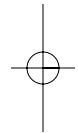


# Social Policy and Productivity: Anybody Here See Any Levers?

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*If you give a man a fish, you feed him for a day. If you teach a man to fish, he'll destroy the cod stock.*

Old policy saying

## INTRODUCTION

The topic I have been assigned is “social policy and productivity.” After a detour that takes on the prior task of trying to establish the usefulness of productivity growth, the conclusion I draw is that the connections between social policy and productivity are not yet (and may never be) clear enough to provide policy-ready estimates of the payoffs from the many different social policies that today are often thought to encourage productivity growth. For the time being, therefore, it may be better to base decisions about social policy on considerations other than its presumed ability to boost economic performance. Such a conclusion may disappoint those who see growth effects as a persuasive new rationale for greater spending on social policy, but even in a post-Reagan, post-Thatcher era, older rationales

having to do with fairness and equality still have political and intellectual purchase, even if they may not justify spending at the levels to which we have become accustomed in the last few decades.

## PRODUCTIVITY DEFINED

Most Canadians think about productivity the way most children think about spinach: they have often been told that it will be good for them in the long run but they suspect it’s not going to be fun. When it’s their employers asking them to increase their productivity, they generally assume that means they’re going to have to work harder. When it’s the government asking them, they probably have little idea of what’s intended — and neither, in fairness, may the government. In fact, most Canadians apparently don’t spend much time thinking about productivity: a Pollara poll taken in 1998 revealed that only 21 percent of respondents felt they had a good understanding of what the word meant. (This is only slightly less than the number — 36 percent — who were able to correctly

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define the number “one billion.”) Among those with university degrees, 37 percent felt they understood the productivity issue, though among those with a high school education or less only 14 percent did. Pollara’s president, Michael Marzolini, said, “A 14 percent awareness level is the lowest that I have ever seen for an issue this important, an issue being called a national priority” (Marzolini 1999). It was because of poll numbers like these, presumably, that the federal government reportedly abandoned the idea of a productivity budget.<sup>1</sup>

The gut feeling of many Canadians that raising their productivity is going to require them to work harder is only partly correct. Improving effort per worker hour *is* one way to increase output per worker hour (a standard definition of productivity). But in fact economists usually focus on other methods, such as giving workers more and/or better capital to work with, or making workers themselves “better” by increasing their “human capital” (economists’ jargon for knowledge, skills and experience). Finally, there’s also the possibility of increasing the efficiency with which all these “factors of production” are combined, so that more output can be produced with a given set of inputs. If, for instance, a firm can figure out how to get people to move around the factory floor without bumping into each other so much, things will run more smoothly and more output will be produced without anyone in particular working harder.

Increasing productivity without increasing the number or quality of inputs used sounds dangerously like the free lunch economists are not supposed to believe in. In the real world, figuring out how to use existing resources more efficiently probably takes

money: you may have to hire time-and-motion experts, or spend paid downtime with your employees, who are often their own best time-and-motion experts, asking them how a given set of tasks could be done smarter. Raising productivity in this way is therefore an investment. Effort and expense are incurred now in anticipation of a reward later — a reward measured in terms of reduced effort and expense for a given output, or increased output for given effort and expense. The other obvious way of increasing productivity — by making machines and/or workers smarter — also involves investment: it takes time, effort and expense to figure out how to do that; new machines have to be designed and developed and workers have to be trained in how to use them. And even if it’s just a question of increasing the number of old-style machines that workers work with, buying more machines costs money.

## HOW POLICY FITS IN

Casting the productivity problem in these terms allows us to borrow some tried-and-true rules from investment theory. For example, if an investment in increased productivity is to make sense economically, its cost should be less than its benefit. That may sound obvious, but in some circles “productivity” is a motherhood phenomenon: you supposedly can’t have too much of it. On the contrary, a basic rule of economics is that you *can* have too much of a good thing. If the effort required to increase productivity is greater than the value of the extra output gained, then the game isn’t worth the candle, and society should do without the extra productivity. The American cartoonist Rube Goldberg made a

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career drawing infinitely complex machines that accomplished trivial tasks. Society wouldn't want the Rube Goldberg version of a productivity agenda: a massive investment that brings forth only trivial returns. In theory, at least, there may be better places to put the money.

An obvious investment strategy is therefore to go for the productivity improvements whose benefits most exceed their costs and to stop when the rate of return of the next investment considered is less than the going rate of interest. Going beyond that and investing in any project that cannot pay back the money it requires is a misallocation of resources. The advantage of a market economy is that lots of people throughout society will have every incentive to follow this strategy in pursuing productivity investments, the reason being that they stand to profit — either financially or otherwise — by doing so. Workers can increase their productivity, and therefore their wages, by investing in their own human capital. Firms can cut their costs or increase their revenues by investing in physical capital. Researchers can make money inventing new intellectual capital. And so on. From this perspective, the role of the policy-maker is secondary: to seek out high-return investments in productivity that, because of one form or another of "market failure," are not being undertaken. Are workers unable to find financing for their educational self-improvement because the capital market won't lend them money they would have every likelihood of being able to pay back if only they could get the education? Are researchers unable to appropriate the benefits of their research — and are they therefore discouraged from undertaking it — because new ideas are easily commandeered by competitors? Are

firms not investing in enough machinery or equipment because tax policy has been designed with insufficient attention to its effects on the incentive to make such productivity-raising acquisitions?

Stated this way, the job of the policy-maker is simple: look around the society, canvass all the possible productivity-improving investments, and use taxes, subsidies and any other policy instruments you can think of to encourage those that aren't being done. Of course, lots of apparently simple things are hard to do well. High jumping, for instance. What could be simpler? "Jump high!" But very few people excel at it. Designing policies, in this case social policies, to improve productivity is similarly difficult. The main problem is that costs and benefits do not reveal themselves spontaneously. And in those cases where "externalities" or "non-pecuniary benefits" are involved, they may not reveal themselves at all.

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## THE VALUE OF "OUTPUT," THE MEANING OF "EFFICIENCY"

Before going on to consider the assigned topic — the relationship between social policy and productivity — it may be useful to consider an objection to this overall framework that has been raised by Joseph Heath, both in his contribution to this volume and in his remarkable book *The Efficient Society: Why Canada Is as Close to Utopia as It Gets* (Heath 2001).

Heath's main objection, to paraphrase very baldly, is that productivity increases may not have the payoff we seem to expect from them. He is, of course, at least partly right. As already argued, even in traditional economics productivity isn't everything. The

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blind pursuit of productivity increases may well turn out to be wasteful: they may not offer, even *ex ante*, benefits greater than their costs. But Heath argues, more provocatively, that some improvements that do pass the economist's customary cost-benefit test may not be worthwhile from a broader perspective. In particular, he complains that productivity growth has not (1) brought increased leisure, as was widely expected; (2) increased consumer satisfaction; (3) eliminated poverty; or (4) decreased social inequality. I want to consider each of these points very briefly and in reverse order.

### Inequality

Why increasing productivity, all on its own, should be expected to reduce social inequality is not immediately obvious. If productivity gains were systematically greater among society's least productive members than among its most productive, then productivity growth *would* reduce social inequality. The well-known "convergence hypothesis" holds that this is exactly what happens among nations: growth rates do tend to be higher in countries that start out behind. But there is no obvious reason to presume it should also happen among individuals. And if the ability to become more productive really is greater among those who already have acquired human capital, as both the conceit of academics and the folklore of the new economy suggest, then productivity growth may well *increase* inequality, as a good deal of literature suggests has happened in the United States in the last two decades.

Heath has a more complicated process in mind, however. If a taste for income redistribution is income-elastic — that is, if people want to share more as their incomes grow

— then increased productivity eventually will lead to increased redistribution. But there is at least some evidence to suggest that this is exactly what has happened in Canada. Over the last five decades, increases in the rate of income redistribution in Canada have effectively offset increases in inequality in "market incomes," with the effect that the post-tax and -transfer distribution of income has remained almost eerily constant. A dramatic illustration of that is provided by a graph of the ratio of the incomes of the top fifth and bottom fifth of families as ranked by income (Statistics Canada 1999). In terms of pre-tax and pre-government-transfer income, the top fifth earns more than 20 times as much as the bottom fifth. In terms of post-tax and post-government-transfer income, however, the top fifth earns only a little more than five times as much as the bottom fifth. This difference between what might loosely<sup>2</sup> be called "pre-government" and "post-government" ratios is, of course, the result of income redistribution. While the post-tax and -transfer ratio has been quite constant over time, the pre-government ratio has fluctuated considerably and in recent years has risen (it was between 10 and 15 in the early 1990s and rose almost to 25 in the early 1990s). That the post-government ratio nevertheless has not changed appreciably means that the amount of income redistribution has in fact increased, as the hypothesis Heath disputes would suggest. The only complication in this story is that the evident increase in redistribution has not coincided with any great productivity boom.<sup>3</sup>

### Poverty

Inequality may or may not be a problem. Poverty clearly is a problem. But if absolute measures of poverty are used, there is simply

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no question that productivity increases have dramatically reduced poverty in Canada and throughout the Western world. As Nathan Rosenberg and L.E. Birdzell, Jr., put it: "If we take the long view of human history and judge the economic lives of our ancestors by modern standards, it is a story of almost unrelieved wretchedness... Only during the last two hundred years has there come to Western Europe, the United States, Canada, Australia, Japan, and a few other places one of history's infrequent periods when progress and prosperity have touched the lives of somewhat more than the upper tenth of the population" (Rosenberg and Birdzell 1986, 3). And even the favoured upper decile often lived in conditions that would be widely unacceptable today. A recent biography of Queen Elizabeth I informs us that one reason the royal household moved frequently during the summer months was that "the smells of a household occupied for several days by many people, and of stables and courtyards crowded with horses, could not be tolerated for long... There were no water closets in any of the royal palaces until 1597 (Hibbert 1992, 130–131). Moving further forward in time: my McGill colleague, economic historian Mary Mackinnon, tells of how, during the Great Depression, in some Canadian jurisdictions welfare recipients could be cut off by the authorities if they were discovered to have indulged themselves in the luxury of owning a toothbrush. In the 21st century, the debate over what welfare recipients should be entitled to involves such things as colour televisions and personal computers. It is hard to imagine the fury that would be unleashed on any politician who dared suggest they should be deprived of toothbrushes.

If, on the other hand, relative standards of poverty are the metric of choice, then, in

the absence of any presumption that productivity improvements should disproportionately increase the incomes of lower-income workers, it shouldn't surprise anyone that productivity increases may not have reduced poverty. If that is what people expected, they were simply wrong to expect it.

### Happiness

Whether higher productivity has led to greater consumer satisfaction or, to use the technical philosophical term, "happiness," is a more difficult question. At any given time, income does seem to be associated with people's declared estimate of how happy they are. On the other hand, through the decades there apparently has been no persistent increase in people's characterization of their lives as happy or not happy. Again, this may not be surprising. Rosenberg and Birdzell's observation on the possibility that societies can "move from poverty to wealth without producing a people serenely satisfied with itself" is that "in fact it may be doubted that self-satisfied people could move from poverty to wealth in the first place" (1986, 5). Another possibility, favoured by Heath, is that happiness is a relative thing and that humans, in their characteristically misanthropic way (my judgement, not his), feel best off when they are doing better than their fellows.

Of course, if rankings really are what counts, it might seem that we could all save ourselves a good deal of trouble by agreeing to strive less. If everyone did cut back on striving by, say, 10 percent, then happiness rankings would be preserved and absolute happiness levels would be higher, since striving presumably consumes energy. (If striving is itself satisfying in some way that does not show up in standard audits of happiness, then the policy

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obviously would have to be reconsidered.) One problem with this policy strategy, however, is that laws to reduce unproductive striving are unlikely to preserve rankings. The analogy is often used of a crowd at a football game. If everyone stands up, it is argued, everyone expends more energy but no one sees any better. We would be better off if we all sat down. To someone such as myself, who is six foot six inches tall, that argument has never made sense. My height is in my legs. If everyone stands up, I see much better. If a regulation is passed requiring everyone to sit down, I will be relatively disadvantaged; the ranking will not be preserved. On balance, the law may increase aggregate welfare (everyone will sit) but it will also redistribute welfare (the tall will see less well than formerly).

There is also the problem that regulation forcibly restricts people's choices. Although a majority may feel the restriction is justified, a substantial minority may not. Applying the Pareto principle, which is so beautifully elaborated in Heath's book, the majority might be able to compensate the minority. (In this case the grounds for compensation — how long a person's legs were — would not be easily subject to dissimulation.) But in practice compensation is seldom paid, and there is therefore good reason for the potential victims of any such regulation to resist it.

Heath's discussion of the contemporary addiction to consumption does have the ring of truth — though as applied to other people, of course, never oneself. Addiction is probably always harmful, but at least many of the good things in life — books, travel, music, restaurant meals, abundant insurance, hyper-fast computers, single-malt Scotch, to enumerate the standard professorial compulsions — are not generally "positional goods," and

can therefore be enjoyed by increasing numbers of people as productivity increases. Beyond that there is the question of whether addictions are best overcome by state action. Will anti-consumption laws — or anti-work laws, as in France — do a better job of changing behaviour than other means by which mores change, as they clearly do from era to era? Governments do not have a sterling record when it comes to discouraging addiction. As is often observed, they are themselves addicted to gambling revenues.

## Leisure

Finally, there is the question of leisure. In the immediate post-war years, it probably was expected that increasing affluence would lead people to consume more leisure. That this has not happened, however, does not necessarily mean the impressive productivity improvements that have occurred since then either were for naught or should be reversed. It may simply be that people's preferences turned out to be different from what they had thought they would be. Or other things may have occurred that frustrated their desire to consume more leisure — steep increases in taxes, for instance. It is also true that rising affluence has increased the price of "positional goods," such as desirably located houses, with the result that the benefits of productivity increases have been transferred from those who have brought about the productivity gains to the original owners of such assets. (Baby boomers who have seen their parents sell the family home for many times what they paid for it in real terms will understand this argument well.) If some way could be found to limit the transfer, then such assets could be purchased at a lower cost in time and effort, though also at a lower gain

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to owners. This is an argument not so much about productivity, however, as about production. If the goal is to limit incomes to a certain level, that level can be achieved with less effort if productivity is higher.

### PRIVATE AFFLUENCE, PUBLIC SQUALOR?

The other major part of Heath's critique of our normal assumptions about productivity is the Galbraithian one that the public sector is stunted. Or at least, to put a contemporary spin on Galbraith, that the dramatic late-20th-century growth in the size of the public sector — its remarkable de-stunting in most jurisdictions since 1958, when *The Affluent Society* appeared — has been entirely justified, and in fact was and is "efficient" in the economist's sense of that word (Galbraith 1958).

In the definition of productivity provided above, the economist's generic term *output* was used. But surely it matters what the output in question is. If productivity increases serve merely to increase the size and garishness of automobile tail fins, as seemed to be the case when *The Affluent Society* was written, not just philosophers will wonder whether the effort has been worth it.

Two qualifications are necessary here, however. The first is *de gustibus non disputandum*. There may be greater willingness these days than 20 years ago to hold to absolute standards of taste — and indeed Galbraith himself was perfectly happy to look down his (very long) nose at some people's preferences. But elite opinion is still careful in dismissing the pleasure other people derive from what may seem to be bizarre consumption choices. Heath is

aware of and accepts this point. As he writes in *The Efficient Society*, "Bad taste is not a crime, nor should it be. We can use the critique of consumerism as grounds to harangue our fellow citizens and try to get them to improve their consumption choices, but we cannot use it as a basis for public policy. The problem, ultimately, is that the standard critique of consumerism is a disguised form of perfectionism" — by which he means "the idea that the purpose of political association is to achieve 'the perfection of man,'" and to organize "all of society to assist individuals in the pursuit of [the]...ideal of the best human life" (Heath 2001, 254, 28). We generally don't do that any more. Within limits, we let people make their own consumption choices for themselves.

Even in a purely Galbraithian perspective, however, productivity improvements may be useful. If productivity increases mean that any given number of tail fins of a standard size and vulgarity can be produced with less effort, then that presumably is a gain to society. At least in principle, the resources freed up by the productivity gains could be put to "better" use, even if in practice there is the danger that tail-fin designers will move on to making video games or body jewellery, with no resulting betterment and possibly a depreciation in the human condition as a result.

Although Heath parts company with Galbraith on perfectionism, his key policy recommendation is decidedly Galbraithian. But it derives from the more mainstream economic view that because markets fail many public expenditures are likely to be efficient. (Hence the title of his book.) That is certainly true for goods that suffer from the traditional market failures of externalities or "publicness," and few economists will disagree with this possibility. But Heath goes on to

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argue that a more general form of market failure causes consumers of private goods to play negative-sum games with one another. "Prisoners' dilemmas" and other forms of "collective action problem" are, he believes, endemic in modern society. For example, drivers persist in passing one another on the road even though both logic and empirics suggest that traffic moves more quickly when people stay in their own lanes. Or, still on the subject of driving, in a world in which no one drives a sport utility vehicle, buying an SUV will improve the purchaser's chances of surviving a highway collision; but if everyone drives an SUV, no one's chances are improved. Or, to switch to professional sports, the first user of steroids may obtain a significant competitive advantage, but once steroid use is widespread users no longer achieve any competitive advantage and yet still suffer the dangerous side-effects of steroids.

If market failure of this sort is endemic, then, Heath argues, corrective government intervention may also have to be endemic. To my mind, this ignores two serious difficulties. The first is that although game theory of the sort Heath exploits so adeptly may well result in a longer list of potential market failures, it also introduces a whole new category of potential *government* failures. The "tragedy of the House of Commons," to use a phrase coined by Ken McKenzie of the University of Calgary (McKenzie 2001), is that politicians will spend much of their time in prisoner's dilemmas from which they cannot escape, and they will do so in contexts that can lead to widespread inefficiency. For example, in the spring of 2002 a sitting prime minister argued, apparently seriously, that one of the key functions of a Member of Parliament is to help the people of his riding get as large a share of

public munificence as possible. If MPs do take that attitude, it is hard to imagine that public spending and taxation will come to rest at levels that could by any stretch of the imagination be considered optimal.

Mention of taxation raises the other great difficulty with further increases in public expenditure: their cost. Estimates of the marginal cost of public funds are controversial and, as usual in such exercises, depend on the assumptions that are made. But a good bet is that this cost is substantial and has grown. In 1961, three years after *The Affluent Society* appeared, overall government receipts were 27.8 percent of GDP. In 2000 they were 44.3 percent of GDP (Finance Canada 2001, Table 53). A fundamental theorem of public finance is that the efficiency cost of the tax rises with the square of the tax rate. It seems all but certain, therefore, that the marginal cost of taxation is higher now, possibly substantially higher, than it was then. Investments in public activity that were efficient then may well not be efficient now. Canadians who feel they are somehow less selfless than their parents were should not get down on themselves: the social cost of selflessness was lower when their parents were young.

But leave aside this large political question of how big the government should be. Once the allocation problem has been dealt with — once "the Heath problem" has been overcome and we can be reasonably sure that all the different goods on the extensive menu of consumption available in a modern society are being produced in their "right" amounts — then the virtues of productivity improvements, of "more with less," become apparent again, subject to the provisos already stressed about the need not to spend more improving productivity than is available from the productivity improvement. If, for example, Canadians have made clear that they want more health care, and

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if productivity improvements are available in the health-care sector that cost less than they are worth, then it is hard to see how undertaking them would not be socially beneficial. Whether health care and education are financed publicly in Canada because, as Heath argues, doing so is efficient, or because, as the opinion polls suggest, most people worry that with private finance poor Canadians would receive less of these goods than the rest of us, once it has been decided to finance such things in the public sector, productivity improvements will make more of these services available with less sacrifice in terms of other goods and services. The same is true in the private sector, once its appropriate size has been determined. It is therefore hard to understand how getting more "stuff" for a given effort would be wasteful — even if it is true that more of anything can be harmful if the margin is extended far enough.

### SOCIAL POLICY AND PRODUCTIVITY

So, finally, how does social policy come into play in a discussion of productivity? Social policy can be defined in many ways, but for present purposes suppose it comprises public policies in health, education and welfare. Some such policies are probably good for productivity, as the Left has been arguing, often with urgency born of desperation, since the collapse of communism put it on the intellectual and for a time political defensive in the early 1990s. Educated workers may be more productive workers; education is at least publicly financed and in some cases even publicly produced; ergo government can be good for productivity — though it does not follow that the next dollar spent on education will be good for productivity, or anything else for that matter.

The same argument is often made about health care: unhealthy workers may well be unproductive workers, though such a truism is not by itself sufficient to justify increased expenditures on health care.

But if some social policies increase productivity, other social policies probably reduce it, as the Right has argued, with increasing persuasiveness from the middle of the 20th century on as the state has grown, apparently without limit. If you pay people to be unemployed, and pay them year after year, as Canada's unemployment insurance program does, they are more likely to be unemployed and less likely to make investments in themselves. If you pay people to stay in regions of the country where their productivity is low, or grows only slowly, then pursuing such a policy has a cost in reduced productivity. If higher and higher taxes create bigger and bigger "tax wedges" (the difference between what the buyers and the sellers in a transaction receive), then the consequent discouragement to effort and investment may deter productivity improvements that without the tax wedges would have produced benefits greater than costs. If you provide people with all they need in essential goods and services such as education and health care, then the income they derive from their own efforts can be spent only on frivolous things such as tail fins and video games.<sup>4</sup>

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### EFFICIENT SOCIAL POLICY

The policy strategy described above — to search the economy for market failures that need to be corrected and to undertake the bigger-payoff investments first — is generally the strategy adopted by the contributors to this volume (which is not

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surprising, since most are economists). Most are concerned, at least implicitly, with using correlation analysis of one kind or another to determine whether the particular social policies they are interested in tend to encourage productivity growth. Once these “drivers” of growth are discovered — be they health care, education, day care, on-the-job training or any other aspect of social policy — it presumably follows that they should be subsidized. To inject Churchillian construction into the jargon of welfare economics: “Give us the triangles and we will finish the job.”

As I saw it, my role as a contributor to this volume, one I was happy to play, was to stress just how difficult a job it is to decide what resources to put where. This theme was first developed by Hayek (1945) in his famous essay “The Use of Knowledge in Society.” Societies are extremely complex phenomena, and it is very difficult for any agent or set of agents to develop an understanding of their complexity sufficient to allow successful manipulation of the various “policy levers” in such a way as to achieve desired social outcomes. (Indeed, as the quotation marks are meant to indicate, the term is itself a considerable conceit.) A number of difficulties arise, both conceptual and practical.

To begin with, it is not certain that past drivers will be future drivers. Thanks to the work of Vaillancourt, Finnie and others, we have a rough approximation of what the private and (by one definition, at least) the public returns to various Canadian university degrees were in the mid-1990s, by level of education and in some cases even by discipline (Vaillancourt and Bourdeau-Primeau 2002; Finnie 2000). But is anyone really confident that these rates of return will be the same five or 10 years from now, when any new monies

that we decided to devote to education today would start to produce graduates? In a recent note, the Federal Reserve Bank of St. Louis (2001, 1) pointed out that in the latest US recession unemployment rates rose more quickly for highly skilled workers than for less-skilled and unskilled workers — a reversal of the experience of the early 1990s. In some of his writings, Paul Krugman has argued, in a similar vein, that professions like lawyering and doctoring may experience declining demand as new technologies take over routine tasks in their fields. As with mutual funds, so may it be with education: past returns are no guarantee of future profitability. Beyond that, there is the problem that most calculations of the rate of return on education do not even attempt to estimate the size of the externalities that constitute a large part of the potential gain in the minds of those who favour increased public spending on schooling. As a result, anyone who had the job of allocating monies across disciplines — or even across levels of education — in an attempt to maximize the social return would have little more than hunch and anecdote to go on.

A second general difficulty, as already suggested, is government failure. Assume for a moment we are agreed, and we may not be, that social policies should aim at making the greatest possible contribution to productivity. The best way to do this would be to send out battalions of economists to make their best guesstimates of where marginal dollars will pay off most. But of course the age of economist-kings is some way off yet (even if the federal Leader of the Opposition holds a master’s degree in the discipline). Other considerations are likely to intrude and, once the “policy process” has acted itself out in full, money may

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end up very far from where, by economic criteria at least, it would do the most good.

There is also the need for policy-makers to be sure they are not simply duplicating private efforts. Ministers of industry at all levels of Canadian government set great store by the high-tech revolution and in most cases are eager both to be associated with it and to encourage it — sometimes, it seems, the former more than the latter. But does anyone seriously believe that investment in high technology was underfunded in the 1990s?

A further difficulty is that subsidies have to be precise. As suggested above, too much of a good thing can be bad. Externalities can be over-corrected. It is at least conceivable that at some point we will spend too much on education (however heretical that may sound coming from a university professor). Reading some of the final exams and papers submitted in my courses suggests that maybe we already do: many people currently in university pretty clearly should not be there. Or perhaps this anecdotal evidence suggests instead that we need greater investment at the pre-university level.

Finally, it is always important for policy-makers to keep in mind that the funds they are using are expensive, and increasingly so as rates of taxation rise. I do understand that some taxes may now finally be falling — slightly — but the recent declines are not yet enough to establish a trend. Public revenues remain at record ratios of GDP.

### WHAT DO WE KNOW?

The greatest difficulty with the “subsidize the drivers” strategy, however, is that

we simply do not know anything very precise about what the drivers are. The correlations that are the stock-in-trade of this kind of analysis simply are not very conclusive. To quote from Richard Harris’s paper in this volume (282): “...strong policy conclusions are well ahead of both theory and evidence. Neither provides conclusive support for the proposition that either (a) policies directed at reducing inequality will increase productivity growth, or (b) increased social spending will raise productivity growth.” In this inconclusive conclusion he echoes Jonathan Temple’s survey in the *Journal of Economic Literature*. “Even the most enthusiastic proponent of cross-country regressions must acknowledge that we are a daunting distance from the ultimate goal, a model with high explanatory power which indicates with precision the relative contributions of different influences” (Temple 1999, 148).

One reason why it is difficult to make strong conclusions on the basis of statistical correlations is that the explanatory variable “social policy” is very hard to pin down. In two recent papers, the OECD’s Willem Adema shows how the scale of a country’s social policies varies according to its use of different mechanisms for delivering such policies — whether they be direct spending through the public sector, tax expenditures or mandated private expenditures. Thus, for instance, in 1997 gross Canadian public expenditure on social policy was 20.7 percent of GDP at factor cost, compared to just 15.8 percent in the United States. But in the same year, what Adema calls “net total social expenditure,” which includes spending, tax expenditures and mandated private expenditures, was 21.8 percent in Canada and fully 23.4 percent in the United States. The two countries’ rankings

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obviously changed dramatically (Adema 2001, Table A2.1).<sup>5</sup>

### WHAT DO WE DO?

In his contribution to this volume, Richard Harris observes that “[o]ften in economics, in the absence of decisive evidence for or against a hypothesis, economic theory plays an important role in determining the priors of economists both as social scientists and as policy advisers” (297). Unfortunately, as he also concludes, in the case of the effects of social policy on productivity growth, theory often provides ambiguous predictions. He might have added that ideology will also have a continuing influence on the Canadian policy debate, and ideology, whether of left, right or centre, never provides ambiguous predictions.

In the absence of clear indicators of the likely social return on the next dollar invested in various areas of social policy, what is to be done?

One suggestion is that economists keep correlating. Temple does note a growing view that “regression fatigue” is beginning to set in, “so that hearts sink when yet another dubious growth regression is presented” (1999, 148). But in fact the field is relatively new, the data keep accumulating, computers are becoming ever more powerful, and theoretical work on the determinants of growth continues apace, so it is best for the profession to keep at it, even if the likelihood that clear policy directives will emerge from the effort does seem small. The question of why some countries grow and others don’t, which is in a sense the founding question of modern economics, remains compelling even if the answer remains elusive.

And of course, clear directions from economists or not, policy will have to contin-

ue to be made. By all measures, most developed countries have a large chunk of their GDP caught up in one form or another of social policy. Within this very large expenditure envelope, allocation decisions have to be made — and doubtless will continue to be made even if all the growth correlations economists calculate turn out to be statistically insignificant or, for that matter, negative. There are a number of reasons for this: redistribution is important; economic optimality does not always (or perhaps even ever) govern policy; and, try as we might, conservatives will never block all public spending (supposing that is what we wanted to do).

If there will be spending on education, health care and welfare, the policy problem then reduces to where we should increase spending and where we should decrease it. This is probably best done at the margin, in the small, program by program. The fundamental question, as always, is where would you get the biggest payoff, the biggest efficiency bang for the buck, from an extra dollar of spending. Should you provide further tax help for investments in machinery and equipment? Should you boost subsidies to R&D? Should you put more money into higher education? Into high schools? Into health care? Which parts of health care? I’m afraid that on the basis of what I heard at the authors’ workshop and have since read in the papers prepared for this volume I don’t really see much guidance for beleaguered policy-makers.

We do all have our hunches about where the payoffs would be greatest. In terms of health care, an Ipsos-Reid poll released in January found that given a choice between making people more personally responsible for the services they use and cleaning up the mismanagement in the system, 63 percent

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wanted the system cleaned up, 34 percent said people should be made more personally responsible.<sup>6</sup> That is an interesting tradeoff to read about, but it may not be a policy-relevant tradeoff: cleaning up the mismanagement of the system may not provide savings sufficient to achieve the efficiencies people want. The official political line from most governments seems to be that money is not the problem, that what the system needs is reorganization. Economists, who consider that more money will help most problems of perceived shortages, find this a strange argument, but the "Gorbachev strategy" of reforming the system rather than starting over from scratch seems to be politically saleable. My own view is that we badly need competition within the system. The two places where Canadians feel most abused these days are in hospital waiting rooms and Air Canada departure lounges.

As for education, the question again is: where are the rates of return likely to be highest? Current public policy, particularly at the federal level, seems to put the greatest emphasis on post-secondary education. On the other hand, François Vaillancourt's work seems to suggest the pecuniary returns, both public and private, are greatest at lower levels of education. Those who do worst in this society very likely are not unemployed university graduates. They probably are high-school dropouts who lack basic literacy and numeracy. Of course, it does not follow that the marginal return now would be as high as the average return in the mid-1990s, which is the latest era for which we have estimates. Nor do existing studies have much to say about the size of the externalities from different types of education. As Jeffrey Smith cautions in a recent C.D. Howe Institute book, "While it is handy for

those of us who make our living in the higher education sector to point to the shimmering hope of externalities to justify our funding, the taxpayer would be better served with some hard empirical estimates" (Smith 2002, 278). At the margin, I suspect the financial constraints are more severe for those who wish to borrow in order to complete high school than for those who wish to finance university education. We who have children in the education system, even in Quebec's education system, which was highly praised at the authors' workshop, would also wish to introduce more competition and incentives to good performance.

Regarding welfare, the consensus in the policy establishment seems to support the OECD's preference for active labour market policies. I wonder, though, whether there are not cases in which cash payments are admissible. Since the Clinton reform of welfare, United States policy in effect insists that the mothers of young children go out into the workforce and find gainful employment. The rationale for this must be that work habits are subject to "hysteresis" — that they are self-reinforcing. In this regard, the disappointing long-term effects of the policy measures tried in the Self-Sufficiency Project (SSP) — when subsidies to work were removed participants in the project had essentially the same work patterns as the control group — suggest that the long-term cost of allowing women to take time off to care for their young children may not have permanently debilitating effects on their employability.<sup>7</sup>

That welfare policies can have harmful effects on productivity in other ways is illustrated by the case of Fishery Products International, which in the winter of 2001-02 attempted to rearrange its production methods in Newfoundland so as to provide year-round employment for a substantially smaller

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number of workers than it currently employs on a part-time basis. Although the total amount paid out in wages would not have changed, and the company's productivity would have increased substantially, fewer people would have been eligible for Employment Insurance premiums. The widespread public opposition to this proposal may have had more to do with the perception that it constituted a double-cross on FPI's part. But whether that is true or not, the company quickly withdrew the proposal, with the effect that its productivity level will remain subject to customary, not accelerated, growth rates. Applying Heathian principles to this case, preserving the status quo may for the time being create greater aggregate happiness in Newfoundland than the firm's proposal would have done, but it is hard to see how what seems bound to be declining competitiveness on this firm's part will help Newfoundland in the long run.

The discussion of this paper at the authors' workshop wound down in an exchange over how much we really know about the effects of various social policies. One or two people better acquainted with the relevant literature than I argued that in fact we know a good deal. I'm less optimistic. It seems to me we have very little idea of the likely payoffs to different types of investment in the area of social policy, which means policy is likely to be determined by politics and by whatever the common sense of the day suggests. That is a sad commentary on economics. I fear it may also lead to sad policy outcomes.

## NOTES

1 The contribution by Frank Graves and Richard Jenkins to this volume generally suggests greater familiarity with productivity issues on the part of Canadians,

though it does not ask the straightforward question about Canadians' understanding of the concept of productivity in the way that Marzolini did. They, too, conclude that poll results caused the government to recast its productivity agenda as an innovation agenda.

2 Only loosely, however: it does not include transfers in kind.

3 The Statistics Canada chart referred to goes only as far as 1997.

4 The disturbing moral implications of such a situation are described in Acton (1993).

5 Note that the fact that the United States moves from virtually last on the list of OECD countries to first may actually improve the correlation between social policy and productivity, since US growth rates have been so strong in recent years.

6 See Mickleburgh (2002).

7 Conceived and funded by Human Resources Development Canada (HRDC), SSP is a research and demonstration project to test a policy innovation that makes work pay better than welfare. The Self-Sufficiency Project was designed as a social experiment using a rigorous random-assignment research model. In the main SSP study, a group of 5,688 single parents (primarily single mothers) in New Brunswick and the lower mainland of British Columbia who had been on Income Assistance (IA) for at least a year were selected at random from the IA rolls with one-half assigned to the program group which received the SSP supplement while the remainder formed a control group.

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