Chapter I: Introduction

I.A. Preface/Overview

Democracy and capitalism distribute political and economic resources differently. Therefore, when democratically elected politicians form governments to make economic policy in capitalist economies, they will not usually make economically efficient tradeoffs between competing concerns. Thus, when postwar governments in each of the developed democracies\(^1\) committed themselves to political provision of social insurance and pensions, public goods, and macroeconomic management, their evolving over-commitment or, more exactly, inefficiently managed commitment to this postwar settlement on Keynesian Welfare State (KWS) policies was predictable. Indeed, from the fifties through the eighties, the GDP share of transfer payments more than quadrupled in some countries, public indebtedness surpassed GDP in some others, and macroeconomic (fiscal and monetary) policy grew increasingly inaccessible and/or ineffective, politically in most countries and economically in some. Add concurrent worsening of macroeconomic performance, blame for which many attributed to these expanding KWS commitments, and the recently rising public dissatisfaction with democratic management of the economy is wholly comprehensible (if not necessarily fully justified).

However, not every developed democracy amassed large public debts; some retained greater macroeconomic-policy maneuverability than others; and transfer-payment burdens merely grew in some but exploded in others. Therefore, no general tension between distributions of economic and

\(^1\) *Developed democracies*, here and throughout, are the relatively wealthy, capitalist, and democratic countries: the United States, Japan, (West) Germany, France, Italy, the United Kingdom, Canada, Austria, Belgium, Denmark, Finland, Greece (excluding an autocratic period in the late sixties and early seventies), Ireland, the Netherlands, Norway, Portugal and Spain (since the late seventies), Sweden, Switzerland, Australia, and New Zealand. More substantively, the arguments considered in this book typically presuppose relatively free-market capitalism and relatively liberal democracy to be widely undisputed across the population. The theoretically important aspect of that presupposition is that political-economic actors do not seriously consider continued democracy or free-market capitalism themselves to be at risk depending on their actions. *Developed democracies* are occasionally abbreviated as the *OECD* because they are the prominent membership of that organization, but that is merely a convenient empirical (not theoretical) grouping.
political influence suffices to explain the evolution of the KWS in capitalist democracies, and such tensions alone would poorly guide any analysis of the prospects for its continued maintenance and utility. This book develops a theory of comparative, democratic macro-political-economy, i.e., of macroeconomic policymaking and outcomes in democracy, that begins with such universal tensions between the distributions of economic (e.g., money) and political (e.g., votes) resources, but argues that the differing structures of interests and of political and economic institutions across capitalist democracies, and multiple interactions between and among these structures and institutions, create differing incentives for policymakers to respond to these common pressures even when facing similar economic challenges. Thus, common democratic pressures and shared exposure to global economic challenges produce varying policymaker responses, resulting in differing inefficiencies in the management of the KWS, in different democracies at different times.

This theory of political economy evolved from three separate projects, one exploring transfer-payments growth (Chapter II), another analyzing public-debt determination (Chapter III), and a third considering the interactions of the structures and institutions of monetary policymaking with those of wage-price bargaining in the regulation of inflation and unemployment (Chapter IV). One benefit of these origins that each chapter maintains is its self-containment as a study of the democratic management of its dependent variables. Together, however, these studies develop a framework for the analysis of macroeconomic policymaking in capitalist democracies in general and the evolution of redistributive systems, public indebtedness, and monetary-policy and wage-price bargaining in particular. That theoretical framework organizes the book’s comparative, historical analysis of the growth and retrenchment of the KWS as democratic governments sought to fulfill their commitments and to maintain or rebuild the broad political coalitions behind them.

The comparative, historical tale begins with democratic governments’ postwar commitments
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to social insurance, welfare, and public pensions. When economies were growing at paces typical of the early postwar period, these commitments remained relatively inexpensive, but, with stagflation in the seventies, continuing stagnation through the eighties, and aging populations throughout the period, the costs of redistributive generosity rose everywhere until at least the early nineties, and so further expansion of transfer systems became politically and economically problematic.

Thus, much of the postwar growth in transfers has largely economic, and common, origins, reflecting the rising costs of past political commitments. (Of course, these past commitments and how well different countries held to them will also require explanation.) However, transfers also rose most swiftly where, e.g., political institutions fostered greater political (e.g., voter) participation. As Chapter II more fully explains, economic inequality, specifically the gap from the median voter’s to average income, drives democratic demand for redistribution. However, since electoral participation correlates positively with relative income, the gap between the median voter’s and mean person’s income is typically larger at higher aggregate participation rates for any given gap between median and mean person’s income. Therefore, the effective democratic demand for broad redistribution is larger in more participatory democracies at any given degree of inequality in the population, and governments in those countries accordingly increased transfers more over this period. I.e., common political pressures and economic challenges, processed through differing institutional structures, elicited differing degrees of transfers expansion from different democratic governments.

This common growth, at varying rates, in transfers (variably) drove growth in government more generally among developed democracies in the postwar era. The general growth of government involvement in the economy, in turn, fueled public-debt growth since the seventies. Basic economics also mostly explains the commonalities in public-debt developments. Prior to the seventies, strong macroeconomic performance produced steadily and rapidly increasing tax bases, which allowed
democratic governments to expand public involvement in the economy and reduce debt-to-GDP ratios simultaneously. However, high unemployment and slow growth in the seventies, given the KWS commitments, produced simultaneous government-spending increases and -revenue decreases: i.e., public deficits and debt-accumulation. Then, when governments shifted monetary-policy sharply in the early eighties to combat the oil-crisis induced inflation of the seventies, the resulting high real interest rates increased the costs of servicing the newly accumulated debts. These monetary policies and policy-shifts, too, are explained, but, whatever their sources, the combination was disastrous for public indebtedness. Debt exploded in several countries that entered the latter half of the postwar period with moderate to high debt levels, i.e., those that had insufficiently reduced wartime debt by then. However, again, political conditions in some places magnified and, in others, mitigated these impacts. For example, as Chapter III more fully explains, exploding debt requires fiscal adjustment, but any adjustment plan will tend to favor some constituencies over others. Where governments were more unified (e.g., single party majorities in parliamentary systems), the majority could more easily shift adjustment costs onto their opponents’ constituencies. Where governments were less unified (e.g., multi-party coalitions), distributing adjustment costs neutrally among those wielding policy vetoes proved more difficult. In the latter countries, governments delayed implementing necessary fiscal adjustments, magnifying the explosive impacts of stagflation in the seventies plus high real interest in the eighties. Once again, common political pressures and economic challenges, funneled through differing institutional structures, produced differing democratic-policymaker responses.

As public transfers and general spending rose and macroeconomic performance stagnated, governments’ fiscal policies aiming to provide social insurance, public goods, and macroeconomic management grew increasingly expensive and constrained politically and economically, and perhaps also increasingly ineffectual economically. Ever greater shares of public resources were absorbed
in transfers entitlements, and some of those programs induced labor-market rigidity that undermined fiscal-policy as a tool of macroeconomic management. Similarly, rising public indebtedness, coupled with increasing international exposure, limited fiscal-policy maneuverability and, perhaps, efficacy as the accumulating public debts raised debt-service costs, limiting resources available for other fiscal goals, and increased the deleterious interest ramifications of deficits relative to their Keynesian expansionary effects. With fiscal-policy feasibility and utility in increasing doubt, its less disputable distributional aspects were increasingly highlighted, magnifying the political difficulties involved in using it effectively. Therefore, governments, first in the U.S. and then elsewhere as Bretton Woods collapsed, shifted toward monetary policy to fulfil their commitments and to rebuild broad postwar coalitions behind democratic management, putatively for aggregate efficiency, of the macroeconomy.

Turning toward monetary policy after the stagflationary seventies, democratic governments sought first to reduce inflation. Broad academic agreement, persuasively simple evidence, and real-world anecdotes all seemed to persuade policymakers that shifts toward monetary conservatism could reduce inflation without adverse unemployment or growth effects, provided these policy-shifts could be made credible with economic actors. Accordingly, fiscal policy being much constrained, a new monetary-conservatism orthodoxy became the cornerstone of both right and left governments’ attempts to rebuild broad postwar coalitions behind their revised macroeconomic-policy paradigms.

Chapter IV demonstrates, however, that the anti-inflationary shifts, even if highly credible, had real consequences, which again differed across democracies depending on their institutional structure. Weak strategic capacity in labor- and goods-markets in some places (i.e., less-coordinated wage-price bargaining) magnified both the anti-inflationary benefits and the unemployment costs of monetary conservatism. Moreover, public-sector employment had risen dramatically in some countries, especially among those with greater coordination for reasons that are also explained. This
created an increasingly disadvantageous structure of interests among bargainers, rendering monetary conservatism increasingly costly in real terms there too, where it had previously been least costly, while magnifying its anti-inflationary impact. Thus, as with fiscal policies, the evolution of the KWS amplified the distributional effects of monetary policies and, thereby, the institutions and structures that determine them, relative to their efficiency effects. Governments’ similar anti-inflationary policy-shifts, however couched in the language of aggregate efficiency, retained strong distributional effects, effects which differed across democracies depending on the multiple interactions within the differing networks of institutions and structures characterizing their political economy.

Therefore, while the evolution of the KWS may have reduced governments’ macroeconomic policy-maneuverability, it has also drawn the distributional aspects of macroeconomic management into sharper relief. That is, the shared interests of different political constituencies in the KWS have decidedly shrunk relative to their conflicting interests. Policymakers responded by increasingly shifting attention to structural and institutional reforms. They sought to rationalize welfare systems, sell public monopolies, increase the credible conservatism of monetary-policymaking institutions; some even sought electoral-institutional reform, hoping to alter their party systems and the types of governments formed from them. All in the attempt to rebuild or to create new broad constituencies of shared interest in macroeconomic efficiency. In themselves, some of these reforms may be entirely desirable, but, as the book shows throughout, these reforms, whatever their efficiency impacts, cannot evade classic political conflicts in economic policymaking.

Reducing transfers-generosity may reduce labor-market rigidity, and perhaps unemployment thereby, but it also worsens the plight of the remaining unemployed. Reducing debt-financed public investment and spending may free resources for private allocation, but that private allocation differs radically from the public, with important distributional consequences whatever the efficiency effects.
And policy-shifts toward the new monetary-conservatism orthodoxy, however credible, have real-unemployment as well as nominal-inflation effects, with obvious distributional implications. Thus, new versions of the old right-left, inflation-unemployment, efficiency-equity tradeoffs that had so dominated political conflict within the KWS through the eighties remain implicit in more-modern battles over institutional and structural reform of the KWS. Shifting the locus of political battle, from the policies themselves, to the institutions and structures within which democratic policymakers choose those policies, hardly abrogates politics. Indeed, the new battles this book describes will look remarkably familiar to students of comparative democratic political economy.

As this overview suggests, the book undertakes four tasks to make these arguments. Chapters II, III, and IV offer three self-contained studies of the politics and economics of macroeconomic policymaking and outcomes within the KWS in developed democracies. Specifically, Chapters II and III address fiscal-policy elements of the KWS, public transfers and debt respectively, and Chapter IV addresses monetary policy and wage-price regulation aspects. Through these studies, the book elaborates a theory of comparative democratic political economy in which universal tensions between liberal democracy and free-market capitalism, arising from their differing distributions of political and economic influence, induce different responses from democratic policymakers across countries and over time depending on multiple interactions among the international and domestic political-economic institutions and structures of interests within which they interact. Applying that framework, these studies also jointly elaborate a theoretically guided aggregate empirical history of the evolution of the Keynesian Welfare State in developed democracies in the postwar era.

In accomplishing these first three tasks, the book argues, fourth, that (a) this evolution has involved increasing political and economic difficulties for democratic management of the KWS, exacerbating the distributional conflicts inherent in KWS policies while undermining its more-
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... universally desired role in fostering economic growth and efficiency; so (b), in response, politicians increasingly turned sequentially through the KWS’ emphasis on fiscal and monetary policies toward, more recently, various political and economic structural and institutional reforms intended to rebuild broad coalitions behind their purported efficiency-improving effects; but (c) these reforms, whatever their efficiency-effects, and despite frequent claims to the contrary by many politicians and some academics, retain important distributional implications; and so (d) the traditional conflicts of macro-political-economy between right and left partisans—efficiency-equity, growth-distribution, inflation-unemployment—which used to occur primarily over policies conducted within the KWS, are now reproduced in modern battles over reforms of the KWS, i.e., in conflicts over the institutional rules within which democratic struggle over macroeconomic policy and free-market competition continue.

The chapter proceeds to introduce these arguments further thus. Section I.B. describes the political commitments implicit in the KWS, which all developed democracies made to some degree in the immediate postwar era, and the tensions within those commitments created by the differential distributions of political and economic influence in capitalist democracies. Section I.C. offers a brief empirical tour of the extent and evolution of these commitments. It documents trends in the size of government generally, and in public transfers, debt, and employment specifically, and concurrent trends in macroeconomic performance (growth, unemployment, inflation), and it presages some of the arguments and findings in subsequent chapters about these developments. Section I.D. outlines the broad approach to explaining the observed variation across developed democracies over time, elaborating a cycle of political economy framework within which explanations for the problematic developments sketched in previous sections are derived theoretically and examined empirically. Section I.E. briefly overviews some of the political and economic implications of over-commitment to—more exactly, inefficient tradeoffs between—the public-policy agendas embodied in the KWS.
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I.e., it discusses some of the ways the problematic policy developments affect the political and economic outcomes about which citizens and therefore policymakers and scholars ultimately care. The section then previews the argument that modern political conflict over institutional-structural reforms reflects rather than replaces familiar conflicts over policies. Section I.F., finally, guides the reader through the consummation of these agendas in the rest of the book. An outline overview of the arguments and findings in the book conveniently follows.

I.B. Democratic Governments’ Commitments to Involvement in the Economy

Political scientists have long noted that each of the developed democracies has committed itself, to greater or lesser degree, to at least three economic-policy agendas: (1) some provision of social insurance for unemployment, illness, old age, and disability, (2) some provision of “public” goods and services (usually exceeding the standard public goods of economic theory), and (3) some public management of the macroeconomy and the macroeconomic cycle through fiscal, monetary, and wage-price-management policy. The terms of this commitment were perhaps most explicitly stated in the United Kingdom in the forties. The Beveridge Report to parliament in 1942 advocated universal social security and fully publicly-funded health care (the National Health Service); it was largely achieved under Aneurin Bevan’s leadership (1946-8) and has not been seriously challenged since, at least until recently. Concurrently, the 1944 White Paper on Employment Policy confirmed the bipartisan acceptance of political responsibility for macroeconomic management:

The Government accepts as one of their primary aims and responsibilities the maintenance of a high and stable level of employment after the war. (Quoted from Hall 1986.)

This tenet has likewise gone largely unchallenged, at least until recently. Thus, fairly explicitly in the UK and more implicitly elsewhere, these three political commitments established the broad scope and boundaries of government responsibility and capability in the economy. Of course, democratic

\footnote{For alternative expressions, see, e.g., Shonfield 1965; Cameron 1978; Cameron and McDermott 1995; Esping-Andersen 1985, 1990; Katzenstein 1985; Hall 1986; Lindblom 1977; Offe 1984; Rose 1984; Wilensky 1975.}
political struggle and capitalist economic competition continued to range freely, but only within boundaries defined by these broadly unchallenged commitments to political provision of social insurance, public goods, and macroeconomic management.

The literature refers to these commitments and the policies and policymaking institutions that arose to fulfill them variously as the postwar settlement, the class compromise, or the Keynesian welfare state (KWS). Each phrase refers to essentially the same constellation of commitments, policies, and policymaking structures, but also carries an implicit statement of its political and economic purposes and, thereby, of its political-economic underpinnings. Accordingly, this study of comparative democratic management of the KWS begins with a brief overview of these three conceptualizations of the class compromise embodied in the postwar settlement on the KWS.³

I.B.1. Postwar-Settlement, Class-Compromise, and Neoclassical Views of the Commitments

In the postwar-settlement view, these democratic commitments arose from an immediate-postwar struggle between collections of interests pitting their political might against each other to determine the role of government in the polity and economy, each group struggling to set boundaries that would maintain and augment its advantages. The settlement (often ennobled: historic) on these commitments is an agreement—usually implicit and long-lived but not necessarily permanent—of the ground rules under which further struggles between these interests are to occur. The postwar-settlement view thus stresses the political roles of the KWS commitments in determining the scope for legitimate democratic-contestation of government action in the economy, with its distributional aspects remaining especially contested. Political conflict continues between organized interests competing to influence policymaking within boundaries institutionalized by the settlement on the

³ These very stylized summaries will do great injustices to the specific examples cited. They are not intended as criticism but merely to set the stage for the synthetic view taken in this book. Hall (1989) collects an excellent set of essays on the theory and practice of the KWS spanning these views.
KWS. Therefore, key to understanding the evolution the KWS from this view, are the institutional structures of society and governmental politics: e.g., the organization of labor and employers for wage-price bargaining, the party-system, internal decision-making rules of government, and also the position of the domestic political economy relative to global markets. Aspects of this view figure prominently in, e.g., Katzenstein’s *Small States in World Markets* (1985) and Hall’s *Governing the Economy* (1986), and Gourevitch’s *Politics in Hard Times* (1986).

The neoclassical view emphasizes instead the economic roles of the commitments, focusing on the common interest of political-economic actors in erecting and sustaining a system that fosters efficiency-improving government action in the economy. However, it also stresses that democratic governments will not automatically seek, much-less undertake, even purely and highly efficient actions. Rather, the view acknowledges that the polity and economy contain divisions that tend to produce the more purely distributional and otherwise political battles that the postwar-settlement view highlights. Indeed, this democratic contestation over the distributional effects of KWS policies is what jeopardizes their aggregate economic efficiency. Such concerns that democracy relatively empowers those who would otherwise be economically and educationally under-privileged by free-market outcomes and so endangers capitalism itself have a very long (traceable, e.g., to Aristotle), varied (including, e.g., Mill and Marx in broad agreement), and distinguished (also De Tocqueville, Hamilton, et al.) intellectual pedigree:

“[T]he egalitarian threats of mass society and democratic mass politics...would necessarily lead to tyranny and ‘class legislation’ by the propertyless, uneducated majority.” (J.S. Mill, quoted in Offe 1984: 179).

“[Democracy is...] a political form that...exacerbate[s] social contradictions by withdrawing political guarantees from the socially dominant and giving political power to the subordinate.” (Karl Marx, quoted in Offe 1984: 179).

More-recent scholars emphasize democratic dangers to capitalism’s aggregate efficiency rather than to capitalism itself, sometimes explicitly considering the economic costs of the postwar settlement
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on the KWS to be the price of this reduced danger to capitalism. Key to understanding KWS evolution from this view, then, are the organizational advantages of special interests (Olson 1965, 1982) and other characteristics of electoral and governmental politics that weigh citizen inputs to democratic policymaking differently than the market weighs their inputs to aggregate economic outcomes: e.g., division of voters into electoral districts, obstruction of policymaking decisiveness from multiple veto-actors within government, etc. This view most animates the public-choice school as, e.g., in Buchanan and Wagner’s *Democracy in Deficit* (1977) and Meltzer and Richard’s “A Rational Theory of the Size of Government” (1981).

Whereas the first two views differ mainly in their emphases on the economic or political roles of the KWS, the class-compromise view contrasts more directly with both. For example, the class-compromise view often flatly rejects the neoclassical view of economic efficiency as instead being merely that which is in the interest of the privileged, i.e., more wealthy and therefore more powerful, class. Likewise, what the postwar-settlement view identifies as pivotal struggles for individual and group advantage, the class-compromise view sees as merely symptomatic of and epiphenomenal to more fundamental struggles between privileged, capital-owning classes and productive, working classes. From this view, the class compromise (often infamized: historic) and the set of policies and policymaking structures that support it are what sufficiently coopt the working class to enable capitalist accumulation to continue relatively unmolested under democracy.

Modern protagonists still stress inherent contradictions in democracy and capitalism, but their emphasis is on constant political struggle to manage those contradictions. The core conflict involves bringing the necessary productive results of capitalism into manageable disagreement with its equally logically-necessary consequence of working-class impoverishment. Key to the evolution of the KWS from the class-compromise view, then, are the political and economic strength of capital (business)
and labor (workers), and the alliances each are able to make within the party system. For example, where capital is economically and/or politically fractionalized but labor remains unified, e.g., in social-democratic-corporatist countries, one expects more generous KWS developments. Aspects of this view are prominent in, e.g., Esping-Andersen’s *Politics Against Markets* (1985) and *Three Worlds of Welfare Capitalism* (1990) and in Claus Offe’s *Contradictions of the Welfare State* (1984).

The broad conception of the KWS in this book synthesizes these approaches, taking each view as emphasizing different but equally real aspects of the functioning of the postwar settlement and class compromise embodied in it. The KWS did and does serve as the accepted boundaries for the continuing democratic struggle between the conflicting interests in society. The KWS did avert working-class radicalization, and conflicts between its goals of fostering capitalist growth and efficiency and of ameliorating the inegalitarian consequences continue to underlie political conflicts over and within the KWS. And the differing distributions of political and economic influence in the capitalist democracies within which the KWS operates did and do make efficient macroeconomic management politically problematic. Precisely because it did and does each of these things, none of these views, singly, could manage fully to explain the evolving democratic management of the KWS and to explore its prospects for continued maintenance and political-economic utility as intended here. Accordingly, the next section elaborates the synthesis underlying the present approach.

**I.B.2. Over-Commitment, Mismanagement, and the Crises of the Keynesian Welfare State**

The KWS, defined here as the set of policies and policymaking institutions that implement democratic governments’ commitments to political provision of social insurance, public goods, and macroeconomic management, has come under considerable strain in recent years. Both popular and academic presses in all developed democracies now teem with cries for various reforms to address

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4 Modern readers should not forget that European fascism arose partly in response to real fears of communism and that these fears continued to drive foreign and, somewhat, domestic policies through at least the early postwar period.
burgeoning social-insurance systems and public indebtedness and for related public-policy reforms. For example, in recent (1992-98) reports on national political issues in 28 democracies, published annually in the *European Journal of Political Research* and written by local experts, virtually every entry mentions one or more of these issues as a, and often, as the major political issue in the country.\(^5\)

Not coincidentally, seemingly inexorable growth of government, higher unemployment, and slower real-GDP-*per-capita* growth accompanied the rising discontent. In the most dramatic cases, transfer payments exceeded 25% of GDP in Belgium, Finland, the Netherlands, and Sweden; public debt surpassed 100% of GDP in Belgium, Ireland, and Italy; and government employment accounts for over 30% of total employment in Denmark, Norway, and Sweden. Meanwhile, double-digit unemployment is now common, and sustained real-\textit{per-capita}-GDP growth much over 3% seems only a fond memory. In this context, recent lamentations (or celebrations) of crises in the KWS are eminently understandable. This book seeks to explain prominent aspects of this public-sector growth and macroeconomic-performance decline and to explore their political and economic consequences for the continued maintenance and utility of the KWS as democratic governments seek to sustain or to rebuild broad coalitions behind their involvement in the economy.

Broadly, these KWS crises have roots in two related contradictions, which a synthesis of the analytic views outlined above will illuminate. As the class-compromise view emphasizes, the KWS seeks simultaneously to address two important needs of modern democratic-capitalist society:

The strategic intention of Keynesian economic policy is to promote growth and full employment, the strategic intention of the welfare state to protect those affected by the risks and contingencies of industrial society and to create a measure of social equality. The latter strategy becomes feasible only to the extent that the first is successful, thereby providing the resources necessary for welfare policies and limiting the extent to which claims are made on these resources (Offe 1984: 198-9).

Thus, in implementing the KWS, policymakers sought to buttress and facilitate capitalist economic growth...
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development, but they also sought to ameliorate the distributional consequences of that development.

As Offe notes, only success in the former goal can sustain the ability to pursue the latter; as he also notes, the problem is that the latter goal frequently proves inimical to the former: 6

1. The Keynesian welfare state is a victim of its own success. By (partly) eliminating and smoothing crises [i.e., economic downturns], it has inhibited the positive function that crises used to perform in the capitalist process of ‘creative destruction’.

2. The Keynesian welfare state involves the unintended but undeniable consequence of undermining both the incentives to invest and the incentives to work.

3. There is no equilibrating mechanism or ‘stop-rule’ that would facilitate adjustments of the extensions of social policy so as to eliminate its self-contradictory consequences; the logic of democratic party competition and the social democratic alliance with unions remains undisciplined by ‘economic reason’ (199).

The first two points are the core contradiction in the KWS from a class-compromise view. Capitalist development cannot continue (politically) without government involvement in ameliorating the risk of macroeconomic fluctuations and in sufficiently coopting workers, i.e., without the KWS, yet successful amelioration and cooptation undermine the incentives that drive capitalist development, which, in turn, is necessary to fund KWS policies. The postwar-settlement and neoclassical views more clearly explicate the third point and its relation to the first two.

Perhaps most directly expressed in Meltzer and Richard (1978, 1981), the neoclassical view argues that the fundamental problem in the democratic implementation of KWS policies lies in the differential distribution of influence in the political and economic arenas. In the political sphere, each person has one vote; thus, in principle, political influence is uniformly distributed. In the economic arena, the unit of influence is, of course, wealth, and that is distributed rightward skewed (many poor and middle class, fewer but very rich). Therefore, when implementing the KWS involves tradeoffs between its goals of facilitating capitalist efficiency and growth and of ameliorating its distributional

6 He attributes these arguments to “conservative economic policy ideologues” but notes that they are “equally, if reluctantly, acknowledged by practice and partly by theories of the left” (nor does he challenge them himself).
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consequences, as it frequently will, democratic policies will tend to overemphasize the distributional goal relative to long-run aggregate economic efficiency. Democratic governments tend to become over-committed to the KWS; i.e., governments tend to be too large and overactive in the economy.

what actually results from this potential conflict between the distributions of electoral and monetary influence, though, is an empirical issue. if, e.g., control of investment capacity more than compensates for the fewer votes of the wealthy, the effects just described would reverse. also, as others within this school stress, rationally-ignorant voters will find proper and full evaluation of the costs and benefits of government activities difficult because budgets are complex (Buchanan and Wagner 1977) and public-good benefits are inherently hard to evaluate (Downs 1960). If the latter consideration dominates, or if spending-side dominates revenue-side complexity of budgets, then governments will be too small. Thus, the simple neoclassical view will not suffice; analysis must attempt to consider the cognitive challenges for voters and the potential for other sources of political influence, e.g., money, institutional organization, etc., to counteract or reinforce electoral numbers. Chapters II and III attempt some inroads into the empiricism necessary to address these issues.

Moreover, as the postwar-settlement view more directly emphasizes, interests that cut across class divisions can also employ the political arena. For example, when technological shifts or terms-of-trade shocks threaten particular sectors of the economy, the goals of the KWS can again conflict. Capital and labor in the afflicted sector will likely press policymakers for subsidies, protection, or otherwise to redress their losses. Policies accommodating such demands might accord with the KWS’ distributional goals, but, by subverting free trade or technological improvement, they would also conflict with the goal of fostering capitalist development. again, the distribution of political

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7 Rationally ignorant voters realize that the probability of an individual vote altering an electoral outcome and so the expected benefits of casting an informed vote are minuscule, so they do not expend effort becoming informed.

8 Some limited subsidy mechanism, as social insurance against uncertainty over returns to investment subject to such risks, might even be economically efficient. Even so, a tradeoff would
exist between the distributional goal and the need for insurance on the one hand and gains from trade and technological progress on the other. Still, the different distributions of political and economic power and the different manners in which each translates into political influence would imply that democratic policymakers will not generally make such tradeoffs economically efficiently.

The preceding paragraphs may seem contradictory. The first argues that, as poor outnumber rich, democratic governments will overemphasize distributional relative to efficiency goals in implementing the KWS. The second claims, inversely, that the smaller group will influence policy more. The first seems to ignore Olson’s logic of collective action, but the types of policies and the absolute and relative sizes of the groups involved differ importantly. Broad redistribution distinguishes only rich from poor. Both groups are “very large” from an Olsonian view, so neither can coordinate much more effectively than the other. The other policies distinguish one sector from the rest, and a sector is much smaller than the economy and so should manage to coordinate much more effectively. Plus, losses from freer trade are concentrated, individually large, certain, and current while gains are diffuse, uncertain, and in the future. Gains and losses from broad redistributive policies, contrarily, tend to be more certain and current, and of roughly equal relative magnitude.

A synthesis brings these considerations together, allowing fuller analysis of the evolution of the KWS and of its economic and political consequences. The postwar-settlement and neoclassical views both suggest a tendency toward over-provision and over-management in the evolution of the democratic commitments to provision of public insurance, goods, and macroeconomic management. This, as the class-compromise view elucidates in turn, suggests a universal tendency toward crises in the development of the KWS. Indeed, the extreme sizes to which some public-sectors have grown and the rising predominance of public-sector reform as a political issue noted above provide prima facie evidence of just such tendencies toward crises. However, not every developed democracy has accumulated equally massive debt, nor does each face the same difficulties in macroeconomic management, nor even is each saddled with equally burgeoning transfer systems. Conversely, while no two countries confront the same set of difficulties, times and places where at least one of these
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elements of the KWS does not seem critically over-extended are exceedingly rare. I.e., at different times in different places, the universal pressures manifest as different crises.

Subsequent chapters offer and empirically evaluate several explanations of these phenomena. Broadly, the differential distribution of economic and political resources fundamentally drives the inability or unwillingness of democratic governments to maximize the aggregate efficiency of their economic policies fully. However, political economies with differing structures of interests and institutions, respond to that common pressure differently, even when facing similar international and domestic economic challenges. For example, plurality parliamentary systems tend to produce single-party governments of oscillating partisanship, rendering stable and consistent policies over time difficult to maintain. Conversely, proportional parliamentary systems tend to produce multiparty coalition governments of less variable partisanship, rendering stable policies less problematic but also tending to produce sluggish policy responses to economic challenges. Section I.D. elaborates the theoretical framework from which such explanations derive and that organizes their empirical evaluation, but, first, I.C. provides more detailed empirical descriptions of the dimensions to which, in pursuing the goals of the KWS, some democratic governments have become committed.

I.C. The Scope of the Democratic Commitments and Macroeconomic Performance

I.C.1. The Overall Size and Growth of Government Activity in the Economy

Figure I.1 begins broadly, documenting KWS evolution in developed democracies by plotting consolidated-central-government revenues, expenditures, and their sum as shares of GDP (first, second, and third columns), annually over the postwar era within each country, by country-average over the period, and by year-average across countries (first, second, and third rows). By any measure, government activity in the economy was large and expanded dramatically in most times and places.

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The first row reveals, e.g., that about half the economy circulated through central government by 1990 in France, Belgium, Denmark, Ireland, the Netherlands, Norway, Portugal, Sweden, and New Zealand. In half the rest—Germany, Italy, the UK, Austria, Finland, and Greece—government budgets circulated over one third the economy by 1990. Only the US, Japan, Canada, Spain, Switzerland, and Australia kept revenue plus expenditure below 60% of GDP. From the mid-fifties to the late-eighties, moreover, Swedish governments tripled in size, and most others doubled or more, including many that began the period with less government involvement in the economy, though some recent retrenchment is now also visible. A fairly typical pattern of roughly stable sizes until the early seventies, swiftly expansion in that stagflationary decade, slower expansion continuing in the eighties, and perhaps some retrenchment in the nineties is apparent. However, variation in the size of government and in the pattern and pace of its growth is at least as striking.

The second row graphs government-size by country, highlighting tremendous cross-country variation. Differences across countries’ postwar-averages alone, e.g., encompass 50±%\(^{11}\) of the total country-time variation seen in the first row. French, Belgian, or Dutch government-size averaged about four times Swiss government-size and over twice US, Japanese, Canadian, or Spanish government-size. Moreover, these 21 countries also experienced widely differing variation in the scope of their governments’ activities in the economy over this period; e.g., inter-standard-deviation and inter-extrema ranges in Portugal and Austria dwarf those in Australia and Canada.

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\(^{11}\) This figure corresponds to \(R^2\) from regressions of revenues, expenditures, and their sum on the complete set of country indicators, which yield \(R^2=.535\), \(R^2=.496\), and \(R^2=.539\), respectively.
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Figure I.1: The Overall Size of Government in Developed Democracies in the Postwar Era
The third row plots across-country averages and inter-extrema and standard-deviation ranges by year, highlighting the shared time-path espied in the first row and described above. Focusing on the second column, e.g., expenditures were typically stable until they began to rise in the mid-sixties. The cross-country average jumps a bit in 1973-4 and 1979-80, reflecting the oil crises, then flattens somewhat through the mid-eighties. Some retrenchment occurs in the late-eighties, but expenditures rise again in the early nineties, reflecting renewed recession. (Retrenchment may have returned in 1994. Although the country-average time-path is clear and accords well with this historiography, it represents only $32\%$ of the total variation (first row). Moreover, since the late-sixties, increasing cross-country variation and perhaps also increasing skew—with a few governments remaining much smaller than the rest—is equally apparent. Again, variation is at least as striking as commonality.

To sum, the broad outlines of the public economy clearly exhibited some common tendency to expand considerably in the postwar era as the discussion above suggested. As Chapters II-IV will demonstrate in more detail, common patterns at this broad level arose because governments faced similar economic conditions and democratic pressures in implementing their similar commitments to provision of social insurance, public goods, and macroeconomic management. Still, wide variation in where, when, and to what extent government activity in the economy grew equally clearly remains to be explained. Some of the variation, obviously, stems from differences in the precise economic conditions each country faced; but, in exploring three prominent components of KWS expansion, Chapters II-IV find the differing structures of political and economic institutions and interests, and various interactions among them, were at least as central. The next subsection details empirical developments in these three components: public transfers, debt, and employment.

**I.C.2. Aspects of the Size and Growth of Government**

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12 This figure corresponds to $R^2$ from regressions of revenues, expenditures, and their sum on the complete set of time indicators, which yield $R^2=.271$, $R^2=.364$, and $R^2=.321$, respectively.
I.C.2.a. Public Transfers

While revenues and spending grew swiftly enough in most countries, Figure I.2 reveals that transfers grew absolutely meteorically virtually everywhere.\textsuperscript{13} E.g., in under forty years, transfers as a percent of GDP nearly sextupled in Finland and the Netherlands, quintupled or quadrupled in US, Japan, Greece, Norway, Portugal, and Sweden, and doubled or tripled everywhere else except

\textsuperscript{13} OECD National Accounts Volume II: Detailed Tables 1996 disk, extended from print editions where possible. “Transfer payments” sum items 30-32 of “Table 6: Accounts for General Government”. “General Government” includes national and subnational governments and separate public agencies.
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Germany (where they increased by more than 50%). Commonality in the largesse of these transfer systems in pursuing the democratic commitment to social insurance is also remarkable. Governments now redistribute over 10% of GDP in every country, over 25% in three—Finland, the Netherlands, and Sweden—and over 20% in five more: France, Austria, Belgium, Denmark, and Norway.¹⁴ In the early fifties, contrarily, nine—the US, Japan, Canada, Finland, Greece, Ireland, Norway, Portugal, and Switzerland—redistributed less than 5%. The massive redistribution characteristic of the modern KWS and the dramatic and common trends depicted in Figure I.2 give further prima facie support to the argument above that the different distributions of political and economic influence in capitalist democracy create certain universal pressures toward large and expanding government activity in the economy. The sizes to which redistributive states have grown and the paces of their expansion also render the recent, widespread cries for transfer-system reform wholly unsurprising. However, variation across time and countries is again as noteworthy.

While the common trend illustrated in the bottom-right of Figure I.2 does account for 48±% of the total variation, increasing diversity and skew are equally apparent. Inter-standard-deviation ranges in the eighties double (±) those in the sixties, and a few countries begin to develop much larger transfer systems than others in the seventies. Moreover, cross-country variation in the postwar average size of transfer systems (bottom-left) is nearly as large: 43±% of the total. E.g., the Belgian transfer system redistributed, on average, over three times the share of GDP that the Portuguese did and over twice what the American, Japanese, Canadian, or Australian did. The bottom-left of the figure also reveals differing experiences with the variation of transfer-system size over this period; e.g., the Dutch redistributed as little as 5.5% and as much as 28.3% of GDP, a 22.8% inter-extrema range, the Finns from 4.4% to 25.4% (range: 21%), while the analogous figures for Australia are only 5.1-11.3% (range: 8.2%) and, for Japan, only 2.8-12.1% (range: 9.3%).

¹⁴ Belgium redistributed more than 25% of GDP until recent retrenchments.
Chapter II seeks to explain these widely varying sizes and growth-rates of redistributive states and the otherwise-common upward trend. Presaging, the commonalities are largely economic and demographic in origin; higher unemployment, lower inflation, inequality, older populations, and, especially, slower real-GDP-per-capita growth increased the costs of the democratic commitments to social-insurance provision. As the synthetic view of the KWS suggested, democratic governments found reducing transfer-system generosity to redress these increased costs very difficult because net-beneficiaries of progressive transfer-systems outnumbered net-contributors and also because older citizens, having already paid for others’ generous transfers, were now reluctant to accept reductions in theirs. Thus, all democracies experienced swift growth in and now have large transfer systems.

Yet, variation is again as notable. And, again, part of the variance across country-times in transfer-system size and growth stems simply from differences in the economic and demographic challenges faced, but at least as much arises from differing structures of political and economic institutions and interests, and interactions thereof, across those country-times. Stronger blue-collar organization, e.g., fostered larger redistributive states, as did greater income-distribution volatility, reflecting increased risks in individuals’ income streams. Election-year politics and left-partisanship also had predictable roles in supporting redistributive states. Most interesting, though, was how transfer systems responded differently to increases in income inequality in different polities.

The rightward skew characterizing income distribution in all developed democracies—i.e., a few very rich and more poor and middle class—implies net-beneficiaries of broadly proportional and progressive transfer-systems will outnumber net-contributors, creating democratic pressure for such redistribution. However, what matters democratically is the distribution of income relative to that of political influence: specifically, the mean income in the population relative to the income of

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15 The evidence strongly suggests that, in the short run, transfer systems less than fully adjust for inflation. Thus, downward movements in the inflation rate actually increase transfer-systems’ real costs.
the person at the median of political influence when the population is arrayed from poorest to wealthiest. Since relative wealth correlates positively with political participation,\textsuperscript{16} democracies with greater participation generally exhibit greater skew between mean income in the population and the income of the median-influence citizen for any given distribution of income. Thus, governments in democracies whose institutions fostered greater, broader citizen participation in politics responded to (increases in) income inequality with more generous (increases in) transfers than did those in less-participatory democracies. In short, the interaction of the structure of interests, as reflected in the income distribution, with the political institutions that foster or hinder greater electoral participation produced greater or lesser transfer-system growth across different country-times.

Employing the simplest possible statistical techniques,\textsuperscript{17} Chapter II then demonstrates that the dramatic (but varying) growth in transfers drove the (also varying) growth in government more generally and that the latter, in turn, tended to produce deficits proportionately. Specifically, the estimates suggest that governments typically expanded total expenditures to absorb transfers shocks fully and that they gradually redressed expenditure shocks, but only by reducing other expenditures excluding transfers. The estimates also demonstrate that only about two-thirds of spending increases, in transfers or elsewhere, were met over the intermediate term by corresponding revenue increases. Thus, the growth of government driven by transfers in turn drove the growth of public indebtedness.

Finally, Chapter II shows that, while these burgeoning transfer systems did generally alleviate distributional inequities arising from unfettered capitalist competition, they also tended to foster labor-market inflexibility, exacerbating unemployment, and especially long-term unemployment, problems. Thus, recent political battles over reforms of and reductions in transfer-system involve

\textsuperscript{16} Some other conditions, which Chapter II explains, and which the evidence suggests hold, are also necessary.

\textsuperscript{17} Country-year vector-autoregression and Granger-causality analysis of transfers, revenues, and expenditures.
familiar left-right issues quite directly. Greater social-insurance generosity increases unemployment, as critics argue, but also reduces the economic hardships of those unemployed, as critics forget.

I.C.2.b. Public Debt

Given the sharp growth in transfers and other spending just described, the concurrent public-debt growth, documented in Figure I.3, is unsurprising. Perhaps more unexpected is that debt had generally been falling as a share of GDP in most places until the stagflationary seventies; only then did it reverse direction, often swiftly rising thereafter, although some retrenchment is now apparent. However, differences are again as notable as these commonalities. Italy, Belgium, and Ireland, e.g., amassed central-government debt exceeding 100% of GDP by the late-eighties, after having reduced it in the fifties, while Germany, France, Denmark, Greece, Norway, and Switzerland kept debt levels below 50% of GDP and Australia achieved roughly continuous debt-reduction throughout. Indeed, the common time-path highlighted in the bottom-right accounts for only 19±% of the total variation observed in the top; differences in postwar-average debt across countries (bottom-left), contrarily, account for 55±% of the total, leaving fully 26±% of the variation unique to country-year. Thus, while some common tendency for debt growth emerged in the seventies, levels and paths of decline and growth in debt-to-GDP ratios also exhibited vast differences across countries and over time.

Chapter III explores these developments in public debt, rediscovering many themes from Chapter II’s exploration of transfers. First, economic conditions, especially the adverse terms-of-

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18 The figure refers to gross debt of consolidated central government, taken from IMF *International Financial Statistics*, 6/96 CD-ROM, extended from tape and print editions and by country-specific regressions on OECD data for gross and net debt of general government (from *OECD National Accounts, Volume II: Detailed Tables*, 1996 diskette, extended from print editions) where possible. Regression of each on the other two extends all three series, yet none is ideal. The IMF series neglects subnational debt, which is substantial in some places. The OECD gross and net series double count in some places by including debts from one level of government to another. The net-debt series also has very limited coverage prior to extension. The book employs the IMF data because they cover a far larger sample prior to extension and because the arguments to be explored regarding debt determination generally refer to central government. Nonetheless, correlations across series are comfortably high (see Chapter III).
trade shocks in the seventies and the rise in unemployment and fall in growth they triggered, are again central to the common time-path. Given the democratic commitments to KWS policies, these shocks increased expenditures and reduced revenues, creating structural deficits that reversed the downward trend everywhere. Then, as policymakers used monetary contraction to combat inflation, real interest rates skyrocketed, increasing interest-payment burdens on their now-accumulating debts, and inducing explosive debt in countries that entered this period with relatively large debt burdens already, like, e.g., Italy, Belgium, and Ireland. By themselves, these economic conditions, the variation across country-times in their incidence, and the temporal dynamics of debt can explain 43±% of the total variation observed in the top of Figure I.3.

\[19\] Demographic considerations proved less central to debt than to transfers, for obvious reasons.

\[20\] The figure is adjusted $R^2$ from a panel-weighted regression of deficits on lagged deficits and debts and the economic conditions mentioned (see Chapter III for details).
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Second, the varying structures of political and economic institutions and interests, and certain interactions among them, were again especially critical to cross-country and -country-time variation. Election-year politics and government partisanship, e.g., played interesting roles (see Chapter III and Franzese 1999b). The extra deficits incurred around election years are large enough and debts and deficits adjust slowly enough for election frequency—which depends on constitutional and other institutional factors, inter alia—to impact long-run debt-levels appreciably. Contrarily, partisan effects are usually more short-run, smaller, and often counter-intuitive, though they can be large and
intuitive if government-partisanship alternations are sufficiently large and frequent, which likewise depends largely on institutional characteristics of the polity. Other broad macro-institutional features of the political economy also figure prominently in explaining cross-country differences in debt, especially presidentialism and central bank autonomy and conservatism, and perhaps also the number of electoral constituencies and federalism. Also, varying tax-system complexity fostered differing degrees of fiscal illusion among voters—i.e., citizen difficulty in evaluating properly the full costs and benefits of government activity—and so produced statistically strong and substantively important differences across country-times in the public debt accumulated by elected governments.

Most important and interesting, though, was how political fractionalization and polarization, again largely institutionally determined political conditions, differentially retarded fiscal adjustments to the adverse economic developments described above. Absent such fiscal adjustments, the adverse expenditure, revenue, and interest-rate movements would have created explosive debt paths in many countries. However, any fiscal adjustments would typically favor some groups over others, so parties to budgetary legislation contested the allocation across constituencies of these adjustment costs, even if they agreed on the necessity of fiscal redress. Where governments were more unified (e.g., single-party majorities in parliamentary systems), fewer veto actors operated on the policymaking process, so majorities could more easily shift the costs onto opponents’ constituencies. Where governments instead contained multiple veto actors (as, e.g., in multiparty coalitions), these actors found plans that would distribute costs neutrally among themselves more difficult to devise. In such circumstances, governments delayed fiscal adjustments, magnifying the explosive impacts of the high real-interest-rates that followed stagflation. Notice in Figure I.3, e.g., that the UK, Canada, Italy, and Belgium had similar debts as the seventies began, yet debt exploded in Italy and Belgium, which had multiparty-

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21 However, the multiple-constituencies result is less strong statistically, and the federalism result may simply reflect that central-government debt is the dependent variable. See Chapter III for details, discussion, and qualifications.
coalition governments, but not in the UK and less in Canada, which had single-party governments.

Thus, once again, similarly capitalist democracies faced similar economic challenges to their similar KWS commitments, yet differences as well as commonalities emerged in policy responses because the latter depend also on interactions of differing structures of interests and institutions.

Chapter III then demonstrates that, at least in the short run, deficit spending by governments has had statistically significant and substantively important impact on unemployment and inflation, generally reducing the former and increasing the latter, but has not had significant impact on growth. Thus, recent debates over fiscal reforms intended to reduce debt are, in fact, distributional more than efficiency issues, and so they engender familiar partisan conflict. However, Chapter III also notes that large outstanding debts have increasingly constrained governments in their fiscal activities (see, e.g., Blais et al. 1993, 1996). Governments have felt this constraint, whether political or economic in origin, and increasingly turned toward monetary policy to implement their KWS commitments to macroeconomic regulation and to try to sustain postwar coalitions behind them. Unfortunately, as Chapter IV demonstrates, monetary-policy efficacy depends critically on the relative strength of public- and traded-sector workers and employers within the wage-price-bargaining system; and public employment, too, expanded over the postwar period.

I.C.2.c. Public Employment

Figure I.4 plots public employment as percent of total employment. Unfortunately, data only begin in 1960 in most countries and a bit later in others, but, still, the fairly common path of public employment since then is readably apparent. It began this period expanding everywhere, though at different paces, and finished the period shrinking virtually everywhere, though retrenchment (i.e., ceasing or reversal of growth) began at different times, from different maximum levels.

\[22\text{ Data refer to government civilian employment as a percent of total civilian employment and are from OECD Economic Outlook, Historical Statistics, 6/97 diskette, extended from print editions where possible.}\]
Retrenchment began earliest in the US in 1976, followed by Japan and New Zealand in 1980. In several others, it began in the mid-to-late-eighties—the UK, Canada, Belgium, Denmark, Greece, Ireland, the Netherlands, Sweden, Switzerland, and Australia—while growth continued in Germany, France, Italy, Austria, Finland, Norway, and Spain until the mid-nineties and was still rising in Portugal as of 1997. The maximum public-employment shares reached also varied widely, ranging

\[ \text{Figure I.4: Public Employment in Developed Democracies in the Postwar Era} \]

Retrenchment begins earliest in the US (1976, from a maximum 17%), followed by Japan and New Zealand (1980, 9% and 18%). Several others begin around 1984: UK (22%), Canada (22%), Denmark (31%), the Netherlands (15%), Switzerland (14%), and Australia (18%). Sweden follows in 1986 (33%), then Belgium (21%) and Ireland (19%) in 1987, while public employment seems to have leveled (at 10±%) in Greece since 1990. Growth continued in Germany until 1993.
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from 8.8% in Japan to 33.4% in Sweden. Moreover, the pace of growth varied considerably, being most dramatic in the social-corporatist countries: Denmark, Finland, Norway, Sweden, and, less so, Austria. Three countries—Denmark, Norway, and Sweden—now exceed 30% of employment in the public sector. The share has remained relatively stable, contrarily, in US and New Zealand (15±%) and in Japan (8±%). Thus, while the average path is clear in the bottom-right of Figure I.4, rising from 9.7±% in 1960 to 18.4±% in 1986 and roughly flattening thereafter, increasing divergence is equally apparent; indeed, the common trend accounts for only 23±% of the total variation seen in the top of Figure I.4. As illustrated in the bottom-left, cross-country differences are far larger, accounting for 63±% of total variation, suggesting that important aspects of any explanation for the observed variance should be factors that vary relatively fixedly across countries over time.

As Chapter IV argues in more detail, encompassing wage-price-bargaining that coordinates wage levels (wage increases) across sectors of varying productivity (productivity growth) would tend to hinder private-sector provision of low-skill (low-skill-growth) services. Governments in such countries would therefore have the choice of accepting low employment growth or of absorbing such service-sector growth into the public sector (see also Iversen and Wren 1997, 1998). This explains why public employment is highest and has grown most in social-democratic countries with left governments and highly coordinated wage-price-bargaining their labor markets: Austria, Denmark, Finland, Norway, and Sweden. That Austria saw somewhat less growth to a lower level is also explained; Austrian wage-price-bargaining organizations have tolerated greater wage inequality than bargainers in other corporatist countries have. The logic also illuminates the moderate growth in Germany, France, Italy, Belgium, Ireland, and the Netherlands, where some combination of lesser, more-wage-inequality-tolerant bargaining and/or more conservative governments operated. Japan (16%), in Spain until 1994 (15%), in Italy, Finland, and Norway until 1995 (18%, 24%, 31%, respectively), and in Austria until 1996 (23%). France saw its highest level in 1996 (at 25%), and Portugal is still rising (19% in 1997).
and Switzerland, meanwhile, exhibit some coordination, but more conservative governments and not-great wage equality, and so retained small public-sector employment. The rest—the US, the UK, Canada, Greece, Portugal, Spain, Australia, and New Zealand—have more liberal-market and/or less wage-equality-inducing bargaining systems, so their private sectors could absorb the increasing service-sector employment-demand as economic development advanced. In these countries, partisan shifts in government or regime, and/or shifts of interests within the polity, more exclusively drove the evolution of public-sector employment.

Chapter IV also and more directly addresses the consequences of public-sector employment-growth for monetary management of the macroeconomy, demonstrating that monetary management of inflation and unemployment is more effective, i.e., achieves less inflation at lower unemployment, where credibly conservative monetary authorities, e.g., independent central banks, face coordinated wage-price bargainers led by the traded sector. Where wage-price bargaining is less coordinated, and/or the public sector is more dominant, reliance on monetary policy to fulfill the macroeconomic management aspect of the democratic commitment to the KWS involves less-favorable tradeoffs. Thus, once again, recent shifts in political debate toward dispute over putatively more efficient institutional arrangements for monetary policymaking simply recast familiar left-right battles in somewhat newer and only marginally different terms.

To sum, the class compromise and postwar settlement in developed democracies on the KWS commitments to public provision of insurance, goods, and macroeconomic management do seem to have produced some universal tendency toward broad growth in government involvement in the economy. The universal pressures ultimately emanate from differing distributions of political and economic influence in capitalist democracy, but these common pressures manifested themselves in varying degrees and paces of growth in government depending on the interactions of structures of
interests and institutions operating in different country-times. However, merely noting that transfer payments rose starkly, that public debt reached striking levels and/or rose swiftly, and that public employment exhibited similar patterns establishes neither that democratic management of the macroeconomy is in crisis nor much at all regarding the origins of these trends or their implications for the continued maintenance or utility of the KWS. This section previewed some of the arguments and findings in the book about the roots of these developments; section I.E. introduces some of the implications. Chapters II-IV explore both more fully. First, though, the next subsection briefly documents the varying macroeconomic performances, in terms of unemployment, growth, and inflation, that attended these government-growth developments.

I.C.3. Macroeconomic Performance

I.C.3.a. Unemployment

As the top of Figure I.5 reveals, unemployment\(^{24}\) increased through the oil-crises-plagued seventies in every country except oil-exporting Norway, from the lower levels most enjoyed through the fifties and sixties. However, the rise was massive in some countries and almost unnoticeable in (very) few others, opening large differences in unemployment across countries. Unemployment did not return to pre-oil-crises levels in most countries in the eighties, in some it hardly fell at all, and in others it continued to increase, further widening the disparities. The nineties brought still further deviations as conditions improved in some places but worsened in others.

Thus, as the bottom-right tracks, the cross-country average floated between 3.3% (1958) and 2% (1965) from 1955 (2.7%) to 1973 (2.4%). Following the 1973-4 oil crisis, it rose sharply to 4.8% by 1978, leveling at 4.7% before the 1979-80 oil crisis struck, when it jumped sharply again to 8.3% by 1984. It drifted gently back to 6.7% by 1990 before rising back to its 1990 peak at 10%, returning

\(^{24}\) Data refer to the internationally comparable figures from the \textit{OECD Economic Outlook, Historical Statistics}, 6/97 diskette edition, extended from print editions where possible.
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only to 9% by 1997. Even though this shared time-path accounts for 45±% of the total variation, the figure also clearly illustrates the increasing divergence in the seventies, eighties, and nineties. Indeed, cross-national differences in postwar averages (28±% of the total variation) and in postwar variation are also quite apparent in the bottom-left. Average unemployment levels differ remarkably, more since than before the oil crises, but they have always differed appreciably.

Figure I.5: Unemployment in Developed Democracies in the Postwar Era

What, then, might explain these varying performances, and are they somehow linked to the developments tracked in Figures I.1-4? The conclusions to Chapters II and III raise these questions,
and Chapter IV focuses on them more directly. Summarizing exceedingly briefly: first, the shared exposure to adverse international shocks clearly underlies the commonalities. Next, Chapter III finds evidence that debt-accumulation tends, if anything, to reduce unemployment, suggesting that the evolution of public indebtedness bears little relation to these unemployment developments unless recent debt-retrenchments share blame for continued unemployment rises. Transfers growth (Chapter II), contrarily, increased labor-market rigidities, exacerbating especially long-term unemployment problems, and therefore may bear some relation to the tendency, more pronounced in some countries than in others, for unemployment to ratchet upward after each shock. More importantly, Chapter IV shows that the anti-inflationary policy shifts since 1980 were also detrimental, especially in countries with uncoordinated and/or public-sector-dominated wage-price-bargaining systems. Thus, as Hibbs concluded a decade ago regarding specifically The American Political Economy (1987), policymaker reactions often exacerbate rather than ameliorate the impacts of macroeconomic shocks. Additionally here, though, the degrees to which democratic policymakers made anti-inflationary policy-shifts and to which equivalent such shifts worsened unemployment depended on political-economic conditions that varied across country-times according to multiple interactions among the structures of interests (e.g., coordination and public- vs. traded-sector leadership in wage-price-bargaining) and institutions (e.g., monetary-authority credibility and conservatism) characterizing those country-times.

I.C.3.b. Inflation

As Figure I.6 shows, inflation performance varied radically both within and across counties. Following the extreme volatility of the immediate postwar years, more-moderate volatility around lower inflation-rates reigned during the heyday of the Bretton Woods fixed-exchange-rate regime; the cross-country average fluctuated mildly from 2-4.7±% in 1953-69. Inflation then began to rise,

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25 As explained there, especially since no effect on growth is apparent, this likely reflects differences in public- and private-sector-borrowers’ spending priorities rather than some beneficial effect of public-borrowing per se.
spurred by the US monetization of its increasing expenditures in the wars on poverty and Vietnam, which Bretton Woods spread to other developed democracies. The oil crises then brought two spikes, to 12.9% in 1974 and to 11.3% in 1980, dipping to 9.5% in 1978 between. Through the eighties and nineties, lastly, the average fell relatively continuously (back to its pre-crises low of 2% by 1997).
variation across countries in postwar-average inflation, contrarily, covers only 14±% of the total, so inflation has large country-time-unique variation (46±% of the total). So much country-time-unique variation, as Chapter IV demonstrates and Franzese (1999ce) elaborate, arises not only from wide country-time variation in the economic and political challenges that monetary policymakers faced, and from the apparently great fluidity of inflation (i.e., nominal) policies and outcomes, but also from multiple interactions among the widely varying international and domestic institutions and interests that shape policymakers’ differing responses to those challenges.

Figuratively, different sets of institutionally determined hands, each responding to different sets of interests, were effectively on the monetary-policy wheel across these country-times. E.g., under a fixed exchange-rate regime, to the degree the fix holds and capital is mobile, only in the N\textsuperscript{th} country, to which the other N-1 peg, do domestic policymakers retain control of monetary growth and thereby inflation. In the other N-1 countries, policy and inflation are determined in the N\textsuperscript{th} country to the degree the regime binds, and domestic policymakers retain discretion only to the remaining degree. Therefore, US inflation, and thus the economic and political considerations to which US inflation-policymakers responded, largely determined most countries’ inflation during the Bretton Woods era. Under that regime for the US, and throughout the ensuing floating-rate era for all countries including the US, the domestic central bank controlled monetary growth \textit{cum} inflation to the degree it enjoyed autonomy from political influence, and domestic political authorities, i.e., governments, controlled inflation to the remaining degree. Finally, whereas democratic domestic governments will respond to various economic and political pressures felt domestically\textsuperscript{26} for more or less inflation, foreign governments respond to the domestic pressures that they feel, and autonomous and conservative central banks, instead, respond less to either, tending to target more fixed (and low) inflation. Thus, the considerable variation across country-times observed in the top

\textsuperscript{26} They may originate domestically or internationally.
As Chapter IV elaborates, these arguments and those above regarding interactions of monetary policymakers with wage-price-bargainers in determining monetary-policy real-effectiveness, imply that commitments to peg exchange rates and monetary-policy-authority delegation to central banks will have very different economic and therefore political implications, even if they are equally credible and equally anti-inflationary on average or in intention.

I.C.3.c. Growth

Figure I.7: Real-GDP-per-Capita Growth in Developed Democracies in the Postwar Era

As Chapter IV elaborates, these arguments and those above regarding interactions of monetary policymakers with wage-price-bargainers in determining monetary-policy real-effectiveness, imply that commitments to peg exchange rates and monetary-policy-authority delegation to central banks will have very different economic and therefore political implications, even if they are equally credible and equally anti-inflationary on average or in intention.
For completeness, Figure I.7 offers similar plots of real-per-capita-GDP growth-rates in these countries over the postwar era, discussed here more briefly. Growth, though volatile like inflation, slowed visibly in the latter half of the period. While country-average growth fell below 2.5% three years in the fifties and zero in the sixties, it did so four years in the seventies, five in the eighties, and four of the seven years in 1990-6. As the wide inter-standard-deviation and very wide inter-extrema ranges in the bottom-left attest, differences across countries in postwar-average growth comprise little (9±%) of the total variation. The shared time-path (bottom-right) accounts for more (29±%), probably reflecting the relatively common exposure to oil crises and other international conditions, but that still leaves fully 62±% as country-time unique. Like inflation, then, explanations for growth variation across-country times must involve large county-time unique components. As Chapter II suggests, the labor-market rigidities induced by transfer-system growth, by hindering efficient allocation of economic resources, likely bears some blame for the slowdown. Contrarily, as already mentioned, Chapter III finds no support in simple statistical evidence presented in its conclusion for claims that rising public indebtedness has reduced growth. Chapter IV’s conclusion, however, finds support from equally simple analysis for claims that public-employment growth reduced productivity growth and thus also real-GDP-per-capita growth. Otherwise, the arguments and evidence outlined above in relation to unemployment and inflation extend rather directly and intuitively to growth.

Whatever causal connections may exist from the patterns of government growth documented in Figures I.1-I.4 to those in economic performance shown in I.5-I.7, their coincidence certainly drives the current outcry for public-sector reform. This book explores and extends current political-economic theory on transfer-system, public-debt, and public-employment determination, seeking (a) to explain the patterns and variations exhibited in Figures I.2 and I.3 (Chapters II and III) and, more summarily, those in Figure I.4 (Chapter IV), and (b) to explore connections between these patterns
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and those of economic performance shown in Figures I.5-I.7 (Chapters II and III more summarily, Chapter IV more thoroughly). This section demonstrated that democratic management of the KWS did tend toward great extensions of government activity in the economy as the previous section suggested, yet, this common tendency notwithstanding, considerable differences remain. The section also presaged the specific arguments and evidence in Chapters II-IV that explain these developments. Generally summarizing, the common exposure to similar economic conditions and the universal differences between the distributions of economic and political influence explain the commonalities, and interactions among differing structures of interests and institutions explain the differing policy and outcome responses thereto. The next section (a) overviews the general argument that universal conflicts between the distribution of economic and political influence in capitalist democracies produce diverse policy-reactions to these pressures and outcomes across country-times and (b) elaborates the cycle of political economy framework, which guides the theoretical and empirical analyses of macroeconomic policymaking and outcomes throughout the book.

I.D. Explaining Variation in Scope and Performance Across Democracies Over Time

I.D.1. Overview of the Approach

Not every developed democracy experienced debt crisis, nor did each experience the same difficulty in managing inflation and unemployment, nor has each become saddled with an equally excessive transfer system, yet country-times where at least one of these elements of the KWS is not in crisis are exceedingly rare. I.e., at different times in different places, the universal pressures on democratic policymakers described in section I.B manifest different consequences for policies and outcomes, as evidenced in section I.C. If the same fundamental conflicts underlie differing degrees and natures of government activity in the economy across times and places, explanations for such variation cannot come from those common roots. Explanations for the varying postwar experience
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of developed democracies with their KWS’s must instead lie in differences across country-times in...

(a) ...the degrees and types of pressures upon different democratic policymakers in different places at different times to ameliorate market-economy vicissitudes,

(b) and/or the ability or willingness of those different policymakers to resist such pressures in different places at different times,

(c) and/or the economic or political effectiveness of their different reactions to relieve that pressure in different places at different times...

This book develops such explanations within a methodology of comparative political economy that...

(a) ....gives equal weight to domestic and international, political and economic, institutional and structural characteristics of the environments in which strategic actors make policy,

(b) emphasizes the interaction of these institutions and structures to produce the set of incentives applying to the strategic actors that make and influence policy, and

(c) stresses painstaking attention to theoretically informed (and therefore potentially theoretically informing) empirical analysis.

The rest of the section elaborates the view of democratic policymaking underlying this approach.

I.D.2. The Cycle of Political Economy: A Framework for Theoretical and Empirical Analysis

This is a book about macroeconomic policymaking in developed democracies in the postwar era. It asks why some country-times in that sample are characterized by certain kinds of policies and other country-times by others, and, relatedly, why similar policies sometimes produce markedly different outcomes across such similar country-times. The view of comparative, democratic political economy guiding the exploration of these questions—in the context of the KWS commitments to social-insurance, public-goods, and macroeconomic-management provision via transfers, debt, and monetary/wage-price policy—may be condensed to a single paragraph.

Macroeconomic policy is made by politicians who, in developed democracies, are elected by populations with different demographic, political, and economic structures. They are elected to make

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28 This answers Pontusson’s (1995) challenge that institutional political economists “put structure in its place and take interests seriously.”
policy as partisan actors and do so\textsuperscript{29} in an institutionalized environment. Those policies, coupled with other more exogenous factors like economic conditions abroad and more endogenous ones like the actions of non-governmental actors, then produce political and economic outcomes about which the electorate cares. These outcomes may alter the structure of interests within the electorate, which then chooses its policymaking representatives anew. At each stage, all the actors in this cycle realize that it cycles, so their incentives emanate from both the aspects of the current cycle that determined their current situation and their expectations of the structure of future cycles and their situation in them. Figure I.8 offers a schematic representation of this cyclical view of political economy.

\textsuperscript{29}Democratic policymakers do generally fulfill their electoral and partisan promises; see, e.g., Klingemann et al. (1994). Gallagher et al. (1995, ch. 13) summarizes some of the (generally favorable) evidence.
To elaborate, the policy-determination arguments in the book first characterize the interests of the electorate, focusing on the institutional, economic, and demographic structure of the polity and economy. In Chapter II, e.g., the age and income distribution in the polity are center-stage; in Chapter IV, the sectoral structure of wage-price-bargaining—the size and roles of public-, private-traded-, and private-sheltered-sector actors within those bargains—are key; and, throughout, the international exposure of political-economic actors remains important. In each case, these structures

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30 I.e., in the classic cleavage-structure terminology of comparative politics, the focus at this first stage is on *attitudinal or opinion cleavages* (Rae and Taylor 1970), on *economic-function cleavages* (Flanagan 1973), or on *disagreement over policy issues* (Eckstein 1966) within the polity. Lane and Ersson (1994:52-6) give a particularly useful, succinct summary of these cleavage-structure schema.
of interest are funneled through and interact with electoral, government-formation-and-dissolution, and policymaking processes in achieving their impacts on policies and outcomes.

For example, when that interested population elects its representatives to government, it does so largely according to their partisan reputations in serving those interests. In the process, the legal and institutional structure of the electoral system profoundly impacts not only the outcomes of the elections themselves (Rae 1967, Taagepera and Shugart 1989, and Lijphart 1994) but also the policy implications of those elections and their outcomes (Tufte 1978, Dye 1979). Chapter II, e.g., shows how voter participation, which depends, inter alia, on electoral law regarding registration and polling scheduling (see, e.g., Powell 1982, Jackman and Miller 1995, Franklin 1996), modifies the impact of the income distribution on welfare policies. As another example, Chapters II and III both find that electioneering effects on fiscal policies are large enough and fiscal policies adjust slowly enough for variation in election frequency to impact long-run transfer-system and debt GDP-shares appreciably. Election frequency, in turn, depends on constitutional provisions regarding, e.g., whether and under what conditions the government may call early elections and the maximum inter-electoral period and on other institutional-structural features of the political economy, most critically those determining the types and durability of the governments it tends to produce. Moreover, Chapter III also shows that fractionalized, polarized governments magnify the long-run fiscal-effects of electoral frequency (and many other political-economic considerations) because multiparty governments delay policy adjustments. Thus, the impacts of the election process on policies and outcomes, like those of interest structure, depend on (interact with) many other aspects of the political-economic cycle.

Then the elected, partisan representatives form governments (and sometimes dissolve them)

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31 See Downs (1957) for the original argument and Keech and Lee (1995) for the most recent evidence.
32 Lin (1995) finds, similarly, that greater numbers of partisan veto actors in government retard transfer-payment responses to domestic economic and political influences, suggesting that these considerations also operate in that venue.
to make policy within the institutionalized setting of the legislature and executive.\textsuperscript{33} In general, the policies these governments enact follow incentives from democratic competition and, specifically, their electoral promises and partisan preferences in/from that competition. Chapters II-IV, e.g., find that governments tended to increase transfers, deficits, and monetary-growth \textit{around} elections, i.e., in the year before and \textit{after} elections. The former was long expected (Nordhaus 1975, Tufte 1978), but often proved difficult to find empirically (Alesina 1988b, 1989; Alesina and Roubini 1992; and Alesina et al. 1992). Partly, this was because post-electoral effects were not sought,\textsuperscript{34} yet, if governments generally fulfill electoral promises (see, e.g., Alt 1985, Klingemann et al. 1994, Gallagher et al. 1995), and if campaigns tend to induce competitive escalation in promised largesse (Tufte 1978), then governments will tend to provide excess economic stimulation after elections as well. Previous empirics also tended to ignore policymaking-process differences across country times. For example, in some countries, voters elect executives and legislatures separately, suggesting that policy will only partially respond to each election, especially if the election periods are staggered. Elsewhere, governments share control of some of these instruments with other agents less interested in such electioneering—e.g., of monetary policy with their central bank or, through fixed exchange-rates, with foreign governments (Chapter IV; Clark et al. 1998; Franzese 1999ce; Oatley 1999).\textsuperscript{35} In

\textsuperscript{33} While comparative theoretical structures for analyzing such activity in parliamentary and non-parliamentary democracies are lacking (see Tsebelis 1995 for a recent ingress), work on parliamentary government formation and dissolution is vast and growing. (A review might follow Riker 1962; Axelrod 1970; DeSwaan 1973; Dodd 1976; Browne and Dreijmanis 1982; Morgan 1976; Taylor and Laver 1973; textbook treatment: Gallagher et al. 1995:ch. 12; with, e.g., Diermeier and Stevenson 1994; King et al. 1990; Laver and Budge 1991; Laver and Hunt 1992; Laver and Schofield 1991; Laver and Shepsle 1994, 1996; Lupia and Strom 1995; Martin and Stevenson 1995; Stevenson 1994ab, 1997; Strom 1984, 1985, 1988, 1990; Strom et al. 1994; Warwick 1992abc, 1994, 1996; Warwick and Easton 1992).\textsuperscript{34} Empirical examinations typically compared pre-election periods with other periods, including the immediate post-election period, which evidence now indicates was at least as stimulative.\textsuperscript{35} In others, subnational governments may have partial control over these policies; and, in still others, multiple parties in coalition governments, each with potentially conflicting interests over the degree and type of electioneering stimulus to support, control policy. The book less directly
short, these considerations and others from elsewhere in the cycle modify governments’ incentives to provide economic stimuli around elections and/or their ability to act on them.

The impact of government partisanship on policies and outcomes likewise varies depending on other considerations in the political-economic cycle. Again, partisan effects on monetary policy are dampened by international and institutional constraints on domestic government control (Chapter IV; Clark et al. 1998; Clark and Hallerberg 1999; Franzese 1999ce; Oatley 1999). Moreover, partisan governments have mixed incentives regarding deficit spending and debt accumulation, i.e., fiscal policy. Right parties rely for electoral support partly on their reputations for fiscal conservatism; however, if their opponents are suspected to be more default-prone—e.g., the left is generally more inflationary, and inflation is partial default on outstanding nominal debt—then right partisans can broaden their electoral appeal by increasing the stock of (nominal) debt held by voters. Left parties, contrarily, rely on their reputations for fiscal responsiveness, but would narrow their electoral appeal by increasing the stock of debt outstanding if they are suspected default-risks.\textsuperscript{36} Chapter III shows that which consideration dominates depends on partisan polarization across governments, i.e., the ideological distance, in terms of their desired budgets, between alternative governments and the frequency of their alternation. Governments with sufficient security in office, i.e., those that little fear replacement by distant ideological alternatives, tend to use fiscal policy strategically for debt-accumulation’s electoral impact. Governments in more polarized, volatile systems cannot afford to jeopardize their partisan reputations by such untoward policies; there, the left (right) tends toward

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deficit spending (reduction).\textsuperscript{37} Again, polarization across governments and the frequency of their alternation depend on legislative, executive, and electoral institutions, so the impact of partisanship, like that of elections, depends on other aspects of the political-economic cycle in that country-time.\textsuperscript{38}

Fractionalization and polarization within governments also alter macroeconomic policy. As Tsebelis (1995) argues, greater numbers of and ideological spaces between the actors possessing vetoes over policymaking complicate bargains over policy changes, reducing winsets (i.e., sets of politically feasible policy moves), and thereby privileging the status quo. In the public-debt context, scholars (Roubini and Sachs 1989ab; Alesina and Drazen 1991; Drazen and Grilli 1993; Spolaore 1993; Alesina and Perotti 1994, 1995ab) argued that such immobility delayed fiscal adjustments and so contributed to greater deficits following the oil crises in democracies that had fractionalized and polarized governments than in those that had more-unified governments. The evidence that followed was mixed (Roubini and Sachs 1989ab; DeHaan and Sturm 1994; Edin and Ohlsson 1991; Borelli and Royed 1995; Hallerberg and Von Hagen 1996), but these empirical studies generally failed to

\textsuperscript{37}Lambertini (1999) also addresses the strategic literature empirically, but differently, and finds no evidence of strategic manipulation of debt to constrain the opposition. The findings here and in Franzese (1999b) relate differently to the conditions of government alternation that foster traditional or counter-intuitive fiscal policy.

consider the way the delayed-stabilizations produced by multiple veto actors interacted with these economic conditions, and with other political-economic considerations, to determine long-run debt levels. Fractionalization and polarization produce inaction, and the effect of inaction depends on what would happen under reversion to the status quo. Thus, as Chapter III demonstrates, not only did democracies with more partisan veto actors delay stabilization longer and accumulate more debt following the adverse shocks, as the original argument expected (see also Alesina and Perotti 1995b), but the number of veto actors also magnified the long-run impact of all other determinants of fiscal policies, such as those mentioned above (see also Franzese 1998a, 1999b).\footnote{Chapter III and Franzese (1998a, 1999b) also offer important improvements upon the measurement of fractionalization and polarization within (and across) governments.} The cycle of political economy in Figure I.8 again clarifies that international and domestic political-economic conditions, interest structures, and institutions interact to determine policies and outcomes.

Finally, (a) the policy actions that these elected partisan representatives in government take, (b) actions taken by non-governmental actors such as central banks, unions, and firms, (c) actions taken by foreign actors, and (d) more exogenous factors like inherited and international economic conditions, determine the political and economic outcomes that form anew the interest structure of the polity and economy. Then the cycle begins again, from the structure of interests in polity and economy, to election of partisan representatives, to the formation of partisan and fractionalized-polarized or unified governments among those representatives, to their making of policies that depend on their electoral and other incentives and the reputations on which they rely for reelection. Policies are made, other actors move, exogenous conditions change, occasionally governments fall, determining new outcomes, perhaps altering the previously existing structure of interests further.

This leaves the final complication. At every stage in the cycle, any or all of the actors might act strategically because, at least at some simple level, all the actors know that the game cycles.
elected representatives, e.g., know that they will have to face the electorate again. Thus, any of the actors may be motivated at any time by concerns emanating from either direction relative to their current position in the cycle. To repeat an example from above, democratic governments may choose fiscal policies as much to change the structure of interests in the electorate that they must face at the next election as to fulfill electoral promises made to the current electorate. E.g., Garrett (1992, 1994), Garrett and Heath (1991), and Hall (1986) describe how the Thatcher government’s attacks on union bargaining and public housing served electoral purposes weakened her Labour opponents’ union base and turning some public-housing Labour-voters into Conservative home-owners and the rest non-voting homeless. Hibbs (1987) similarly describes the Reagan government’s tax policies, which brought large gains to the wealthiest and produced massive debts, which, eventually, left a more-debt-holding public more anti-inflationary and anti-spending, i.e., more pro-Republican. Thus, the policies and outcomes studied here emerge from the choices of reasoning human beings, but this creates several methodological problems familiar to social scientists. Human beings are generally aware of the cycle within which they are acting, if perhaps only vaguely, and capable of foreseeing the likely outcomes of their possible actions, if perhaps only with great (and usually uncomfortable) uncertainty. Therefore, they are likely to be at least partially motivated by the expected outcomes of their actions, and so scholars must look forward and backward around the cycle just as the political-economic actors that they are studying do. This cycle of political economy framework guides the derivation of arguments and the search for evidence throughout the book.

I.E. The Implications of Democratic Mismanagement of the Keynesian Welfare State

Returning to the development of the KWS outlined above, this section surveys the economic and political consequences that the book links to these varying manifestations of over-commitment, introducing the more-thorough discussion in Chapters II-V of the implications of these developments
for the continued economic viability and the comparative democratic (mis)management of the KWS.

I.E.1. Economic Impacts

Public transfers (Chapter II) are often posited to have two main effects. First, that they reduce or, minimally, ameliorate the economic hardships to which they are addressed—poverty among the unemployed, aged, and disabled—is not generally disputed. Second, contrarily, they are frequently blamed for having deleterious effect on economic efficiency by weakening the harsh incentives of the market-place. However, broad empirical connections between government-size and economic growth have proven difficult to establish, though Cameron’s (1978) finding that taxes as a fraction of GDP related weakly negatively to investment as a fraction of GDP is some indication in this direction. Evidence of connections between the extent of transfers and the unemployment rate was also initially weak, but more recent work notes that, theoretically, unemployment insurance should relate more directly to the duration of individual unemployment stints than to the unemployment rate per se. Here the evidence is very strongly favorable (e.g., Meyer 1990, 1995; Layard et al. 1991).

Additionally, as noted above and shown in Chapter II, transfers growth tended to drive more general growth of government, and the latter tended to drive debt accumulation proportionately. The meteoric rise in transfers, therefore, also tended to tighten governments’ budget constraints, thereby reducing their discretion over other expenditure goals. Moreover, to the extent transfers are deficit-financed, the impacts of public debt are attributable that far to growth in transfers as well.

Until the seventies, macroeconomists generally agreed that public deficits created short-term increases in real demand and, thereby, real output and income but that public debt also crowded out private investment in the long-run, thereby eventually hindering growth. The crowding-out logic was simple. Since increased public borrowing requirements represent increased demand for savings, absent some increase in the savings-rate schedule, the extra borrowing-demand would raise interest
rates, forcing private actors to forego some investments that could have profited at lower rates. In Figure I.9, a purely pedagogical example, start at $O$, where real interest rates are 4% and savings equal private investment at 30, and suppose the government borrows 10. The total borrowing requirement shifts up, and, since there is no shift in the savings schedule, the new equilibrium is at $CO$ where real interest rates are 5% and the total of private investment and public borrowing is 35. Public borrowing is 10 of that, so private investment must have dropped to 25.

Therefore, in basic Keynesian macroeconomics, public deficits increased disposable income (by raising government expenditure net of taxes) in the short-run, giving a consumption-based boost to the economy. In the long-run, public borrowing came somewhat at private borrowers’ expense, exactly how much depending on the elasticities of the savings and investment schedules (slopes of the funds demand- and supply-lines in Figure I.9). Public debt’s long-run effect, then, depended on two factors: elasticities of savings and investment with respect to interest rates, and what the government did with the money it borrowed. The flatter the savings or the steeper the investment curve, the more crowding out was expected, and, of course, the more inefficient public consumption and investment decisions relative to private ones, the more deleterious the effects of crowding out.
Recently, however, the rational-expectations revolution in macroeconomics gave new life to the *Ricardian equivalence* theorem (Barro 1974, 1979) that whether the government borrows or taxes to finance a given amount of spending is irrelevant to the real economy. Referring again to Figure I.9, the private sector now knows that higher borrowing today implies higher taxes tomorrow to repay the debt and so increases savings when the government borrows. Thus, again starting from $O$, when the government borrows 10, the private sector raises savings to cover expected future taxes. The new equilibrium is at $RE$, where real interest rates remain 4% and public borrowing plus private investment total 40. Again, 10 of that is public borrowing, leaving private investment unchanged at 30. Thus, government debt *per se* is no drag on the economy, though what the government does with the borrowed money remains critical.

In theory, then, the real economic costs of public debt depend on the empirical relevance of the Ricardian-equivalence theorem, elasticities of savings and borrowing with respect to interest, and
efficiency of public relative to private spending. Chapter III offers some simple evidence suggesting that debt effects are negligible on real-per-capita-GDP growth but are appreciable on inflation (+) and unemployment (-). This, in turn, suggests that, from a political economy point of view, the impacts of public debt on growth were never the primary issue for those concerned, on either side, over the development of massive public debts. Rather more-central was how governments spent their borrowed money compared to how the private sector would have spent it. Governments seemed to spend with some concern to macroeconomic management, aiming to reduce unemployment (even if this tended to increase inflation), perhaps by raising public-sector employment (see below).

Another effect of public debt, at least as important for present purposes, and, surprisingly, relatively neglected in the literature (but see Blais et al. 1993, 1996), is that debt accumulation tends to constrain future governments from the appropriate use of fiscal policy. Chapter III argues that this, in turn, spurred the shift in policy-emphasis to monetary-policy management of the macroeconomy, especially inflation control, and, subsequently, to supply-side and institutional reforms.

Public employment, finally, is argued to have its main detrimental impacts on productivity, productivity growth. Chapter IV presents some simple evidence supporting this, but, in addition to the obvious growth implications of that, it also argues and finds an important wage-price-regulation impact of public-sector employment-growth. Specifically, the relative insulation of public-sector workers from competition, international or domestic, not only profoundly weakens the ability of coordinated-bargaining institutions to deliver real-wage restraint (see also Franzese 1994, 1996b; Garrett and Way 1995b, 1999ab), but also renders wage-price bargainers less responsive to monetary-policy responses to wage settlements, which otherwise may have reenforced such restraint.

To sum: transfers and spending growth alleviated the economic hardships to which they were addressed, but they also rendered unemployment spells more durable, thereby hindering fiscal-policy
efficacy in reducing unemployment levels. They also drove public-debt growth that, while it may not have harmed growth, highlighted conflicts between unemployment and inflation reduction, and increasingly constrained governments’ fiscal-policy maneuverability. Growing transfers, spending, and debt increasingly constrained governments’ fiscal-policy options, and so turned them toward restrictive monetary policies intended to recreate broad political coalitions behind public action to support macroeconomic efficiency or, at least, low inflation. However, the public-employment growth that accompanied all this fiscal expansion, also increased the real-growth and unemployment costs of that anti-inflationary monetary-policy shift, again highlighting conflicts between inflation and unemployment reduction. Thus, modern political conflicts over various structural-institutional reforms intended to redress burgeoning transfers or debt or to ensure consistently and credibly anti-inflationary monetary policies essentially retain all the left-right, unemployment-inflation, efficiency-equity tradeoffs long-familiar to comparative political economists.

I.E.2. (Other) Political Consequences

Most of the specific political implications of the various manifestations of over-commitment to provision of social insurance, public goods, and democratic management of the macroeconomy that emerged from the conflicting distribution of political and economic influence in developed democracies have been explored above. This subsection stresses four more general implications that were relatively slighted in that discussion or otherwise merit reemphasizing.

First, to the degree citizens hold governments responsible for the functioning of the economy, economic effects are political effects. That citizens do hold governments responsible for economic outcomes is a central tenet of political economy, and supportive empirical evidence across countries is readily available (e.g., Lewis-Beck 1990; Powell and Whitten 1993). Most broadly, then, if the trends in public-sector growth bear some blame for deteriorating economic performance, then some
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part of the public disaffection with governments and parties that is currently epidemic in developed democracies (see, e.g., Koole and Mair 1994) can likewise be blamed on these policy trends.  

Second, public-sector growth in each of these three dimensions created new social cleavages or exacerbated existing ones. For example, as public debt grows, conflicts of interest between those holding relatively larger amounts of public debt and those obtaining relatively larger benefits from debt-financed public spending (see, e.g., Aghion and Bolton 1990) likewise grows. This extends the usual conflict between the holders of capital and the unemployed and unskilled labor force, exacerbating the tendency for the former’s anti-inflationary biases to conflict with the latter’s relative lack of concern about inflation as emphasized in the conclusion to Chapter III.

Third, in some countries, public-sector growth and its popular linkage to declining economic performance have profoundly impacted support for other political-economic institutions. E.g., as decreasing fiscal maneuverability became apparent, support in some segments of the polity—an anti-inflation coalition—for increasing central-bank autonomy to combat inflation grew while in other segments—those most vulnerable to macroeconomic fluctuations, and so most desirous of retaining monetary discretion politically now that fiscal maneuverability is declining—it decreased. Similarly, as argued in Chapter IV, public-employment growth sapped the ability and willingness of coordinated wage-bargainers to deliver real-wage restraint, inducing employers and some workers to abandon such bargaining institutions in some coordinated political economies.

Finally, if, as likely, voters’ distaste for further increases in the tax burden increase with the

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40 More precisely, public disaffection would likely arise from the perception of a causal link even if such a link cannot be found objectively. Another question, then, is whether the perception was warranted.

41 Missale and Blanchard (1992) build from Calvo et al. (1989, 1991) to suggest, relatedly, that, high public-debt increases pressure on governments from debt-holders fearful of inflationary default increasingly to issue indexed or foreign-currency-denominated debt. The mechanism is that inflationary-default-risk premiums on public-debt interest could be avoided thereby. See also the second point in this sub-section and Aghion and Bolton (1990).
existing size of that burden, then fiscal expansion becomes an increasingly unviable option for
democratic governments as debt-financing capabilities become exhausted. Democratic governments,
therefore, increasingly relied on monetary policy or sought to renounce Keynesian counter-cyclical
policy in toto. In fact, the pattern of policy moves beginning in the late sixties seems to progress
from the first through the second. Specifically, first the US-led inflation of the late sixties led to the
abandonment of Bretton Woods, freeing monetary policy to domestic purposes. Then, after the oil
crises, focus shifted to anti-inflationary monetary policies, as fiscal policy proved problematic
politically and/or ineffective economically. Then, as real growth and unemployment performance
continued to worsen through the mid-eighties, focus fell finally on institutional reforms (so-called
supply-side policies): e.g., major alterations in transfer systems in the US, in labor-market regulation
in the UK, in monetary-policymaking institutions, i.e., increased central bank autonomy and/or fixed-
exchange-rate schemes, in New Zealand and across Europe, respectively. As noted repeatedly above
and demonstrated repeatedly throughout the book, though, none of these shifts succeeds in avoiding
the replication of democratic political struggles over the familiar dilemma of the KWS: the conflict
between its goals of fostering capitalist growth and ameliorating its distributional outcomes, and the
universal tension between distributions of political and economic influence in capitalist democracy.

I.F. Roadmaps to the Rest of the Book

As noted at this chapter’s start, this book undertakes four theoretical and empirical tasks to
make these arguments. (1) It conducts three stand-alone studies of specific aspects of the KWS.
Through these, (2) it relates an aggregate empirical history of the KWS in developed democracies,
and (3) develops an approach to the comparative political economy of developed democracies in
which common tensions between the distributions of political and economic influence manifest
differently across country-times depending on multiple interactions among the international and
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domestic, political and economic, structures of institutions and interests characterizing those country-times. And (4), it demonstrates, from that view and in those studies of the evolution of KWS mismanagement, how modern conflict over structural and institutional reforms of the KWS replicate long-familiar political-economic conflicts between left and right, unemployment and inflation, efficiency and equity. Several roadmaps to the rest of the book correspond to these tasks.

First, regarding the chapters independently: Chapter II offers and evaluates theories to explain the political-economic determination of transfer-system size and growth; Chapter III similarly studies public-debt determination; and Chapter IV considers the interaction of monetary-policy and labor- and goods-market institutions, with each other and with sectoral composition of the economy, in macroeconomic management. Those interested exclusively in those topics, can read the relevant chapters independently and Section V.A. for a conclusion to them as a set.

Second, regarding the comparative, aggregate, empirical historiography, refer back to Figure I.8. Chapters II and III focus on the top-right of the political-economic cycle, from the structure of interests in the polity through democratic policymaking. Chapter IV focuses instead on the bottom-left, i.e., on how policy and the institutional and structural features of the polity and economy interact to produce political and economic outcomes and on how those outcomes alter the structure of interests in the polity. These foci reflect the individual chapters’ separate origins and are retained intentionally, enabling each chapter to be read profitably as a self-contained study on that particular topic. The cycle is closed in the “Discussion, Conclusions, and Implications” section that concludes each chapter, thus completing the empirical history of the KWS in Chapters II-IV read consecutively.

Finally, as a whole, these studies combine to more than historiography. They also develop a broad framework for analyzing macroeconomic policymaking comparatively across capitalist democracies, and show how this framework continues to illuminate democratic policymaking as
governments shift toward microeconomic and institutional reforms because the conflicts underlying these debates have not changed, whatever the protagonists might claim. In developing these arguments, the *roadmap* includes this introduction just concluding, which provided:

(a) an introduction and motivation for the book, providing a brief background for the class compromise and postwar settlement on the KWS commitments to democratic provision of social insurance, public goods, and macroeconomic management,

(b) a brief comparative empirical history of the KWS and concurrent developments in macroeconomic performance across capitalist democracies in the postwar era,

(c) an outline of the view of political economy embodied in the book, which explains how common disparities in the distributions of political and economic influences in capitalist democracies manifest differently across country-times depending on multiple interactions of the domestic and international political-economic institutions, structures, and conditions characterizing those country-times,

(d) an overview of the theoretical and empirical framework to be employed in studying the problematics illuminated by that view, and

(e) a quick presaging of the implications of the empirical history of the KWS in developed democracies in the postwar era and of the arguments and evidence presented about its causes and correlates for the continued maintenance and utility of the KWS and for modern political conflict over the institutions within which democratic governments will continue to attempt to fulfill their commitments.

The roles of Chapters II-IV in consummating this chapter’s promises in these regards were detailed above. Section V.B. returns to the broadest of these questions and problematics for further and reconsideration in light of the intervening arguments and findings, and the outline below conveniently summarizes this chapter, these arguments, and the book.
Summary Outline of the Book

I. Chapter I: In the postwar settlement on the class compromise behind the Keynesian Welfare State, democratic governments committed themselves to some (varying) degree of political provision of social insurance, public goods, and macroeconomic-management.

A. These democratic commitments reflect broader, often conflicting, goals both to foster capitalist efficiency and growth and to ameliorate its distributional consequences.

B. Democracy and capitalism distribute political and economic resources differently in capitalist democracy, generally creating popular pressures on democratic policymakers that induce inefficient tradeoffs between these competing commitments.

C. However, the universal tensions induce differing policies and outcomes.

1. Differing inefficiencies in governments’ fulfilment of their commitments and differing crises of the Keynesian Welfare State evolved.

2. The differences arose because the incentives for political-economic actors that emerge from these conflicting goals and conflicting distributions of interest and influence depend on multiple interactions among the domestic and international political-economic institutions, structures, and conditions within which they interact and to which they respond.

D. As these (varying) fiscal-policy difficulties evolved, democratic governments turned first toward monetary-policy and then toward institutional-structural reform, attempting to rebuild broad postwar coalitions behind democratic macroeconomic management (putatively) for aggregate efficiency.

1. However, like their predecessors, these new policy paradigms also have important distributional consequences, whatever their efficiency effects.

2. The new political struggles over institutional-structural reforms look remarkably similar to old left-right, employment-inflation, efficiency-equity tradeoffs familiar to political economists.

3. Only the locus of political battle changed: from the policies themselves, to the institutions and structures within which democratic policymakers choose those policies.

II. Chapter II: Democratic Commitments to Social Insurance, Welfare, and Pensions

A. The differential distribution of votes (one-person, one-vote) and income (few very wealthy, many poor and middle class) in capitalist democracy tends to produce median voters who are poorer than the economy average, generating a general demand for public transfers.

B. Economic conditions and these differential distributions of political and economic influence broadly explain the common experience across countries of rising (rapidly rising) transfers-shares of GDP (since the seventies).

1. While economies grew rapidly in the first two postwar decades, expanding demand for redistribution could be met with only moderately growing transfers-shares of GDP.

2. But, when stagflation hit in the seventies and persisted into the eighties, the costs of maintaining the democratic commitment to social-insurance and so transfers-shares of GDP skyrocketed.

C. Political institutions and structures broadly explain the cross-national differences in the paces of transfers-growth reflecting differing policymaker responses to similar economic conditions and political pressures. For example:

1. Stronger labor organization and more-left governments created more-effective political pressure toward transfer expansion and more government responsiveness thereto.

2. Systems with more frequent elections and slower policy-adjustment, ratchet opportunistic
manipulations of transfers around election years into greater long-run transfers levels.

3. Most importantly, electoral institutions that induce greater political participation increase the range of income distribution, from right (wealthy) to left (poor), represented in the electorate and so increase the effective political pressure on democratic governments from any given distribution of economic resources.

D. Economic Effects and Political Implications:

1. Rising transfers drove growth in government more generally, which was partially deficit-financed, and so they drove growing public indebtedness as well.

2. Rising transfers increased labor-market rigidities, thereby increasing unemployment and reducing fiscal-policy efficacy in controlling unemployment.

3. However, the rising transfers also ameliorated the economic hardships of those who remained or became unemployed.

4. Therefore, political conflicts over transfer-system reforms replicate familiar conflicts.

III. Chapter III: Deficit Finance of the Commitments and Public Indebtedness

A. Common pressures and economic exposure explain the generally shared path of declining debt through the seventies and dramatic reversal thereafter.

1. Common pressures toward partial deficit-finance of the transfers-driven growth in total spending were offset through the seventies by strong economic growth, allowing simultaneous expansion of government involvement in the macroeconomy and reduction of debt-to-GDP ratios.

2. Common exposure to terms-of-trade shocks in the seventies, which triggered stagnant growth and high unemployment through the eighties, increased the debt costs of continuing expansion of the democratic commitments to macroeconomic involvement.

3. As governments turned toward anti-inflationary monetary policy to redress the inflation aspect of stagflation, real-interest rates on the newly accumulating debt rose sharply, dramatically exacerbating the effects of slowed growth and higher unemployment.

B. Interactions among differing political-economic institutions, structures, and conditions magnified these effects in some democracies and dampened them in others, explaining the cross-national and cross-country-time differences. For example:

1. Presidentialism creates a powerful policymaker with a national constituency, diminishing motivations for deficit-financed distributional projects.

2. Systems with autonomous, conservative central banks diminish governments’ access to politically expedient inflationary debt-default, dissuading them from debt-accumulation.

3. More complicated fiscal systems aggravate voters’ difficulties in evaluating the full and true costs of deficit-financing, increasing incentives for policymakers to issue debt.

4. Systems with more frequent elections and slower policy-adjustment, ratchet opportunistic manipulations of transfers around election years into greater long-run transfers levels.

5. Most importantly, fractionalized and polarized governments retard policy adjustments, thereby geometrically multiplying the long-run debt effects of the high real-interest following the terms-of-trade shocks and, indeed, the effects of all other political-economic conditions.

C. Economic Effects and Political Implications

1. Public debt had little effect on real growth, i.e., on efficiency, but strong, opposite effects on inflation (positive) and unemployment (negative).
Comparative Democratic Mismanagement of the Keynesian Welfare State

Robert J. Franzese, Jr.

a. The economic effect of debt, therefore, reflects less any large efficiency difference between public and private investment and more their differing distributional effects.

b. Accordingly, political battles over reforms to reduce debt, however couched in the language of efficiency and responsibility, mirror familiar macroeconomic-policy struggles.

2. Rising public debts, plus transfers-induced increasing labor-market rigidities, plus growing international trade and financial exposure, limited fiscal-policy efficacy and maneuverability.

3. Accordingly, governments turned to monetary policy, freed from fixed-exchange restrictions, to fulfill their democratic commitments to macroeconomic management...

a. ...to redress the inflation inherited from the oil shocks, and...

b. ...attempting to sustain the broad postwar coalitions behind political regulation of the macroeconomy (putatively) for aggregate efficiency.

IV. Chapter IV: Monetary Regulation of the Macroeconomy

A. The anti-inflationary effects of monetary conservatism depended on how inflationary the political economy would be absent such monetary conservatism. Where the institutions and structure of the macroeconomy produce small (great) inflationary pressures, the conservatism of the monetary authority adds little (much) further anti-inflationary bite.

B. The real, e.g., unemployment, effects of monetary conservatism depend on the credibility with which the monetary authority could threaten to quash inflationary pressures, but also on the incentives and capacity of wage-price bargainers to respond efficiently to those threats.

1. More-coordinated bargaining-units encompass greater shares of the economic aggregates to which the monetary authority threatens to respond and so have greater incentives and capacity to respond efficiently.

2. Enaction of monetary threats raises interest rates, hindering private investment and appreciating exchange rates, so private-sector and, especially, traded-sector bargainers have greater incentives to respond more efficiently to monetary threats than public-sector bargainers.

C. Thus, both the nominal benefits and the real costs of governments monetary-policy shifts toward conservatism were larger where political economies had less-coordinated and more public-relative-to-traded-sector dominated bargaining (and where they were otherwise inflationary).

D. Coordinated bargaining tended to equalize wage-growth across low-productivity-growth service and high-productivity-growth industrial sectors, tended to price private sectors out of service provision.

1. Governments in these economies therefore tended to respond by increasing public-sector service provision and employment.

2. However, the increasing public-sector employment undermined the efficiency of coordinated bargaining in delivering wage-price restraint and responding to monetary conservatism.

E. Thus, as governments turned toward monetary conservatism to restrain inflation...

1. ...the real costs of doing so were growing even where they used to be low and everywhere tended to be larger wherever the nominal benefits of doing so were larger, and...

2. ...they converted the inflationary effects of their public-sector employment-growth into real effects, undermining political support for coordinated bargaining.

F. Again, modern political struggles over institutional reforms, increasing labor-market flexibility and credible monetary conservatism, merely paraphrase long-familiar macroeconomic-policy debates.

V. Chapter V concludes summarily.