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The Welfare State – Background, Achievements, Problems

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THE WELFARE STATE

– Background, Achievements, Problems –

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Abstract
This paper starts out with a brief discussion of the historical background, the justifications and the political forces behind the built up of the modern welfare state. It also summarizes its major achievements in terms of economic efficiency and redistribution. The paper also tries to identify some major problems of contemporary welfare-state arrangements, differentiating exogenous shocks from endogenous behaviour adjustments by individuals to the welfare state itself. The latter include tax distortions, moral hazard, and endogenous changes in social norms concerning work and benefit dependency.

Key words: justifications for welfare state, incentive problems, moral hazard, social norms.
JEL classification: H4, H53, H55, J22.

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welfare state. According to a narrow definition, the welfare state comprises two types of government spending arrangements: (i) cash benefits to households (transfers, including mandatory income insurance) and (ii) subsidies or direct government provision of human services (such as child care, pre-schooling, education, health care, and old-age care). By broader definitions, the welfare state may also include price regulation (such as rent control and agricultural price support), housing policies, regulation of the work environment, job-security legislation, and environmental policies. This essay is confined to the narrow definition.

Across developed OECD countries, total welfare-state spending ("public social spending"), including spending on education, varies today (2006) from about a fifth to about a third of GDP. As we would expect, the share is tightly related to the degree of "universality" of public social spending, i.e., the extent to which benefits are received by individuals in all income classes, rather than largely targeted to particular groups of individuals, such as low-income groups. Broadly speaking, the lowest figures are currently found in Anglo-Saxon countries, while the highest appear in the Nordic countries – with other countries in Western Europe somewhere in-between. Indeed, nowadays, welfare states are usually classified in the context of such geographical clusters rather than according to distinctions between Bismarck- and Beveridge-type welfare states, or distinctions in terms of ideological categories along the lines suggested by Esping-Andersen (1990).

JUSTIFICATIONS AND EXPLANATIONS

Urbanization has diminished the reliability of the family as a basis for reallocating income (or consumption) over the individual's life cycle, reducing income risk, and providing human services. Moreover, in connection with industrialization, new types of labor contracts emerged according to which unemployment and retirement became

more discrete (abrupt) events than earlier (Atkinson, 1991). Industrialization and the subsequent increase in office work also required an expansion of education at all levels. Meanwhile, progress in health and medicine enhanced the usefulness of professional medical services.

Needless to say, such developments by themselves do not justify government intervention in the fields of income insurance and human services, rather than simply relying on voluntary solutions via markets and private networks ("civil society"). There are, however, well-known efficiency and distributional justifications for government intervention in these fields; see, for instance, Barr (1998). It is useful to divide the *efficiency justifications* into three categories:

(i) The microeconomic literature identifies a number of limitations ("failures") in markets for voluntary income insurance: advantageous selection ("cream skimming") of insurance applicants, when insurance providers can differentiate between low-risk and high-risk individuals; adverse selection, when insurance providers cannot do so; myopia, when individuals underestimate their future income needs; and free riding on the altruism of others, when individuals expect others to assist them in case of economic distress. Mandatory income insurance ("social insurance") helps solve all these problems. Moreover, poor individuals may simply believe that they cannot afford to save or to buy income insurance: their marginal evaluation of immediate consumption is higher than their marginal evaluation of future income security. Paternalistic governments may prefer to deal with this issue by mandatory insurance rather than by cash transfers to such individuals. In addition, a monopoly provider may largely avoid marketing costs – although at the expense of individuals' freedom of choice.

Even if some of these problems may also be mitigated by group insurance, such arrangements are associated with well-known weaknesses. For instance, occupational income insurance often results in limited portability across jobs, and sometimes deficient financial viability, in particular when individual production firms or industries are in charge of the programs. In some countries, such problems are avoided, however, by institutional integration of occupational and government-operated arrangements ("corporatist" systems), such as in Germany and France.

(ii) Mandatory income insurance may also bring about risk-sharing across generations. This is difficult to achieve by voluntary contracts alone since the potential parties of such contracts may not live simultaneously – both when the contract is signed and when it is supposed to be fulfilled.

(iii) There is also general agreement among economists that investment in human capital (such as education and health care) tends to be suboptimal without government intervention (in the form of subsidies or direct government provision) – either because of the difficulties in borrowing with expected future human capital as collateral, or because of unexploited (positive) externalities in connection with such investment.

While the efficiency gains from government intervention in the context of the first two justifications show up in improved income smoothing and risk-sharing, the efficiency gain according to the third justification takes the form of higher labor productivity and/or faster economic growth – provided disincentives due to higher government spending do not predominate these potential efficiency gains.

The *distributional justifications* for welfare-state arrangements also appear in different forms:

(i) In the case of policies designed to fight poverty, it is natural to refer to genuine altruism or enlightened self-interest (a desire to mitigate negative externalities, such as ugly neighborhoods and street crime). Intergenerational transfers in favor of old cohorts – for instance via a pay-as-you-go (paygo) pension system – may also be justified by altruism, since lifetime income tends to be lower for older cohorts than for subsequent cohorts in growing economies.

(ii) Income insurance automatically reduces the overall dispersion of the *ex post* distribution of income. This holds for both yearly and lifetime income. Moreover, social insurance, as usually designed, may often reduce the *ex ante* dispersion of the distribution since such arrangements are seldom actuarially fair. A fairly common belief is that increased income security, and perhaps also a reduction in the overall

dispersion of the distribution of income, up to a point, tends to promote social peace, and that this in turn is favorable for economic growth; indeed there is some empirical evidence in support of this view (Alesina and Rodrik, 1994). In other words, a distributional argument may, up to a point, be turned into an efficiency justification for income insurance and redistribution of lifetime income.

Of course, neither historical background factors nor theoretical justifications (rationales) by themselves can *explain* the actual emergence and expansion of welfare- state arrangements. References to the political processes are required. In countries where policies are based on electoral processes, the distribution of voting power across socioeconomic groups is a natural starting point. It is also tempting to explain politically generated redistribution across generations by the distribution of voting power across cohorts. For instance, current generations may transfer resources to themselves at the expense of future generations, which (by definition) do not have voting rights, although they may later renege on political favors acquired by earlier generations. At the same time, young adults with children would be expected to push politically for education (and infrastructure investment), while older cohorts are particularly likely to push for paygo pension systems and old-age care. The political outcome of such diverse interests, then, would be expected to depend on the relative power of different cohorts.

Indeed, some authors have tried to explain the emergence of modern social spending in western countries from the mid-nineteenth century to the early twentieth century by the gradual widening of franchise (Flora and Alber, 1981; Lindert, 2004). There are, however, obvious limitations to policy explanations in terms of relative voting powers of different interest groups. In the late nineteenth century (and even earlier), some welfare-state arrangements actually emerged in favor of individuals without voting rights; important examples include poor relief, mandatory and subsidized (even free) primary education, work-injury insurance and modest pensions. It is, therefore, tempting to assume that altruism and enlightened self-interest also help explain early welfare-state reforms – another example of how a justification may be turned into an explanation of actual development.

Moreover, the main expansion of welfare-state spending did not take place until half a

century after the emergence of general franchise – indeed, mainly during the first three decades after World War II. One explanation for this apparent time lag may be that urbanization and industrialization were gradual processes, so that the political demand for new social arrangements likewise emerged gradually. It may also have taken considerable time to mobilize new groups of eligible voters. The time lags, and related gradualism in the expansion of welfare-state spending, could perhaps also be regarded as the result of an "experimental approach" on the part of politicians and/or voters, due to uncertainty about the effects in various dimensions of higher welfare-state spending and related tax increases.

ACHIEVEMENTS

Not only the level but also the composition of welfare-state spending, such as between transfers and human services, differs across countries. For instance, while about half of total public social spending consists of transfers in Western Europe as a whole (varying from 33 percent in Iceland to 60 percent in Austria), the corresponding figure is about 42 percent in Anglo-Saxon countries outside Europe.

Transfers. What, then, is the relation between the size of aggregate government transfers, on one hand, and the degree of income security and government-induced redistribution of income across households, on the other hand? To answer the first aspect of the question, it is important to consider the extent to which government-provided arrangements are a substitute for private income insurance. To answer the second aspect of the question, we would ideally also need to determine to what extent government transfers have resulted in induced (endogenous) changes in the distribution of factor income (general equilibrium effects). Unfortunately, our knowledge on both issues is quite limited.

Scattered evidence suggests, however, that voluntary private income insurance and social insurance are rather close substitutes at the margin. In particular, government-provided benefits tend to be topped up by occupational pensions in countries with only modest public benefits (Pearson and Martin, 2005, pp. 8-10). As a result, *total* yearly per capita disposable income of retirees does not differ much across the eight West European countries studied by Forssell et al. (2000), in spite of considerable differences in the replacement rates in government-operated pension systems. It is

also noticeable that total (public *plus* private) pensions are at least as large as a share of GDP in the United States as in Western Europe (indeed somewhat larger in the US) in spite of the fact that the GDP share of public pensions is higher in Western Europe, and that the population is younger in the US (Table 1). Another example is that *total* per capita sick-pay benefits do not vary much among six West European countries studied by Kangas and Palme (1993), in spite of quite different replacement rates in government-operated systems – although the substitution is not complete.

Table 1 Composition of total public social expenditures in 2001 (% of GDP)

	United States			Western Europe*		
	Public	Private	**Total**	Public	Private	**Total**
Cash transfers	7.9	4.3	**12.2**	14.2	1.8	**16.0**
Pensions	*6.1*	*3.8*	*9.9*	*8.5*	*1.0*	*9.5*
Human services	11.9	7.2	**19.1**	15.1	0.9	**16.0**
Health	*6.2*	*5.0*	*11.1*	*6.4*	*0.4*	*6.8*
Education	*5.1*	*2.3*	*7.3*	*5.4*	*0.4*	*5.8*
Active labor market programs	*0.1*		*0.1*	*0.9*		*0.9*
Total social expenditure	**19.8**	**11.6**	**31.3**	**29.3**	**2.7**	**32.0**

Sources: Adema and Ladaique (2005) and OECD Education at a Glance (2004).

* Unweighted averages have been calculated for Austria, Belgium, Denmark, Finland, France, Germany, Iceland, Ireland, Italy, the Netherlands, Norway, Spain, Sweden, and the United Kingdom. Note that the figures for private health spending only cover private insurance programs and exclude individual private health costs.

There seems to be less substitution between public and private provision in countries where there is no government-operated system at all. The relatively low coverage of sick-pay insurance, sick-care insurance, and paid parental leave ("parent insurance") in the United States is a suggestive illustration. Thus, in areas where there is no government-operated system at all, it seems that the earlier discussed obstacles to the emergence of voluntary insurance arrangements "kick in".

Since the distribution of disposable income is considerably more even than the distribution of factor income, it is natural to argue that welfare-state arrangements, and their financing, actually contribute to reducing the unevenness of the distribution of income. Moreover, based on data from the Luxembourg Income Study (LIS), Korpi

and Palme (1998) found that the relative difference between the market-income Gini coefficient and the disposable-income Gini coefficient tends to be larger in countries with universal transfer systems than in those with a strongly targeted system. (Market income is then defined as factor income *plus* occupational pensions.) In this sense, universal systems tend in fact to be more redistributive than targeted systems. However, this conclusion does not hold concerning the redistribution *per unit* of aggregate public social spending; rather the reverse tends to be the case (although the difference is not statistically significant).

The observation that welfare-state arrangements, in fact, have reduced the dispersion of the distribution of yearly income relies, of course, on the implicit assumption that an induced widening of the distribution of factor income has not offset the direct impact on the distribution of disposable income. One indicator that such adjustments have not taken place is that the distribution of yearly factor income did not become more uneven – at least not much – during the period when the generosity of public benefit systems increased the most, i.e., from the late 1940s to the mid-1970s. Moreover, the subsequent widening of the distribution of yearly factor income in a number of countries (until about the mid-1990s), has been particularly pronounced in the United States and the United Kingdom, i.e., in countries where welfare-state spending has increased *less* than in other countries. Thus, it seems reasonable to assume that government transfer systems (including social insurance) have, in fact, reduced the dispersion of the distribution of yearly disposable income.

Human services. In most developed countries, government intervention in the area of human services mainly takes the form of direct provision, rather than general subsidies of such services. The effects of these policies would, however, be expected to differ systematically between low- and high-income citizens. One reason is that the per capita volume (or quality) provided by the government is often larger than what low-income individuals would have chosen themselves. Since human services cannot be resold in the market, the consumption of such services would be expected to increase among low-income groups. By contrast, it would be expected to fall among high-income groups, assuming (realistically) that human services, by contrast to income-insurance cash benefits, are difficult to supplement. (For instance, as a rule, parents do not divide up their children's attendance between a public and a private

child-care center or school.) Such a fall in consumption of human services among high-income groups would also be expected to take place among individuals who abstain from the public services offered and instead buy their services in the market. The reason, of course, is that their disposable income is reduced by the taxes they have to pay to finance the provision of human services to other citizens (basically reflecting an income effect).

There is a corollary to this reasoning: unless the volume provided is quite large, it is probably easier for the government to control the distribution than the aggregate volume of human services by direct provision. Total per capita consumption would therefore be expected to differ less across countries than the volume of government-provided services. Indeed, in spite of the fact that public-sector provision of human services is a larger share of GDP in Western Europe than in the United States, 15.1 percent versus 11.9 percent, total (public *plus* privately provided) consumption of such services is larger in the United States than in Europe, 19.1 versus 16.0 (Table 1). In fact, this is the case both for education and health care – possibly partly reflecting a high income-elasticity of demand for such services (with an “automatic” supply response when such services are provided by markets).

It is probably also easier to boost the aggregate consumption of human services by subsidies than by direct government provision – although the opposite is often asserted to be the case. (The government can be rather confident that general subsidies do increase the aggregate consumption of such services, in contrast to the case of direct government provision.) It is also *cheaper* for the government to boost such consumption by a certain volume by way of a subsidy than by way of direct provision. (While in the case of government provision, the government has to finance the entire spending on such consumption, it only has to finance a fraction of total spending in the case of subsidies.)

There are other important differences between subsidies and direct government provision of human services. A subsidy allows the price to clear the market (zero excess demand), which implies that individuals will be able to choose volume and quality themselves, based on each individual’s preferences and budget constraint. When judging the usefulness of allowing freedom of choice in the consumption of

human services, it is, however, important to consider a number of other aspects as well, such as the efficiency of production and the quality of the services, the distribution of the services among households, and possible tendencies toward clustering (“segregation”) of specific types of consumers (in terms of income, education, ethnicity, ideology, etc.) on specific providers.

The age-specific nature of public social spending, of course, results in redistribution of resources (income as well as human services) over each individual’s life cycle (intra-individual redistribution). Usually, resources are transferred to individuals below age 20-25 and above age 60-65, and extracted (via taxes) from individuals in the age groups in-between. Indeed, we may regard public financing of education as a (collectively decided) loan from the middle-aged to the young, and public financing of pensions as a subsequent pay-back of the loan via payroll taxes (Becker and Murphy, 1988). By these arrangements, two problems of intergenerational contracting are solved simultaneously: a liquidity constraint is removed for investment in human capital, and a universal pension system is created.

Indeed, in countries with highly universal welfare-state arrangements, the *bulk* of social spending constitutes such intra-individual redistribution rather than inter-individual redistribution of lifetime income (“wealth”), in contrast to countries with strongly targeted systems. For instance, the universal character of public social spending in Sweden and Italy explains the high shares of aggregate social spending that constitute intra-individual redistribution over the individual’s life-cycle in these countries (83 and 76 percent, respectively, according to Finance Department in Sweden, 2003, and O’Donogue, 2001). By contrast, the strongly targeted character of the social system in Australia explains its rather modest fraction of public social spending that consists of such intra-individual redistribution (38-52 percent according to Falkingham and Harding, 1996). As pointed out above, in countries with large intra-individual redistribution over each individual’s life cycle, the remaining part of public social spending (and its financing) is often sufficient, however, to generate considerable inter-individual redistribution of yearly income.

There is so far very little knowledge about the consequences of welfare-state arrangements for the distribution of *lifetime* disposable income. However, some

simulations based on Swedish data indicate that lifetime income ("wealth") is to a considerable extent redistributed from the upper part of the distribution of lifetime income (the highest two quintiles) to the lower part (the lowest three quintiles) – abstracting from conceivable general equilibrium effects (Finance Department in Sweden, 2005).

PROBLEMS

It is useful to classify major problems of contemporary welfare-state arrangements into (i) basically exogenous disturbances and (ii) basically endogenous developments caused by the welfare state itself.

(i) *Exogenous factors.*

It is a commonplace that recent and predicted future changes in *demography* in developed countries, in particular the "graying" of the population, simultaneously boost social spending and have a negative influence on the tax base – since there are seldom automatic adjustments of social security fees and benefit rules in response to changes in demography. Indeed, in the EU-19, the number of individuals above the statutory retirement age is already close to 25 percent of the number of individuals of working age – and is projected to rise to about twice that figure, or even more within three or four decades. It is difficult to alleviate this problem in a medium-term perspective except via immigration and tougher social-insurance legislation in the form of higher contribution rates, reduced benefits, stricter controls, and a higher effective retirement age.

The slow-down of the rate of *productivity growth* in the market sector in developed countries after the mid-1970s has created more or less the same financing problems, since neither the contribution rates nor the benefit rules in the social insurance systems are automatically (fully) adjusted to changes in productivity growth. So far, politicians have usually tried to deal with this problem in the same way as they have tried to adapt to demographic changes, that is, by *ad hoc* reductions in benefits and increases in social-insurance fees.

In recent years, the *internationalization* (globalization) of national economies has become perhaps the most hotly debated exogenous factor behind actual and predicted

future welfare-state problems in developed countries. International trade theory predicts that the entry into the world economy of a number of countries with abundant low-wage labor (including China, India, the former Soviet republics, and countries in Eastern Europe) will reduce both the wage-income share of national income and the relative wages of low-skilled workers. Clearly, these consequences are bound to create problems for policy ambitions concerning the distribution of income in many developed countries. It is often also argued that the rate of structural change is likely to accelerate, thereby resulting in tendencies toward higher structural unemployment, due primarily to limited flexibility of the allocative mechanisms in national economies. For given social legislation, this would certainly boost transfer payments (including unemployment benefits) and give rise to an erosion of the tax base, thus threatening the financial sustainability of the welfare state.

If such problems would actually arise, the standard policy advice is, of course, measures to promote the flexibility of domestic product and factor markets, for instance, along the lines of the so-called Lisbon Agreement among EU countries. Important examples are retraining of workers, easier entry and expansion of firms, less strict job-security legislation, and more flexible relative wage rates – possibly combined with employment subsidies for low-skilled workers (the “working poor”).

Another common worry in connection with the internationalization process is that important tax bases tend to become more internationally mobile. While, so far, this has occurred mainly for capital income, there is a possibility that similar (although less pronounced) consequences will emerge for other tax bases as well, possibly resulting in increased tendencies toward tax competition among governments. To the extent that such developments will actually occur, increased international tax coordination (“harmonization”) is perhaps the most frequently recommended, and predicted, policy response.

Moreover, increased immigration to developed countries may place an additional strain on the financial position of various welfare-state arrangements, in spite of the fact that such immigration is likely to “improve” the age structure of the population. The reason would be difficulties for such individuals to get employment. Poorly functioning labor markets, partly as a result of regulated wages, would be an

explanation. To the extent that governments are unable to alleviate these deficiencies, politicians will most likely remain under political pressure to stiffen the restrictions on immigration.

Internationalization is, however, not the main reason for the serious *unemployment problems* in Western Europe in recent decades, boosting welfare-state spending and damaging the tax base. Regardless of whether the background is a higher equilibrium unemployment rate or increased unemployment persistence (after unemployment-creating macroeconomic shocks or increased microeconomic turmoil), approximately the same types of structural reforms are potentially useful. If the problems are caused by persistence mechanisms, there is, however, also a strong case for liberalizing job-security legislation, and taking other policy measures that reduce the market power of labor-market insiders – both phenomena contributing to inertia of the employment level. Countercyclical demand management policies (monetary and fiscal policy) are also more useful if it is unemployment persistence (after unemployment-creating macroeconomic shocks), rather than higher equilibrium unemployment, that are the problem.

Baumol's "cost disease" (Baumol, 1967) regarding labor-intensive human services – such as child care, education and old-age care – is another largely exogenous threat to the financial viability of today's welfare-state arrangements. More specifically, since the relative costs of such services tend to increase over time (owing to slow productivity growth for such services), it will be necessary to raise tax rates gradually (without apparent limits) in countries where these services are tax financed, even if the provision of such services would be allowed to increase only rather slowly. The problem is somewhat different in the case of health care. After all, productivity in the health-care sector tends to rise rather rapidly along with advances in medicine and surgical techniques. However, since these improvements partly take the form of increased possibilities to treat health problems that could not be treated before, it is unavoidable that the demand for health care will also be boosted (at given incomes and prices). As a result, health care will, in fact, be exposed to similar financing problems as other human services, although partly for different reasons.

As a result of Baumol's cost disease, countries that today rely mainly on tax financing of human services will sooner or later have to limit the rate of expansion of such services (to the same rates as the increase in labor productivity of such services) or they will have to introduce complementary methods to finance human services, such as fees or (voluntary or mandatory) insurance. Indeed, countries that are unwilling to accept such complementary financing methods may very well find themselves unable to finance equally large volumes of human services as countries with other financing methods. Perhaps these considerations help explain why both education and health spending, as mentioned above, are higher in the United States than in Western European countries (although relatively high wages in the health sector in the US is another explanation).

(ii) Endogenous factors.

In contrast to the welfare-state problems discussed above, disincentive effects via tax distortions and moral hazard are (by definition) the result of endogenous adjustments of individuals to the welfare-state itself. In the case of income insurance, moral hazard (*ex post*) arises simply because the individual will be able to choose more leisure at a very low cost to himself in terms of lost income. It is also well known that health-care insurance induces some patients to ask for excessive medical tests and expensive treatment, demands that many physicians may be willing to satisfy.

Formally, the individual will (tautologically) choose work rather benefits only if $u\left[w(1-t)\right] > u(bw) + \alpha - f(n)$, where u is consumption utility, w the wage rate, t the average tax rate, b the benefit (replacement) rate, and a the *difference* between the utility of leisure and the intrinsic utility that one may derive from work. $f(n)$ denotes the disutility of stigmatization when breaking the prevailing work norm, where n is the aggregate number of individuals (or peers) who actually obey the work norm (or a norm against living on government benefits). I assume that the disutility of being stigmatized increases with the number of individuals who work rather than live on benefits; hence, $f'(n) > 0$. Abstracting, for the time being, from the social norms expressed by the stigmatization term $f(n)$, the individual may prefer to live on benefits rather than on work already when the after-tax rate ($1-t$) is only modestly higher than

the benefit rate (*b*), provided he evaluates leisure at least somewhat more than work (so that *a* is at least somewhat positive).

Of course, sufficiently strong social norms in favor of work (or against living on benefits) i.e., a sufficiently high value of the *f*(·)-function), may prevent widespread and frequent reliance on benefits even if the difference in income when working and when living on benefits is quite small. After a while, however, some "entrepreneurial" individuals may be tempted to exploit the benefit systems. As a result, social norms in favor of work (against exploiting the benefit systems) may erode among others as well (Lindbeck et al., 1999; Lindbeck and Persson, 2006). The long-term negative effects of more generous welfare-state arrangements on aggregate labor supply may then be stronger than suggested by traditional microeconomic studies of the elasticity of labor supply with respect to after-tax wage rates. (Empirical research on the role of social norms in favor of work and/or against living on benefits is, however, still in an early stage.)

As an illustration of the potential importance of moral hazard for per capita hours of work, we may note that nearly a fifth of the population of working age (15-64) in Western Europe today (2006) live on various cash transfers from the government – the most important examples include unemployment benefits, labor-market programs, social assistance, sick-pay insurance, and early-retirement pensions (OECD Employment Outlook, 2003, pp. 188-190). Such moral hazard effects of generous welfare-state arrangements in Western Europe are, therefore, an important explanation for the limited per capita hours of work in that part of the world. As a comparison, per capita hours of work (per year) in the United States are between 30 and 50 percent higher then in Western Europe. (Prescott, 2004, has instead tried to explain this phenomenon by the higher *marginal* tax rates in Western Europe, assuming quite high labor-supply elasticities with respect to after-tax wage rates.)

The character and size of the incentive effects of welfare-state arrangements depends, of course, on the specific rules of both the benefit arrangements and the financing of these. For instance, to the extent that tax-financed benefits are paid to retired individuals rather than to individuals in working age, the negative substitution effects

on labor supply of the tax wedges are counteracted by positive income effects of the tax payment (since, in this case, the taxpayers of working age do not get anything back in exchange for the tax payments). It is also well known that the negative substitution effects of marginal tax wedges on the labor supply are mitigated if there is a (positive) link between the individual's contributions to various social-insurance systems and his expected future benefits – as in the case of actuarially fair or "quasi-actuarial" social-insurance arrangements – provided the individual is aware of this link. It is also a commonplace that negative incentives to acquire education as a result of marginal (in particular, progressive) tax rates are often counteracted, or perhaps even overcompensated, by subsidies to investment in human capital. Moreover, in some countries tax revenues are used to finance services that are close substitutes for home production, and hence complements to work in the open labor market. Subsidies to child care and old-age care outside the family are important examples. In this special case, the negative substitution effects of tax wedges on the labor supply would be counteracted by positive cross substitution effects on labor supply of the subsidized (or directly provided) services.

From an empirical point of view, the consequences of welfare-state spending on the efficiency and growth of the national economy are, of course, a perennial question. In the case of countries with modest levels of such spending, there is rather general agreement among economists that the positive effects of higher welfare-state spending on economic efficiency and economic growth are likely to dominate over the negative effects. This is particularly likely if increased public spending, starting from low levels, is concentrated on features such as sanitation, basic health care, elementary education, and infrastructure, and if more comprehensive and generous income protection would further mitigate tendencies toward social unrest. However, there is also general agreement that, sooner or later, ever-increasing social spending will render the net effects on economic efficiency and growth negative, although it is difficult to identify the "turning point".

The complexities of analyzing and aggregating the effects of various types of benefit arrangements, and related taxes, have prompted many economists to try to find shortcuts, by simply regressing either the level or (more often) the aggregate growth rate of per capita GDP on broad aggregates of taxes and/or government spending

programs. It is a fair summary of this huge literature that there is stronger support for the hypothesis that the effects of higher spending and taxes in today's developed countries are negative than that they are positive. (Basically, studies conducted over the last fifteen years conclude that the effects are either negative or absent.) There are, however, serious methodological problems inherent in such aggregate studies.

NEW REQUIREMENTS

The modern welfare state is a success in the sense that it has contributed to solving a number of potentially serious social problems. It encounters, however, financial difficulties in several countries. Some welfare-state arrangements, and their financing, have also created *new* problems, including benefit dependency and other incentive effects. These developments are, of course, the background for ongoing and planned reforms of, and retreats from, existing welfare-state arrangements in a number of countries.

At the same time, strong political demands have emerged for new or improved social arrangements in several areas. For instance, increased female labor-force participation has raised the demand for paid parental leave, subsidized child care, and old-age care outside the family – basically to facilitate everyday life among families with two income earners. In some countries, such arrangements are also regarded as important methods for restoring rapidly falling birth rates. The reduced stability of the family has also generated political demand for legislated property rights in the spouses' social-insurance benefits, in particular pensions.

There is also evidence of increasing individualization of values and life style in developed countries, as compared to the situation when today's welfare-state arrangements were designed a number of decades ago; see evidence of such value changes in Inglehart et al. (2004**).** Obvious ways of adjusting various benefit systems to these new values are more individually differentiated and portable social entitlements (nationally as well as internationally), as well as increased freedom for the individual to choose type of (mandatory) income insurance and quality of various types of (subsidized) human services, for instance via voucher systems (in a wide sense of the term).

Moreover, the incidence of economic and social misery among specific minority groups has recently increased in several developed countries – partly as a result of rising long-term unemployment, immigration of low-skilled groups from poor countries, alcoholism, drug abuse and de-institutionalization of the mentally ill – the "truly disadvantaged" individuals. These problems require more than a generally improved situation on the labor market; new types of *targeting* of social policies are necessary to help specific minority groups. A generally accepted view among social workers seems to be that it is also important to integrate more closely the administration of social insurance, social assistance, labor-market exchange systems, health care, rehabilitation, labor-market training, etc. Moreover, in some cases, non-governmental organizations, including non-profit organizations, seem to be more successful than governmental organizations in such endeavors. These observations raise the issue of the potential usefulness of new divisions of tasks among governments, markets, the family, and civil society.

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