The free economy, the welfare state and government borrowing

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Basic principles

The focus of this seminar is the welfare state and government borrowing. First, I want to discuss some principles of Catholic social teaching. Catholic social teaching has generally welcomed what I shall describe as a 'free economy'. I use the phrase 'free economy' – as also used by John Paul II in *Centesimus annus*, advisedly. The word 'capitalism' was coined by the enemies of a free economy and the phrase 'market economy' excludes much free economic activity that takes place outside the sphere of the market: I shall expand on this later. Free economic activity is really about human action in the economic sphere. Whilst the market is an important forum for free economic activity, much economic action takes place within families, charities, mutual societies and so on.

Why might Catholic social teaching favour the free economy? The opposite of a free economy is an economy where economic action is controlled by the state. In *Centesimus annus* Pope John Paul II welcomed a free economy not just because it was efficient in providing for human needs but because it chimed with the anthropological nature of man. He said about socialism:

> 'the fundamental error of socialism is anthropological in nature. Socialism considers the individual person simply as an element, a molecule within the social organism…Socialism likewise maintains that the good of the individual can be realized without reference to his free choice, to the unique and exclusive responsibility which he exercises in the face of good or evil.'

In a free economy, economic resources are allocated by agreement between individuals, free institutions and so on; as such they are allocated peacefully and all parties benefit from the free economic exchanges that take place even though all are pursuing their own separate interests. Indeed, the main characteristic of a free economy is that it allows human beings to meet their own needs whilst, at the same time, serving the needs of others. Specifically, a business is a community of people that serves its owners' interests by serving the interests of others.

In general, a free economy harnesses self interest – a motive that is not the same as that of selfishness, with which the term is often conflated – in a way which genuinely promotes the common good. Whilst always being cognisant of the imperfections of a free economy, we should also reflect on the dire poverty that exists where a tolerably free economy is absent.

As Pope John Paul II put it: 'The social order will be all the more stable, the more it takes this fact into account and does not place in opposition personal interest and the interests of society as a whole, but rather seeks ways to bring them into fruitful harmony.'

In other words the common good is quite compatible with the pursuit of benign self interest within a market economy. This was an important insight from the late scholastic Catholic thinkers of Salamanca who followed in the footsteps of Thomas Aquinas: self interest, they argued, is an extension of self respect.

So far you might think this is rosy view of a free economy. You might think that, despite all I have said, a free economy deals insufficiently with problems of poverty, income provision in old age, the exploitation of the weak and so on. These are problems caused, of course, by human sinfulness and our fallen nature. They can be thought of as arising because of the sins of omission of people who do not attend to the needs of those whose physical disposition prevents them from earning sufficient to keep themselves and so on. These problems can also arise because the benign force of self interest can turn into the more malign problem of greed.

We may wish the state to intervene to help alleviate these problems and the development of welfare states has often been part of this reaction. But it should be borne in mind that state intervention is not the *ideal*. It is often thought that state provision of income for the poor somehow brings to fulfilment of the spirit of charity and solidarity that should exist amongst the Christian community. This is not so. As is stated in C*aritas in veritate*, ‘Solidarity is first and foremost a sense of responsibility on the part of everyone with regard to everyone, and it cannot therefore be merely delegated to the State.’ (38)

When the Church has talked about solidarity and the ‘preferential option for the poor’ she has generally been referring to it in the context of charity – love and service in providing for one’s neighbour without expecting anything in return. Solidarity is a virtue to be practised and not a political action plan.

The state should create a just order which promotes the common good. The state may intervene, as a last resort, to try to assist the poor. But, the virtue of solidarity, represented by love and works of charity, arises in the first place from the individual, the family and spontaneously from the community. The political order should not be the main vehicle for the practice of solidarity. The state should be the last resort because it can only achieve its objectives using coercion, and also because it is so remote from those whose needs it is trying to meet – one of the messages of *Deus caritas est*.

We need to ask ourselves whether the welfare states in the West support the spirit of solidarity that should emerge spontaneously or whether they have displaced that spirit. Are they promoting human flourishing – or the common good – or are they suppressing it?

We should always bear in mind that there are unforeseen consequences of interventions by politicians. Unintended consequences, about which the French nineteenth-century Catholic economist Frederic Bastiat wrote so well, are so ubiquitous in economics that, if you google unintended, consequences and economics together, you get 1,240,000 responses: more than the total worldwide google responses for the words ‘Catholic social teaching’! We lack the knowledge to plan and perfect a society made up of many individuals who – though they share a common humanity – each have a different place in God’s plan.

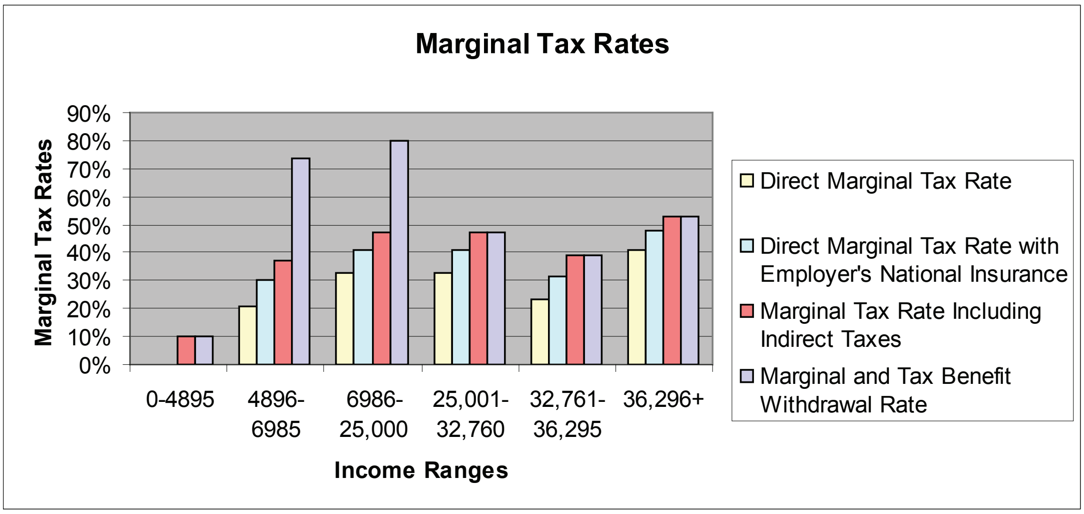
The welfare state

With this in mind I want to move on and talk about some of the problems with particular features of the welfare states in a number of European countries.

Catholic social teaching has always emphasised the importance of work; the importance of women being able to work within the home if they wish to do so; and the importance of all families – including those on low incomes – being able to build up property and capital. We should be very concerned if welfare states make work, saving and family formation more difficult – it would be a sign that they were not promoting the common good in the way they should.

Some welfare states perform very badly in terms of the penalties they impose on family formation – that is couples with children getting married. Specific examples do not prove a general point but perhaps I can just give two examples from the UK welfare system which is particularly problematic in this respect. If we take a family earning £25,000 with one earner and two children (for example with the mother working in the home) the family would gain over £2,000 per annum of net income by having both family members going out to work with them each earning £12,500. This arises because welfare benefits are awarded on the basis of family income but income tax allowances are personalised. More alarmingly, if the same couple split up and lived separately, the tax bill would be unaffected, but welfare benefits would rise dramatically (by several thousand pounds). These illustrations are not dramatic examples of quirks; they are an integral part of the UK tax and benefits system. These disincentives to create self-sustaining family units do not seem compatible with Catholic social teaching.

Catholic social teaching also puts great stress on the importance of work. The UK system is very poor at providing work incentives – and in different ways this is also true of many other European welfare systems. This chart shows the sum of the marginal rate at which income is withdrawn in extra taxes and lost welfare benefits as a result of people earning an extra pound in work. And I should add that it excludes important elements such as housing benefit:



It can be seen from the chart that for families with children below median earnings about 80% is lost. When a country has very high rates of taxes it can often be the poor who suffer most. It is worth noting that both *Rerum novarum* and *Quadragesimo anno* protested against the weight of taxes on the poor and stressed that the tax system should not be so harsh as to prevent the poor saving and acquiring property.

There are different types of problems in different welfare states in the EU and the way in which welfare states interact with labour market regulation is also important. We should be alarmed by the following outcomes though:

- In the UK there are five million people living in workless households.
- Youth unemployment – even before the financial crisis recession – was nearly 25% in France.
- In the EU, about 35% of all the unemployed have been unemployed for more than 12 months.
- In the EU, average unemployment is over 10%.
- There is a strong relationship between welfare state design and moral attitudes towards work.
- Family formation amongst the low paid with children has fallen dramatically in the UK.

These are not acceptable outcomes if we are concerned with human flourishing. More generally, academic work shows a strong relationship – both time series and cross section – between labour market outcomes, family formation and welfare state design. It is vulnerable groups – the disabled, the young, migrants and so on who can be particularly affected.

A third problem with welfare states, as they have developed in the West, is that they provide disincentives for saving – and again this is particularly acute in the UK where people lose vast amounts in welfare benefits in old age if they provide themselves with a pension through saving.

The evidence suggests that policy design really does matter and does affect social outcomes and moral decisions. We might prefer a world where people were not affected by financial considerations but many welfare systems do make it very difficult for well-meaning people to do the right thing. Virtue has to be practised and it can be very difficult to practise virtue when signals are so distorted.

At the end of this seminar I want to bring us back to some more general aspects of Catholic social teaching which are relevant to this debate but, for now, I want to make some further comments on what I regard as quite a gloomy economic prognosis.

Government borrowing and disordered self interest

I want to return to the notion of self interest. Christian politicians often decry the notion of self interest operating in a market economy. As I have noted, self interest operating in a market economy may be beneficial, but it can also become bent and turn into greed. However, it should not be assumed that the problem can be overcome by government intervention because we cannot assume that self interest will not also be present in our political system. Unrestrained self interest can have much more dire consequences in the political system than in a market economy because of the concentration of discretionary power within the political system. I want to examine this further especially with regard to inter-generational problems.

Economists of the public choice school are strongly critical of the way in which it is often assumed that people behave in a self-interested way in a market economy but, in the political sphere, people only behave in the general public interest. This is known as the ‘bifurcation of man’ assumption.

If we are concerned about the effect of disordered self interest in a market economy, the problem can have even worse manifestations within the political system - when people are acting as voters, government officials or political representatives. A middle way Christian Democratic view of the state can lead to unstable outcomes as it creates institutions that have a tendency to grow bigger and acquire more centralised power as those in charge of that process pursue their own self interest.

This is not a pessimistic view of human nature. It is just pointing out that we cannot argue that the concept of self interest leads to problems in a market economy and then assume the concept away when government is responsible for the allocation of economic resources. Many EU countries do have problems with endemic corruption and our own House of Commons in the UK was beset by an expenses scandal recently. Whilst freedom to contract restrains the operation of self interest in the market economy, such a constraint does not exist where the government has control of the economic sector as that government is only disciplined by a quinquennial election. Of course, we would like government also to be disciplined by a moral compass but we cannot always assume that.

In this context we might consider the build up of structural budget deficits. A structural budget deficit involves a systematic decision to impose the costs of consumption by one generation onto future generations. It reflects disordered self interest operating through the political system. This is quite different from the sorts of budget deficits that arise, for example, to fight wars or because of the temporary effects of recession.

There is little in the tradition of Catholic social teaching on this issue. Inflation was discussed by the late scholastics and the importance of monetary stability is referred to in the Catechism. General points telling the faithful to take into account the general good when taking political decisions are made, of course, but there is very little explicit reference to government borrowing in Catholic social teaching. This is despite the growing seriousness of the problem of government borrowing and the growth of the debt burden which this generation will hand on to the next generation.

By way of illustration, this table shows government borrowing in four countries in 1995 and 2010, figures that will probably be familiar:

Country	Government borrowing 1995 (% of GDP)	Government borrowing 2010 (% of GDP)
US	3.1%	14.2%
Japan	4.7%	8.7%
Italy	7.4%	4.8%
UK	5.9%	13.8%

These figures vary, of course, with economic conditions, but there are few countries that have run budget surpluses even in the best economic times. Furthermore, the structural element of the 2010 budget deficits is substantial – the large deficits are not so much caused by the effects of the crash as is generally thought. It is quite simply the case that there has been a tendency for government to systematically spend money whilst imposing the costs on future generations. Traditionally, governments would run up debts to pay for wars and then pay down those debts in peacetime. The long-term structural deficits of the post-World-War-II period are, historically, a new phenomenon.

The extent to which these structural deficits have accumulated over time to raise total national debt is alarming. This is shown by the following table where I have taken the same countries:

Country	Accumulated debt 1995 (% of GDP)	Accumulated debt (projected) 2010 (% of GDP)
US	71.3%	91.1%
Japan	87.6%	194.0%
Italy	121.5%	116.1%
UK	50.7%	81.7%

Again, the trend has been well established for some years but it is worsening. The figures for other countries are not dramatically different.

There is a moral as well as an economic issue here. *These are the debts that we are handing on to future generations of taxpayers who have not yet been born. They have arisen from a desire by the current generation to spend on consumption more than is raised in taxation.*

It would be a relief if the story ended here. However, many governments build up debts off their balance sheets. Interesting work has been done by German academics on the extent of these obligations across the EU. Work has been done by others on specific aspects of this problem. Pensions promised to public sector workers but which have not been funded by the generation to whom they are promised amount to about 100% of GDP in the UK. If we also add in the implicit debts of pay-as-you-go social security systems were, again, future benefits are promised to current taxpayers but the burdens are imposed on future taxpayers, the UK probably has a total level of government debt – on and off balance sheet – of about 580% or nearly six times one year's national income. This is unprecedented in history. The total debts in other EU countries are smaller than in the UK but not much smaller.

The problem here is that pensions systems have been set up by which the current generation has made promises to itself which have to be fulfilled by future generations when we have no real idea whether those future generations will be able to service those promises. These systems are often described as promoting ‘inter-generational solidarity’ and they have replaced systems of provision for old age based on the family, mutuality and capital accumulation. However, in order to be sustainable it is necessary to have a stable ratio of the working population to the retired population. This has not been the case in recent decades. On average, in the last 40 years, each generation in OECD countries is only 60% of the size of its predecessor generation. Fertility rates are below replacement level in all OECD countries except Turkey and Mexico. The simple fact of requiring income transfers from the young to the old cannot guarantee inter-generational solidarity if the generation that makes the promises does not make the necessary sacrifices to ensure that the promises can be fulfilled. If a population is not replacing itself, the financial burden on younger generations successively increases. This strikes me as being a problem of principle in which Catholics involved in public life should be interested.

Back to principles

I have raised two separate – but linked – subjects. I now want to bring us back to basic Catholic social teaching. Of course, it is true, as I said at the beginning, that the government may wish to respond to certain sins of omission where they prevent human flourishing. Welfare systems have their place. However, we should bear in mind that the principle of solidarity, as is stated strongly in Catholic social teaching, cannot be delegated to the state. We have to ask ourselves whether we are trying to delegate solidarity to the state and in the process weighing down the poor – as well as future generations - with unfair taxes.

Secondly, we have to think more incisively about the principle of subsidiarity. This demands two things. It demands that government does not do that which can be done by lower order communities. Secondly, and this is often forgotten, it demands that the state exists to *help* individuals, families, the community and civil associations achieve *their* legitimate objectives and not to displace their initiative. Subsidiarity is not the same as delegation even though that is how the word is understood in the European Union.

If our systems of welfare are to promote rather than undermine human flourishing then they must not militate against family formation, work and saving. They must work with the grain of individual and family autonomy whilst individuals and families seek to flourish in accordance with God's plan for them. Finally, our welfare states must not undermine and crowd out non-governmental providers of welfare: the family, charities, mutual organisations, commercial organisations and so on.

I am going to move sideways and take education – a part of the welfare state that I have not yet mentioned - as an example of how subsidiarity and solidarity can walk hand-in-hand. Here, as Catholics, we need to clearly articulate the fact that the state exists to provide the framework within which parents can obtain education for their children of the sort that parents desire. The state exists to help families obtain an education for their children. No more. That is what the principle of subsidiarity demands. Schools – including Catholic schools – should not be agents of the government providing a service of educating children on behalf of the government. *Indeed, Catholic social teaching in this field has said that the state should provide the same support to parents to have their children educated in a private – or charitable – school as is provided in state schools.* In others words, the parent and the family should be at the centre of decision making and the state merely provides financial assistance to those families who need it.

In the same way – the provision of unemployment insurance, health, pensions and so on – can be provided by a rich tapestry of commercial, mutual and charitable organisations as well as by family initiative. The state must never displace these initiatives; it exists to *support* them: sometimes it does that just by providing the legal framework within which they operate. Indeed, there is no reason why non-state vehicles cannot be the primary mechanism by which welfare is delivered whilst the state ensures that the poor are not left out. The difficulty of the state having primary initiative in this field has long been recognised in Catholic social teaching. In *Centesimus annus* it was written:

> 'In recent years the range of such intervention has vastly expanded, to the point of creating a new type of State, the so-called welfare state. [E]xcesses and abuses, especially in recent years, have provoked very harsh criticisms of the Welfare State, dubbed the "Social Assistance State". *Malfunctions and defects in the Social*

> *Assistance State are the result of an inadequate understanding of the tasks proper to the State*.' (my emphasis).

And, as was stated in *Deus caritas est*:

> 'We do not need a State which regulates and controls everything, but a State which, in accordance with the principle of subsidiarity, generously acknowledges and supports initiatives arising from the different social forces and combines spontaneity with closeness to those in need…This love does not simply offer people material help, but refreshment and care for their souls, something which often is even more necessary than material support' (28).

Caritas in veritate developed these points in a positive way, saying:

> 'Alongside profit-oriented private enterprise and the various types of public enterprise, there must be room for commercial entities based on mutualist principles and pursuing social ends to take root and express themselves. It is from their reciprocal encounter in the marketplace that one may expect hybrid forms of commercial behaviour to emerge, and hence an attentiveness to ways of *civilizing the economy*.' (38)

I think this that takes us back to the points I made at the beginning. The provision of welfare involves a genuinely *free* economy – not just a *market* economy. This free economy involves the family, charity, commercial institutions and mutual societies as well as profit-making corporations. Embedded within these can be a deeper sense of community, solidarity and personal help than is possible by the direct state provision of welfare cash. We should ask ourselves whether, in the field of welfare, the state is serving the family – as should be the case – or the other way round. Are our systems of welfare, supporting the networks of solidarity, reciprocity and community or displacing them? Are our systems of welfare supporting human flourishing through family formation, work and saving or discouraging these things? Are our systems of welfare imposing upon people who have not yet been born obligations that we do not know that they will be able to meet?

A time of financial stringency is a good time to ask these questions because, if savings are to be made, it is much better that welfare is reformed at the same time in ways that better enable human flourishing. The answers I would give to these questions may be different from the answers you would give. But I hope you would accept that it is at least plausible that, despite possibly the best of intentions, the welfare state has lost its way.

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