 Senators in the 100-person Senate voted "No."

In short, real cutbacks in benefits since the 1980s are typically small and incremental - - trimming around the edges of the welfare state. Health-care reform is prominent everywhere. Benefit formulas for pensions are being modified in most countries; to account for increased longevity "normal retirement age" is being raised in many. But nowhere have employment-based pension schemes been redesigned according to the American Concord Coalition recommendation for a tax/transfer needs-based model. Reform is a slow process that encounters strong public resistance. Small incremental reductions in many programs can add up over time; vast majorities of voters whose income and security are threatened sooner or later rebel.

That the consensual democracies have the best chance to control costs of the social and labor-market policies now in place without sacrificing the principles of social right and universality is highlighted by what they have done in the past and are doing now. First, consider the most and least successful strategies for coping with disability.

. For the cost conscious**,** the Netherlands until the mid-1990s was the symbol of what not to do: the combination of wildly loose definitions of disability, indulgent administration, and an almost exclusive focus on passive cash benefits without rehabilitation made it tops in total disability claims and spending, with the lowest average age of first-time claimants (42 yrs. old), and the lowest labor-force participation rate of 55-64 year-old males. A high unemployment rate did not help. The long-term unemployed preferred the higher cash benefits of permanent disability instead of unemployment benefits; and doctors, confronted with the physical and mental health costs of such unemployment would cooperate - - certify them as permanently disabled. Sweden is the opposite extreme: Although it does not run up the total bill as much as the Netherlands, it is tops in interrelated work-oriented rehabilitation, ALMP, and family policies designed to facilitate work; the result is the highest rate of labor force participation for all adults - - and three times the Dutch rate for age 60-64. All these policies indirectly help the disabled to contribute to the economy and polity while they achieve a more independent life. Among the direct measures promoting independence are a legal right to benefits, including counseling and training, support for individuals as well as parents with disabled children, escort services, housing with special service, support for minor handicaps, interpreter services for the deaf and blind, and more. When these services to promote autonomy were expanded in the mid-1990s, eligibility standards were tightened to contain costs.

Second, if we go beyond disability policy to the big cost core programs, pensions and related polices that must be linked to pension reform, we can again see where accommodations between the social partners and political parties are essential. All rich democracies have experienced twin trends that pose a serious issue for policy planners: a century-long decline in the age of exit of men from the labor force; and an increase in healthy older populations. At the root of the problem is management and union desire to ease out older workers. Managers prefer younger, cheaper men and women and middle-aged women and if the state can pick up the tab, they will help older workers into an early retirement; unions go along because they want to reduce unemployment and make way for younger members. In trying to contain exploding costs of pensions while they cope with an oversupply of healthy displaced older workers who prefer to work at least part time, many governments have tried to devise flexible retirement systems. Surely it is good public policy to transform the healthy aged who want to work into taxpayers, part-time workers, and partial pensioners rather than pressuring them to retire fully. But it is extraordinarily difficult both technically and politically to craft social-security systems that would reverse the long-term slide in the age of exit from work. One obstacle is the prevalence of disabilities of various kinds among the aged. The trick is to find the balance between reductions in benefits for very early retirement and generous partial pensions for continued part-time work for aged say 60-70 while avoiding pressure on the worn-out workers in the least attractive jobs to postpone retirement. As in the case of the partially-disabled, this necessitates adequate income and medical supports; or if rehabilitation is the focus, a reallocation of funds toward work-oriented rehabilitation and a tight connection to an active labor market policy.

Both Sweden and Finland, cases of democratic corporatism, have crafted such systems. Both have evidenced a capacity for the necessary policy linkages.

Finland's recent welfare-state reforms are a model of what corporatist bargaining among the social partners (labor, professions, management, and other relevant and inclusive interest groups interacting with government and political parties) can do to forge consensus on major pension and related programs. It is a lesson in how a consensual democracy, especially if it integrates labor and the left into high policy, can reform the core programs of the welfare state to cope with issues of both equity and cost.

Here is a broad outline of a major reform of pension and related programs that was adopted by parliament in 2003 after agreement among the "labor-market parties" and after a thorough government assessment of long-run costs and benefits. Most will take effect Jan 1, 2005.

The major aims: postpone the average effective retirement age by 2-3 years; adapt the pension scheme to an increased average life expectancy and other demographic shifts; achieve unification and simplification of private sector earnings-related pensions. The new system reforms cover three types of pensions: old age, disability, and part-time. (Survivors pensions were left intact.) It changes the pension index (so consumer prices weigh 80%, earnings increases 20%). It establishes specific rights to vocational rehabilitation "if illness, handicap, or injury poses a threat to work capacity within about 5 years" and similar rights within the earnings-related pension system, with appeals procedures.

To further enhance flexible retirement and encourage work, changes in both part time and full pensions are substantial. The part-time pension age is increased from age 56 to 58, with an accrual rate of 1.5% of earnings and 0.75% of the reduction of earnings due to part-time reitirement. Early old-age pensions start at 62. At 63 one can retire on the old-age accrual rate, which begins on earnings after age 18 and climbs in three steps, from 1.5% at age 18-52, to 4.5% at 63-68 - - a strong incentive for continued work. Funding will be increased from 2003 on, but savings from the flexible retirement provisions and later retirement are expected to reduce the growth of pension expenditure as a percent of wages from 2005 to about 2030 and thereafter to level off. Combined with real cuts made in the 1990s—a product of the same consensual bargaining process among the social partners—the current reforms mean that pension expenditures and premiums will grow much less than they would have without reforms.

The High Road to a Good Economy vs. the Low Road

By the mid-1960s all of our 19 rich democracies achieved a level of affluence that put them in the top one-sixth of the world's countries in per capita GNP and have since become richer still. All are market-oriented, stable democracies. What I have shown so far is that some countries within each type of political economy in some lengthly periods have done quite well in economic performance for the last half century even though their policy mixes have had drastically different costs and gains in the wellbeing of their people. One way to put the findings above into bold relief is to outline contrasting paths to economic success, comparing extremes - - the strongest corporatist democracies vs. the United States, a model that appeals to many economists, some with

Ph.Ds from American universities, who promote U.S. policies as the answer to the problems of the EU or Japan. I shall call the contrasts the high road and the low road. Figure 2.1 shows the policy mixes and the resulting wellbeing we see on the high road. What I have not already covered above is elaborated in my book (2002), which demonstrates the connections pictured in that figure.

[figure 2.1 here]

So let us focus instead on the U.S. as emblematic of the low road. Again, the American model is roughly matched by another five of 19 rich democracies. Although these countries did worse or about the same as more consensual democracies in their economic performance for over a quarter century, when the low-road strategy in the U.S. was fully developed in the early 1980s, the subsequent 20 years produced very good economic indicators in some periods, putting it above the average EU-15 performance (see Table 12.5 above). For example, during Clinton's best years, 1995-2001, U.S. real growth in GDP averaged 3.6 percent per year. The figure for the EU was 2.1 percent. U.S. unemployment fell below five percent; EU unemployment rose above 10 percent. (Ferguson, 2003.) (Although Clinton's eight years were unusual in both policy and performance, the low-road had been fully followed throughout the 1980s and after 2001.)

The advocates of a low-road stategy call it "flexibility" and "deregulation of labor markets." Its critics call it a "labor crunch" strategy. There are 13 interrelated dimensions of the American version we can summarize briefly. Only two are so extreme that we can say they are uniquely American; they are marked by an asterisk. They are all interdependent.

1. Decreasing power of labor unions. This is not a universal pattern. Union decline is fastest and most in the United States, France, and Japan, with union density in a few countries increasing and some stabilizing or declining only slightly. Seven of 12 compared ended in 1990 with the same or higher density than in 1950. Scandinavian countries evidenced substantial increases (2002, p.127 n2).
2. Relatively high man-days lost in strikes. Generally confrontational labor relations at the workplace and beyond. Although strike rates have been converging downward among our 19 countries, corporatist democracies remain relatively low. (If it is every union, every employer for himself, if the legal and political climate is hostile to unions, strikes will be one of many expression of labor protest; in contrast, coordinated bargaining shifts industrial conflict to the political arena where more centralized accomodations are reached. The exceptions to this rule are three democracies with a strong legacy of Communist Party domination of labor federations - - Italy, France, Finland. They have maintained higher strike rates than others.)
3. Low and stagnant wages in the bottom third to half of the income distribution. Problems of moving people out of poverty through work are complicated by a low-wage structure. Thus, the working poor are a large part of the poverty population in the U.S.
4. Intensive use of low-skilled workers and the least-educated workers in large, rapidly growing sectors (e.g. retail trades). A rapid growth of the contingent labor supply, (part-time, temporary, or subcontracted workers), a general trend in all rich democracies that is most developed on the low-road. A

related trend is the rise of unconventional schedules (non standard days of work and hours of work) with negative effects on family life and health (Presser, 2003).

5. A widening spread between high-wage, high-skilled workers and the least educated. This is the result of several other trends: deunionization; the neglect of K-12 schooling (the U.S. remains outstanding in the excellence, diversity, and expanded opportunity of its higher education but has virtually abandoned academic standards in all but upper-middle-class primary and secondary schools); the absence of an active labor-market policy; lack of a family policy to cushion the shock of family breakup and help all working parents to cope better with demands of work and family and assure the care and cognitive development of children.
6. Meagre investment in both physical infrastructure and human capital for all but about one-fifth of the labor force who are college-educated upper-middle class.
7. Decreasing job security for most of the labor force.
8. A welfare state that is below-average in spending (GNP share) and with the exception of pensions is inefficient and ineffective. The U.S. is the only rich democracy without national health insurance. Its health care (non)system is about 60 percent private, 40 percent public, spends about 15 percent of GDP, and yields a below-average national health performance (2002 ch.16). It is unique. In its large, intrusive apparatus of investigation and surveillance of the nonworking poor who receive means-tested benefits, the U.S. shares its approach with Britain and Britain abroad. But the U.S. tops them all, with the

UK and Canada a close second or third. (2002, ch. 8 on the welfare mess and table 8.3.) Its approach to labor-market policies is passive: for the disabled, little rehabilitation; for the unemployed, cash but no serious investment in training or the dozen other policies that improve the efficiency of the labor market and the quality of labor (no ALMP).

9. *Greater concentration of wealth, increasing poverty and inequality, family breakup without family policies to cushion the shock, and associated mayhem (high murder rates and correlated violent crime).[9] In the U.S., which scores highest on all of these, one result is by far the highest incarceration rate among 19 rich democracies. This a major reason for the low rate of reported unemployment in the U.S. Western and Beckett (1999) show that America's high incarceration rate combined with a high recidivism rate lowers the conventional unemployment rate by hiding joblessness. Using their careful measures for 1995 for 14 of our rich democracies, U.S. unemployment would increase by 1.9 percent while European unemployment would rise only infinitesimally if all these countries included prison inmates in the jobless figures. They argue that long prison terms, now the standard in the U.S., escalating violence and overcrowdedness reduce the long-term employability of inmates. Thus the U.S. will have to continue to advance its incarceration rate if it is to sustain its two percentage point advantage

[9] In 2002 ch.14 I show that across time and geographical areas and under modern conditions, the combination of poverty and inequality (i.e great absolute and/or relative economic deprivation) and family breakup without a family policy in the context of crowded urban living conditions powerfully and consistently explain homicide rates. This holds even if we eliminate the U.S., which is extreme in its mayhem and murder. No one of these works alone, all interact to explain the variance across countries or even across states within the U.S. A broader measure of Mayhem evidences the same causes.

(economic policies equal) - - a bizarre road to good labor-market performance.

10 *<u>Very high military spending, which subverts both social spending and civilian R&D.</u> While the destruction and total mobilization of World War II brought an ideology of shared sacrifice, the spread of social rights and benefits, and the reduction of unemployment, the Cold War and small wars of 1951-73 subverted both the welfare state and economic progress. This was especially true of the welfare-state laggards or middling spenders that launched a military effort of well beyond six or seven percent of their GNP in the early 1950s -- United States, U.K., and Canada, countries located at or near the center of pacts and alliances. The effect was to retard both social spending and GDP growth and to increase unemployment in subsequent years (Wilensky,1975, pp. 78, 84). The economic explanation: A heavy military burden diverts skilled workers and managers and scarce funds away from more productive investment and employment and thereby slows down economic growth and worsens unemployment. Budget deficits in the absence of productive uses of the borrowed money may be an additional drag. (<u>Ibid</u>., pp. 74-85.)

Two findings emerge from our multivariate analysis. First, in regressions including corporatism, leftism, Catholicism, and military spending as independent variables, <u>the military effort (military spending/GNP) from 1960 to 1986 is consistently and strongly a drag on capital investment</u>. This relationship remains strong even when Israel and the United States and Japan are removed from the equation as extreme cases (Japan very high capital investment, very low military; United States second in military, very low capital investment; Israel first in military, missing data on capital investment).

Second, that advantage in investment enjoyed by countries with a small military burden gives them a clear edge in economic performance, notably by increasing growth. The military impact is entirely rooted in the negative correlation with economic growth. Using time series and comparing the multiplier effects of military and non-military government spending, recent research on the United States also provides strong evidence that military spending has an indirect, delayed impact: by reducing investment it is a drag on economic growth (Mintz and Huang 1991; and Ward and Davis 1992) -- consistent with our 19-country analysis. These findings apply to Bush’s little war in Iraq as well; it may be one factor in U.S. anemic recovery 2001-2003.

Regarding R&D: on the basis of a review of literature and my limited 6-country analysis (pp. 462-465), we can say that despite some positive technological spinoffs from military R&D (radar, jet engines), military R&D is much less productive than civilian R&D and the U.S., which leads in military, has fallen behind in civilian. Another tradeoff - - a long run cost of adopting the role of the world’s only superpower.

11. Intrusive and ineffective regulations. My analysis of the environment (2002, ch.15), violence (ch.14), and health care (ch.16) shows how national regulatory regimes differ as they confront similar risks - - health and safety, nuclear energy, smoking, and air pollution. Both public policies and performance vary markedly by type of political economy. As the EU attempts to write rules in these areas it might look at these contrasting records of the past half century. For instance, consider health-care in the U.S.. In spending it is 60% private and 40% public (pp. 595-596, 612-613). The larger the private share, the more decentralized and diffuse the financing, and consequently the greater the administrative cost and waste (p. 629) and

corruption (pp.. 613-614). It was the anti-regulation Reagan and Bush I administrations that adoped the most intrusive regulations of hospital and physician payments such as rate-setting, prospective payment plans based on diagnostic-related groups and resource-based value scales (ch. 16, especially, p. 597ff.). The net effect: increase administrative complexity and costs; enrage physicians; and shift costs to private insurers, who then raised premiums and gave employers and providers strong incentives to reduce coverage and services (pp. 611-614). Similiarly, consider British PM Thatcher, a dedicated deregulator/privatizer. The 17-year trend she completed in the name of free and fair competition, was more complete and comprehensive, more juridified and codified, more bureaucratic and confrontational and less consensual than it was before. To cope with the process and consequences, the Thatcher government had to create 11 major new independent regulatory agencies (PM Major added one), some of them sharing power with the ministries. "Liberalization" required a proliferation of rules and a boom in lawyers and accountants to keep track of it at all. The government , of course, had to set the rules governing market competition but also to cultivate new entrants, prevent or respond to financial scandals that frighten politicians, raise revenue (but, God forbid, not taxes), and even to protect workers and consumers when they scream too much about the dangers of free-swinging competition to quality, safety, health, employment and job security (Vogel, 1996, chs. 5 and 10).

Finally, systematic comparison of regulatory reform of industry in the 1980s and early 1990s in telecommunications, financial services, broadcasting, transport, and utilities in Britain, Japan, the U.S., France, and Germany shows that the common embrace of deregulation as a good idea belies the action. Ideology and practice were poles apart. What actually happened was contrasting mixes of reregulation and liberalization shaped by national institutions (Vogel, 1996)--a book entitled Freer Markets, More Rules). My book shows the same outcomes for all policy areas. Regarding effectiveness of regulations, the more consensual democracies have a clear advantage in implementing laws and executive orders. If industry, labor and the professions are involved in making and executing the laws, no party fights to the death to subvert them, exaggerate their negative effects, or evade them, as they routinely do in the more confrontational system of the U.S.

12. Long hours of work. Annual hours in all rich democracies declined steadily from the late 19th century to about 1960. Then a hint of divergence appears when, of 11 countries for which we had OECD data 1960-1994 for manufacturing, all but the U.S. and Canada continued substantial declines in annual hours [10] The average drop in annual hours for the four hardest working countries is 16.3%; the average drop for the leisured five is 21.5% (Germany dropped 27%). In other words, the leisure-rich countries are becoming richer; the leisure-poor countries are becoming relatively poorer. The best explanation for these differences in labor-market policies is the power of labor unions and left parties to trade lower hours and other benefits for industrial peace, wage restraint, and pro-employer tax benefits through corporatist bargaining arrangements. Many scholars argue that longer hours countries have an economic advantage and at some extreme - - U.S. and Japan (almost 2000 hours) vs. Germany (1541 hours) - - that may be true. The more you work the more widgets you produce. The puzzle, however, is how have the

[10] The top six in hours in 1994 are USA (1994 hours), Japan (1960 hours), Canada (1898), the UK (1824), Italy (1804), and France (1638). Except for Italy, five of the six are decentralized fragmented political economies with little left-labor power or they are corporatist without labor (Japan, France). The bottom five - - least working hours - - are democratic corporatist: Norway (1549), Germany (1541), Denmark (1573), the Netherlands (1599), and Sweden (1627).

leisure-rich foks done so well for so long despite their short hours. Could it be that they are working smarter and this is another tradeoff?

13.Good job creation. This requires separate analysis because job creation is unrelated to my economic performance index or its components. In fact, the great job-creation machines are often the great unemployment machines. In 2002, ch.13, I show that the consistent big job creators among 18 countries, 1968-1987, are Canada, Australia, the U.S., and Norway. New Zealand makes it to the top 1968-1979, but not in the 1980s. The four countries consistently below the median are France, West Germany, Austria, and Great Britain. In explaining such differences I made two assumptions: First, current discussion of job creation in the United States vs. Europe overemphasizes demand policies and (presumably European) barriers to labor mobility. If job creation is a product of demand policies and is an end in itself, policy analysts should be concentrating their attention on an appropriate mix of fiscal and monetary policies. But if job creation is little affected by economic policy and comes at too high a cost (earnings deterioration, low investment in training, low quality products and services, declines in union voice and worker participation, anemic long-term productivity gains and a concomitant stagnation in national standards of living), then a very different strategy for reshaping the supply and quality of labor is appropriate -- an active labor market policy (see 2002, Figure 2.2), an education policy (chapter 12), a family policy (chapter 7), and labor law reform (chapter 18). Of course it is likely that both economic and labor-market policies contribute to job creation; it is a matter of emphasis.

Second, I assumed that in every country where there is an expanding labor supply, it is possible that counter-cyclical demand policies help to turn the supply into jobs. Data on precise policy mixes for the 18 rich democracies over time are, however, skimpy. Yet it is very likely that when they are compared, their fiscal and monetary policies will not vary nearly as much as their employment growth rates. Similar economic policies cannot explain large differences in job creation. In fact, it is variation in the growth and social composition of the labor supply that accounts for recent national differences in job creation.

Here is the bare outline of the results of my regression analysis by relevant period of the job-creation record of these 18 rich democracies. The most powerful structural sources of job creation are demographic and social structural: the age structure of the population; net migration (roughly immigrants minus emigrants); family breakup (e.g.divorce rates) in the absence of a family policy; and the rate of increase in women's labor-force participation. A country that has a large fraction of people 65+ will not need to create as many jobs as the "young" countries. The top job creators have a low percentage of the aged. A supply of cheap labor comes from young people, many immigrants (most of whom are also young), a rapid rate of increase in the female labor supply, and women heading broken homes pressed to the wall. All of that adds up to low-cost labor. Top job creators score high on all of these. In many industries employers confronted with an abundance of young, cheap labor will organize work to facilitate their use. Conversely, if a country has an abundance of older retired adults and mature high-seniority workers, and a shortage of cheap labor because of a family policy that makes divorced women of any age less desperate, a low rate of increase of women workers of any age, and few low-skilled immigrants, it

> will not create so many jobs and might even move toward high value-added products.
>
> In short, most of the sources of job creation - - changes in family structure, age structure, and immigration - - are beyond the reach of economic policy, except those policies that would directly discourage low-wage work, such as a strongly enforced high minimum wage and a Berlin Wall for every border.

The final message is that the gains and costs of a low-road strategy are very different from the gains and costs of a high-road strategy. Either one can at various times and places result in good economic performance. The choice is a matter of one's values.

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TABLE 12.7 Types of political economy, recent growth in labor productivity and real compensation, and household income inequality

	Labor productivity growth, 1979-96 (%)[b]		Real compensation growth / year, 1989-96 (%)[c]		Household disposable income inequality (90/10 ratio), circa 1990[d]	
Left Corporatist[a]						
Sweden	2.0	(8)	0.8	(8)	2.78	(17)
Norway	1.8	(10)	1.4	(4)	2.80	(15)
Finland	3.6	(2)	2.3	(1)	2.75	(18)
Denmark	2.1	(6)	1.6	(3)	2.86	(14)
cell avg.	2.4		1 5		2.80	
Left-Catholic Corporatist						
Netherlands	1.6	(12)	0.4	(15)	3 05	(13)
Belgium	2 0	(8)	1.7	(2)	2.79	(16)
Austria	2.3	(3)	1.3	(6)	3.34	(10)
cell avg.	2.0		1.1		3.06	
Catholic Corporatist						
Italy	2 1	(6)	0.7	(9)	3.14	(12)
(West) Germany	1.1	(15)	-0 1	(17)	3 21	(11)
cell avg.	1 6		0.3		3.18	
Corporatist Without Labor						
France	2.2	(4)	1 1	(7)	3.48	(7)
Japan	2.2	(4)	0 7	(9)	4.17	(5)
Switzerland	0.4	(18)	0 7	(9)	3.43	(9)
cell avg	1 6		0.8		3.69	
Least Corporatist						
United States	0 8	(17)	0.1	(16)	5.78	(1)
United Kingdom	1.8	(10)	0.5	(13)	4 67	(2)
New Zealand	1.3	(13)	-0.8	(18)	3.46	(8)
Australia	1.3	(13)	0.6	(12)	4.30	(3)
Canada	1.0	(16)	0.5	(13)	3.90	(6)
Ireland	3 9	(1)	1.4	(4)	4.18	(4)
cell avg	1.7		0 4		4.38	
18 country avg	1.9		0.8		3.6	

[a]Israel missing

[b]Business sector average percent increase per year. Source: OECD data in Mishel, Bernstein, and Schmitt (1999), table 8.4 The Irish exception is discussed in chapter 2.

[c]Compensation per employee in business sector. Growth rate for West Germany, 1979–91; unified Germany, 1992–96 Source: OECD data analyzed by *ibid*, table 8 5.

[d]Source: Gottschalk and Smeeding (1997), figure 2. Post-tax and transfer income adjusted by household size based on real income (1991 U S. dollars) as percentage of national median. The 10th percentile receives a higher income than 10% of the population.

TABLE 12.5 THE INTERACTION OF CORPORATISM, VULNERABILITY TO ENERGY SHOCKS, WELFARE EFFORT, AND ECONOMIC PERFORMANCE, 1950 TO 1989

High Vulnerability to Energy Shocks, 1970

Corporatist without Labor: Lean Spenders

	Econ Perf Index 1950–74	1965–74	1974–79	1980–84	1985–89
Japan	4	4	6	6	6
Switzerland	4	3	4	5	5
Averages	4.0	3.6	5.0	5.5	5.5

Corporatist Big Spenders

	Econ Perf Index 1950–74	1965–74	1974–79	1980–84	1985–89
Sweden	4	3	3	4	3
Finland	4	3	[illegible]	4	3
Belgium	4	5	3	3	4
Denmark	3	2	2	2	2
Italy	3	2	1	1	2
Averages	3.6	3.0	2.2	2.8	2.8

Low to Medium Vulnerability to Energy Shocks, 1970

Corporatist without Labor; Big Spender

	Econ Perf Index 1950–74	1965–74	1974–79	1980–84	1985–89
France	3	5	4	1	2
Averages	3.0	5.0	4.0	1.0	2.0

Corporatist Big Spenders**

	Econ Perf Index 1950–74	1965–74	1974–79	1980–84	1985–89
W Germany	5	4	5	4	4
Norway*	4	3	6	5	3
Austria	4	6	6	5	5
Netherlands*	4	3	4	2	2
Israel	2	2	1	–	–
Averages	3.8	3.6	4.4	4.0	3.5

Least Corporatist Lean Spenders

	Econ Perf Index 1950–74	1965–74	1974–79	1980–84	1985–89
New Zealand	3	3	2	3	1
Australia*	3	3	1	3	2
United States*	2	2	2	4	4
Canada*	2	3	2	1	2
United Kingdom*	2	1	1	1	2
Ireland	1	1	2	1	3
Averages	2.2	2.2	1.7	2.2	2.3

**Germany a marginal case of corporatism, Israel a lean spender

*Least vulnerable to energy shocks

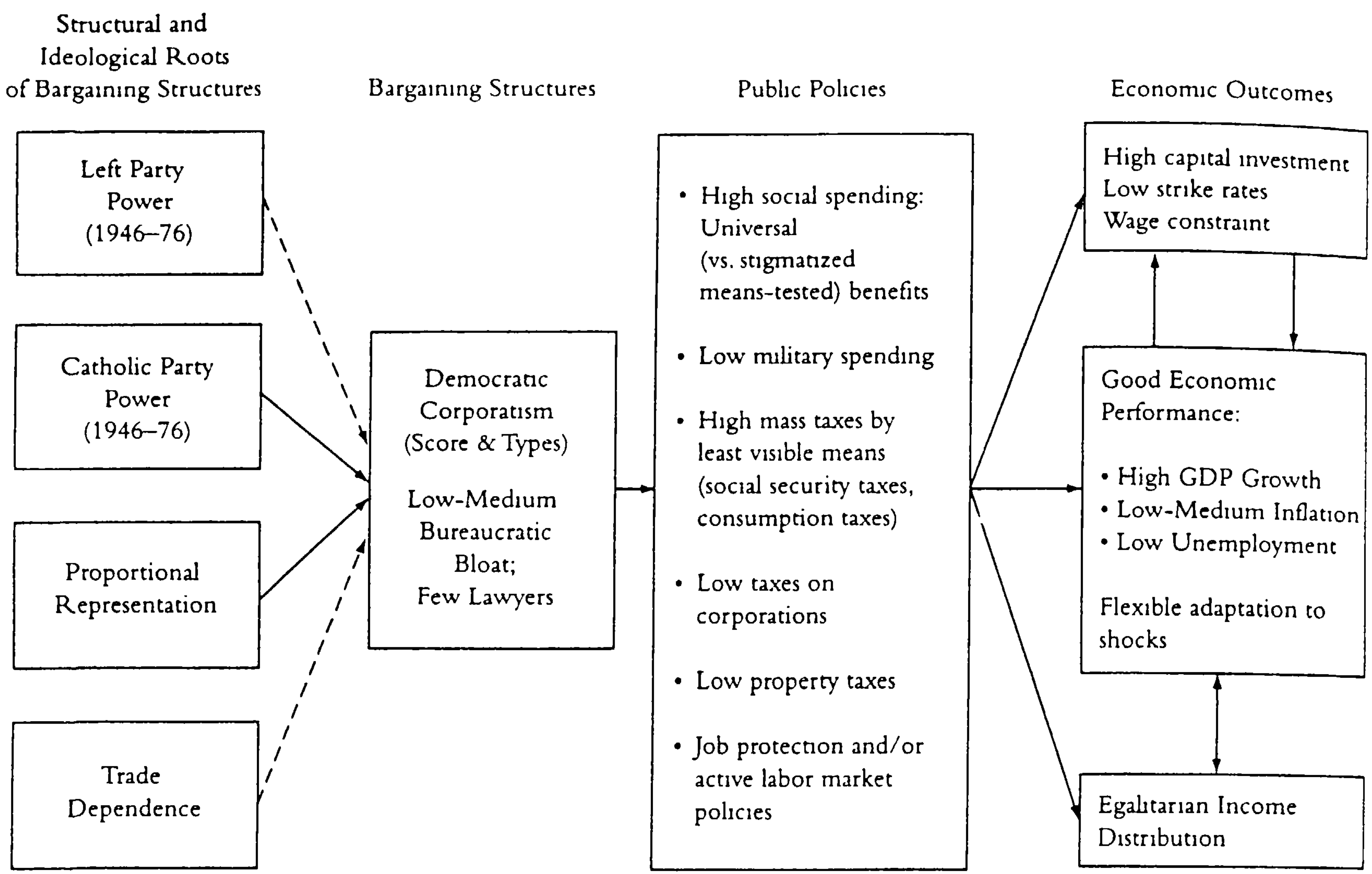
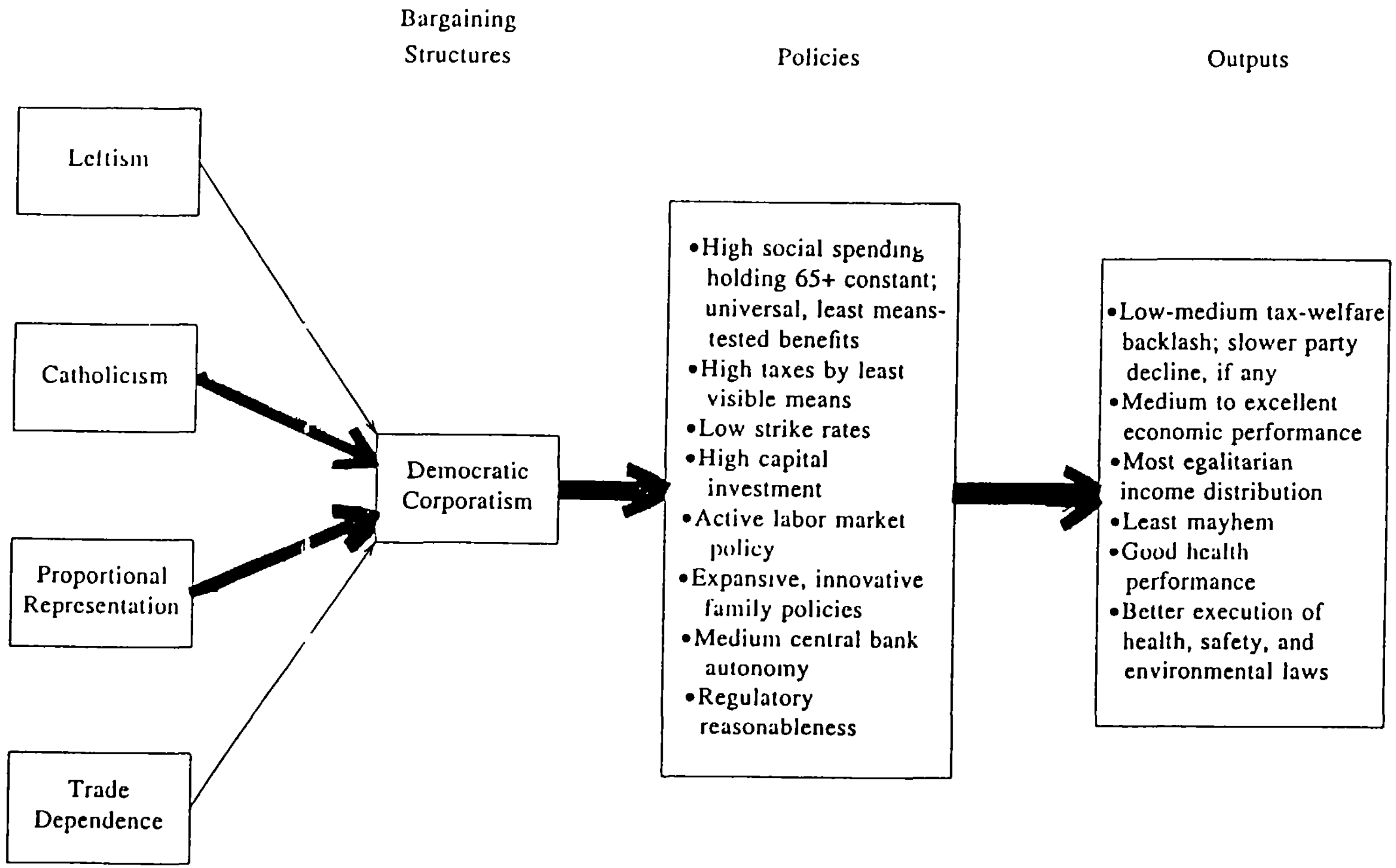


Figure 12.1. Causal model for regression analyses of the major sources of economic performance, nineteen rich democracies

FIGURE 2.1: MODEL EXPLAINING PERFORMANCE AMONG 19 RICH DEMOCRACIES INCLUDING ECONOMIC PERFORMANCE



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