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PART I

OVERVIEW

CHAPTER 1

Enduring Issues

THIS BOOK INTERPRETS A NEARLY GLOBAL HISTORY OF social spending up through the year 2020, drawing lessons for the years up to 2050. In the long history covered here, what most enriches the record has been harvested within the last twenty years – twenty years of experience, and twenty years of accelerating scholarship.[1] The new knowledge extends far beyond the usual tales of the North Atlantic community, inviting new interpretive forays into Latin America, East Asia, and the formerly communist Eastern Europe.[2] While much of the best evidence is recent, the underlying social issues have endured for millennia.

ALWAYS NEEDED, JUST NOW ARRIVED

Human societies have always needed safety nets to catch those who end up in need, whether by unlucky endowments, by past mistakes, or by the arrival of hard times. The risks are not new. They have always been there. Yet for most of human history, we have lacked the means, or the political will, to prevent or cushion them.

With each wave of expansion in the economic base, humans did what little they could to cut risk at the local level, yet serious risks remained. Prehistoric fortunes were never stabilized by hunting and gathering. The arrival of agriculture tens of thousands of years ago initially helped to diversify humanity's economic portfolio, yet brought new vulnerabilities to weather and pests once it had expanded. More recently, as the spread of commerce diversified our sources of supply and allowed a further expansion of population, our risks were reduced a bit further, though they remained. Still more recently – in a mere blink of an eye lasting less than three hundred years – industrialization and the ever-growing reliance on skilled services once again cut our risks somewhat yet have not eliminated them. Our world is risky, but not increasingly so.

A common error in the way we view history, and the way it is taught in school, is to believe that an unprecedented economic insecurity was ushered in by the Industrial Revolution and by the rise of a new greedy market mentality around 1750. Marx and Engels said so. The gentler reformists of the Fabian Society agreed that the age of dark satanic mills brought new urgency to finding ways of providing social insurance and social assistance to the needy. Karl Polanyi's *The Great Transformation* (1944) agreed. While their landmark writings contained great insights, they were mistaken in believing that the industrial era and the rise of a market mentality brought a transformational rise of risk and a brand-new need for social security. The risks were at least as great before the Industrial Revolution. As for the rise of a market mentality, it did not happen. There was no modern dawn of market exchange, nor of self-interest, nor of "greed," because all of these are at least as old as the human species itself.

The risk of mortality, even more than economic risk, has also been dropping over the centuries. There has been a great convergence in human life spans, thanks mainly to the elimination of death from childbirth and infant mortality. In the 2020s, people will naturally share the fear that our vulnerability to mortality shocks is greater than ever, as witnessed by the coronavirus pandemic. Not so. Horrible as it is, the latest pandemic will not match the introduction of smallpox and malaria into the Western Hemisphere, which killed a majority of its population. The Black Death of the fourteenth century killed perhaps a quarter or half of the European population, which the coronavirus will not do. And Chinese history recorded frequent epidemics stretching back at least three thousand years. Life has always been filled with risks as least as great as those we face today, underlining the point that our need for safety nets was at least as great in the past.

Given that humanity's exposure to risks seems eternal, it is puzzling that societies have only very recently built effective safety nets for containing such risks.

Defining Some Terms

- **Social spending** in this book will usually refer to public (tax-based) spending on:
  - education,
  - old-age support,
  - incapacity and disability,
  - health care and health insurance,
  - family assistance,
  - labor-market assistance (retraining, unemployment compensation, etc.), and
  - housing.

In practice, the official measures of social spending only partially cover tax breaks, sector subsidies, public infrastructure, etc., which could arguably be included in the definition if there had been sufficient data coverage of these transfers. The tax breaks and sector subsidies excluded here (e.g. subsidies to the energy sector or the agricultural sector) are often more pro-rich than the social spending covered in this book.

Social spending here excludes private social spending aimed at the same targets, even when the private spending is mandated by government. To be sure, private social spending can make important contributions toward a host of social goals. But the real controversies center on the government's increasingly dominant role, and this book will stay focused accordingly.

- **Safety nets** are society's many supports to keep people from falling too low economically. They consist of both **social assistance** expenditures for those whose needs may be life-long, and **social insurance** expenditures for cushioning temporary falls. In this book, the term "safety nets" is thus broader than just social assistance for the poorest, or "welfare." It covers all of the egalitarian uplift provided by social spending, both short-

(cont.)

run and long-run. Basically, safety nets are what social spending is for.

- **Selfish generations**: The book will use the convenient shorthand *Selfish Generations* borrowed from David Thomson's (1996) fine book on how New Zealand governments had redistributed resources between age groups.

  The **selfish** is a shorthand for "advantaged by inter-generational redistribution." The advantaged "selfish" ones are not the whole generation, but just those of its members who have political voice. In many cases, the selfish generation's poor were not helped. To further clarify, a **generation** in this phrase and in Thomson's book refers to an age group, as in the common parlance about "the older generation" or "the younger generation." It does not strictly refer to a birth cohort, as a demographer might prefer.

BASIC QUESTIONS

The recent global surge of government social spending, after millennia without it, poses some natural questions, each of which is pursued in this book.

(1) Why did social spending arrive so late in human history?
(2) Why has Northwest Europe always led the way?
(3) Did the task of providing safety nets to cushion us against life's many risks really have to fall to government, instead of to private charity and the extended family?
(4) How does a large tax-based social budget affect our livelihoods over our life spans?
(5) For any given size of the government social budget, which countries have been spending it on the wrong things?
(6) What threatens social programs between now and mid-century?

To lighten the burden of carrying so many questions at once into the coming chapters, I will offer two immediate spoiler alerts:

- The answer to the third question is yes. Yes, safety nets had to be administered mainly by government. Private charity and family supports have never been up to the tasks of eliminating poverty or educating the whole population. The forces behind government social programs came together only in the last two hundred years, with almost all their advance coming in the last sixty years. Government social spending has now become worldwide, absorbing around 10 percent of world product.
- A partial answer to the fifth question: The tendency to get the mix wrong is as great among the world's low-spending governments as it is among those who spend more. Thus, the fourth and fifth questions can be studied separately.

A striking pattern will also emerge as to which countries got social spending wrong, either at low levels or at high levels: The clearest mistakes are myopic ones. The errors have tended to be errors of "selfish generations," in which those in office have deprived future generations by appeasing those whose lobbying power is here and now.

AS CONTROVERSIAL AS EVER

The fourth question, whether large "welfare-state" social budgets are better or worse for incomes and wellbeing than smaller budgets, has always been the main fight. The combatants in the debate over the size of social budgets need introductions here, deferring the final verdict until a preview in Chapter 2 and a fuller empirical update in Chapters 8 and 9.

To report on the battle between small-government free-market capitalism and the tax-based social spending, recently dubbed the war between "cutthroat" and "cuddly" capitalism,[3] let us begin by reviewing the classic arguments over the economic effects of social spending versus an imagined free-market alternative. The debate has raged for at least eight centuries. The words have changed, but the opposing positions have not.

TRADITIONAL ARGUMENTS AGAINST GOVERNMENT SOCIAL SPENDING. Each side of the debate sends a respectable signal along with ideological noise. To pick up the signal worth hearing in the critiques of social spending, one must first mute out the noisy demonizing images of welfare queens, welfare bums, and bureaucrats, and the sneers about a nanny state.

For centuries now, the core argument against tax-based social spending, or all civilian government spending, has warned of perverse incentives. The incentive argument has economic plausibility and deserves careful testing. Basically, if the government taxes the incomes or wealth of productive people and gives the money to less productive people in need, the incentives work badly on both sides. The productive lose the incentive to produce, or innovate, or take risks. The less productive are rewarded for being in a bad state, and are likely to respond by staying longer in that bad state and not producing.

The incentives critique has been leveled at all four main forms of social spending – anti-poverty "welfare," public pensions, public health, and public education, in roughly that order of emphasis. The archetypal prediction, since the twelfth century or earlier, is that welfare spending will kill the work incentive. Public pensions are faulted for crowding out private savings, and for killing the work incentive by inviting earlier retirement. Public subsidies to health-care provision or health insurance may have subtler incentive problems referred to as "moral hazard": inviting people to adopt lifestyles with greater health risk or to see the doctor too often, and inviting doctors and hospitals to overcharge. The case against public education is the most muted: Paying for public schools, but not for private schools, may make parents accept lower-quality education and may lower the public schools' incentives to become more efficient.

All of these respectable criticisms deserve careful testing.

TRADITIONAL ARGUMENTS FOR GOVERNMENT SOCIAL SPENDING. The respectable signals in favor of social spending have also had to contend with ideological noise from advocates of greater public assistance. The noise includes demonizing images of greedy and insensitive billionaires, robber barons, and corporations. "Privatization" is used as a pejorative, defined as handing the people's public assets over to the fat cats.

The respectable signals strike notes that are replayed in today's economics textbooks. For basic welfare spending – that is, assistance to poor families and unemployment compensation, the incentives critique is not rejected altogether. Rather, it is rebutted by denying that poor people lost work by choice, or that working more is a valid option without government help.

Public pensions help to smooth consumption over the life cycle, and can insure people against a bad consequence of something good: outliving the wealth they had saved up for retirement. As for the familiar criticism that people should self-save and purchase private old-age insurance, proponents of public pensions counter that people, especially poor people, often save little for the future because shorter-run needs look larger to them, and they cannot borrow at reasonable rates of interest. As for the argument that people could be forced to save in the form of government-mandated paycheck deductions, we return to its complexities in Chapter 13.

Public health care and public health insurance are defended largely on grounds of positive externalities, or spillovers. For example, as a taxpayer, I should help to pay for your vaccinations and good health, lest you pass on infections and over-use my hospital's emergency room. Believers in tax-based health insurance deny that there is much moral hazard, claiming that people do not take big health risks just because taxpayers will cover some or all of their out-of-pocket costs. The alternative of leaving all health insurance to the private marketplace is rejected on the grounds that voluntary private health insurance leads to a "death spiral": The insurers want to cover only those with lower health risks than the premiums will cover; so the insurance will be bought only by those who know they are likely to have health problems, not by healthier individuals; this adverse selection threatens the insurers with higher costs, which they then try to cover by charging still-higher premiums; so even more healthy people drop the insurance; and the cycle repeats, crippling the market for private health insurance.

The argument for public education also rests on a belief in positive externalities, in this case from the knowledge and civic responsibility that schools are supposed to instill. The benefits from a child's education are not captured only by the child and the child's family. All of society benefits from the knowledge, therefore all of society should help pay for it with taxes.

WHY THE CONTROVERSY ENDURES. If the debate is so ancient, why does it persist? A partial excuse is that it takes a lot of effort to dig out the facts, and to run convincing tests. Fortunately, an accelerating volume of economic studies has been delivering the necessary effort, as summarized in the chapters that follow.

More fundamentally, the conflict of self-interests is what generates controversy forever. Any solid research finding can be challenged by those whose self-interest it seems to threaten. Nonetheless, as has been argued several years ago,

> new facts can raise the level of the debate. They can arm all sides with an awareness of how tax-based social spending would affect collective goods that all profess to care about – social peace and the size of the economy. The competitiveness of the intellectual marketplace, and of the political marketplace in electoral democracies, allows new facts to exert pressure toward these collective goods. At the very least, new facts can speed up society's rejection of bad arguments.[4]

Eventually, despite the noise, true signals do come through, and far-sighted societies heed them.

CHAPTER 2

Findings and Lessons

SO WHAT DO WE NOW KNOW ABOUT THE ROLE OF SOCIAL spending in the economy and society? This chapter summarizes ten main findings supported by global experience and fresh research in the early twenty-first century. Documenting these findings yields three clear policy lessons, and an international scorecard on the far-sightedness or myopia of different countries' approaches to social spending.

TEN MAIN FINDINGS

Finding #1. A country's government social spending takes off only after the country has both the fiscal capacity and the political will to build safety nets. This is why the world had only negligible social spending before 1800, and why it emerged first in Northwest Europe after that.

The main reasons why social spending has spread all over the world is the mirror image of what prevented social spending outside of Europe before the last century: Having the government spend on the poor, the sick, the elderly, and school children requires fiscal capacity plus political pressure from below (Chapters 3 and 4).

Within the last sixty years, government social spending has grown to absorb more than a quarter of GDP in over a dozen countries, mainly in Europe. The demand for such tax-based programs was raised by