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by
Assar Lindbeck

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Postadress	Gatuadress	Telefon	Bankgiro	Postgiro
Box 5501 114 85 Stockholm	Industrihuset Storgatan 19	08-783 80 00 Telefax 08-661 79 69	446-9995	19 15 92-5

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Assar Lindbeck*:

HAZARDOUS WELFARE-STATE DYNAMICS

The achievements and costs of the modern welfare state are both usually analyzed in static terms. Some consequences of welfare-state arrangements, however, could rather be characterized as *dynamic*, in the sense of reflecting the interacting adjustments over time of basic behavior patterns of households, firms, interest group organizations, politicians and public sector administrators. Many of these dynamic adjustments are no doubt regarded by most observers as positive, or virtuous. For instance, it is easy to visualize how welfare-state policies, under favorable circumstances, may generate virtuous circles of reduced poverty, better neighborhoods, less street crimes, improved health among low-income groups, the accumulation of widely distributed human capital, increased labor productivity, and higher labor force participation rates for women and various ethnic minorities; and all this contributes to an expanded tax base, which facilitates the financing of the welfare-state programs in the first place. We may also speculate that welfare-state policies contribute to improved social coherence, and perhaps even to greater tolerance in the population for the continual reallocation of resources that characterizes a dynamic market economy, and that this reinforces the legitimacy, and hence the support of the welfare state among those who do not perceive much direct benefit to themselves.

Other dynamic adjustments are more problematic, or "hazardous". Due to limited space, this paper is confined to such adjustments. This does not mean that I regard positive, or virtuous, adjustments as less important than hazardous ones; indeed, it is largely because of various virtuous long-term consequences of welfare state arrangements that I have often described the modern welfare state as "a triumph of western civilization". But if we do not watch out for hazardous dynamics, there is a risk that the welfare state will destroy its own economic foundations.

The following discussion is confined to four types of hazardous dynamic adjustments to welfare state policies: (i) delayed adjustments to the disincentive effects of welfare state policies on private agents; (ii) problematic consequences for short-term macroeconomic stability; (iii) induced changes over time in the behavior patterns of politicians and public-sector administrators; and (iv) the gradual replacement of market risks by political risk. As these dynamic adjustments strongly interact, it seems useful to discuss them together.

I. Delayed effects on private agents

A strongly humanitarian case can no doubt be made for generous benefits to people in connection with contingencies such as unemployment, sickness, work injury, permanent disability, single-motherhood and old age. The basic dilemma of the welfare state, however, is that the more generous the benefits, the greater will be not only the tax distortions but also, because of moral hazard and benefit cheating, the number of beneficiaries. This is a field where Say's Law certainly holds in the long run: the supply of benefits creates its own demand. Indeed, moral hazard and cheating are, in my judgement, the weak spot of the welfare state.

My basic hypothesis is that such hazardous adjustments tend to be stronger in the long run than in the short and medium term. One reason is that individual adjustment in some cases requires collective action. For instance, individual adjustment in work effort may require new collective bargaining agreements between unions and employers, for instance about the number of working hours, which is bound to take time. However, some delays in disincentive effects also depend more directly on the inertia of *individual* behavior. An obvious explanation here concerns the various types of information and adjustment costs, such as the costs and time required to acquire information about the tax and benefit systems, to find out the advantages and disadvantages of adjusting to or exploiting these systems, to adjust investment in human capital, to change jobs, etc.

But a more profound reason why disincentive effects on individual behavior are often delayed is that habits, social norms, attitudes and ethics restrict the influence of economic incentives on economic behavior. More specifically, it is reasonable to assume that the individual experiences disutility when breaking existing habits and social norms -- because of a loss of reputation (possibly in connection with punishment) *and* because of a subjectively felt resistance to violating habits and norms that he or she believes should be obeyed.[1] It is also likely that a single individual is more inclined to conform to traditional habits and social norms, the greater the number of individuals in society who do so -- an example of the importance for individual behavior of a "critical mass" of people with similar behavior patterns.

Obvious illustrations of the role of habits and social norms in the context of welfare-state policies are: that people often abstain from applying for benefits to which they are entitled; that the majority probably do not abuse the system of state benefits even when the risk of being caught is small; and that most people largely comply spontaneously with the tax rules, in particular if they believe that tax revenues are being used in a reasonable way. A well-documented example is the hesitation to apply for social assistance ("welfare" in US terminology) because of the stigma attached to such support, combined with an unpleasant sense of a loss of one's personal integrity. (Horan and Austin, 1974; Rainwater, 1979.) Individuals are probably less hesitant about living on general social security benefits, such as unemployment benefit, sick and work injury pay, early retirement (disability) pension or support for single mothers. After all, benefits from the social security system are often described today as "citizens' rights" or entitlements, for which the individual has qualified by paying contributions earlier.

The analytically difficult issue is how such habits and norms emerge. Here I will simply hypothize that they are partly determined by institutional arrangements, including the incentive and control systems today and in the past. This implies that *new* incentive or control systems easily come in conflict with existing habits and norms, before the latter have adjusted to the new incentive system. I will hypothesize that the aggregate of individuals only gradually stop obeying initially existing habits and norms after the emergence of such conflicts, which tends to delay the disincentive effects on the national economy (Lindbeck, 1994b). Such adjustments may be modeled either as changes in the frequency of the adherence to formerly existing habits and norms, or as changes in the prevailing habits and norms themselves, or a combination of both.

For these reasons, the national economy may be protected for a while from the effects of a deterioration in economic incentives and from a softening in the administrative control of beneficiaries. A large increase in the generosity of the welfare-state benefits, a pronounced relaxation of the control system, or a drastic increase in marginal tax rates, however, may make this protection recede with time. A likely mechanism is that the adherence to previously dominating habits and norms is first abandoned by some individuals, and that others follow suit, particularly if friends or neighbours have started living on social benefits, and perhaps even cheating with benefit rules or taxes -- an illustration of the dynamics generated by the "critical mass" effect mentioned above. Serious benefit-dependency, or "learned helplessness", may therefore emerge only in a long-run perspective. Possible examples of such gradual adjustments are an increased tendency to apply for social assistance, less job search and greater choosiness among unemployed workers, more absence from work for alleged health reasons, more applications for (subsidized) early retirement due to alleged inability to work, and more time and effort devoted to tax avoidance and tax evasion. All this means that warning signals about disincentive effects may be considerably delayed. As the delayed effects are not usually possible to predict in advance, welfare-state policies easily "overshoot" in the sense that politicians would initially have chosen to offer less generous welfare-state arrangements if it had been possible to anticipate from the beginning the negative long-term consequences for the national economy, including deteriorations in the financial position of the government itself (Lindbeck, 1993). We may also hypothesize that changes in habits, norms, attitudes and ethics are particularly likely to occur when a new generation enters working life, and forms its values on the basis of a new incentive structure. Immigrants who have come to a country largely because of generous benefits are also likely to be relatively quick to utilize the existing benefit system; a liberal immigration policy may therefore in a long-term perspective be a threat to a generous welfare state.

It is, however, likely that a major macroeconomic shock that throws a great number of individuals onto various welfare-state safety nets speeds up the process by which habits and norms acquired earlier are abandoned, thus generating a kind of abrupt "ketchup effect" on individual behavior.

It is also likely that habits, social norms, attitudes and ethics are important to *saving behavior*. In many societies it has traditionally been regarded as "proper" to save, and improper to be in debt; the reputation (or status) of the individual has also been connected with wealth. Thus, it may take a long time for non-negligible negative effects on household saving behavior to emerge after higher marginal capital-income tax rates have cut the return on saving and reduced the costs of being in debt, and after improved social security benefits have reduced the need for household saving.

It should be emphasized that a decline in private saving (even if delayed) not only reduces the *aggregate* stock of national wealth in the future -- assuming, realistically, that government saving does not usually increase correspondingly. We would also expect that in the long run the growth dynamics of the economic system will be influenced by a substantial reduction in household saving. The reason is that private entrepreneurship requires private equity capital and this presupposes domestic private saving, in particular for small firms. Capitalism cannot exist without capitalists.

II. Short-term macroeconomic dynamics

Welfare-state arrangements also have consequences for short-term macroeconomic dynamics. The most celebrated example is probably the automatic fiscal stabilizer. At a first glance it is tempting to argue that this is stronger, and hence more favorable, the greater the sensitivity of the budget deficit to variations in macroeconomic activity. In this perspective, macroeconomic stability could be expected to be favorably influenced by high marginal tax rates and generous income compensation to those who lose their jobs, regardless of whether they become openly unemployed, engaged in public sector works or training programs, or take subsidized early retirement.

But the issue is much more complex. Experience in several countries in the early 1990s suggest that very large budget deficits, particularly if combined with a huge initial public-sector debt, may drastically raise interest rates on government securities. Possible explanations could be resulting expectations of higher interest rates in the future and greater uncertainty about future policy and interest rates. In principle, interest rates may rise so much that the expansionary effects on aggregate demand by way of the traditional automatic fiscal stabilizer are far exceeded by the crowding-out effects of the higher interest rates, thus illustrating Patinkin's dictum (1956, p.180) : "Once the Pandora box of expectations and interest and price uncertainty is opened upon the world of economic analysis, anything can happen".

Another reason for modifying the traditional theory of the operation of the automatic fiscal stabilizer during deep recessions derives from the effects on the household saving rate of large budget deficits. More specifically, a galloping public sector debt may lead households to expect either future tax increases or future cuts in entitlements promised earlier, thus generating a negative wealth effect on household spending. Increased *uncertainty* about the entitlements or the jobs, or both, could also be expected to reduce household spending, in particular on durables (Hassler 1993).

These effects could be expected to be particularly strong in countries where households have largely abstained from individual saving because of their confidence in the government's "full employment guarantee" and in the reliability of generous social security entitlements. The reason is that the marginal utility of the holdings of financial assets and voluntary insurance policies may then increase drastically in response to lower expected social security entitlements and increased job uncertainty. In this situation households are likely to decide that they must increase their own saving substantially both for "a rainy day" and for retirement, hence reversing the previously discussed trend towards lower household saving in advanced welfare states in which individuals have confidence in the full employment guarantees and the social security entitlements. This tends to generate procyclical behavior in the private consumption rate in deep recessions that are characterized by "galloping" public-sector debt and drastically rising unemployment. It seems important, therefore, to modify traditional theories of consumption smoothing (permanent-income, life-cycle and multigenerational theories) in order to incorporate concern not only for changes in expected future taxes and welfare-state benefits but also for changes in uncertainty about jobs, taxes and benefits.

For all these reasons we may hypothesize that the effects of a larger budget deficit on aggregate demand is not *monotone*: while a modest increase may stabilize aggregate demand, along the lines of the traditional theory of the automatic fiscal stabilizer, a huge increase -- particularly when starting with an initially large government debt -- may very well be a destabilizing factor. A macroeconomic vicious circle may then emerge in recessions, with a galloping government debt, increased uncertainty, higher interest rates, an increased household saving rate, a further fall in aggregate demand, a still deeper recession, and so on. The experience of Finland and Sweden in the early 1990s can perhaps illustrate this.

III. Consequences for political and administrative processes

Important welfare-state dynamics are also present within the political process itself. The most obvious example is perhaps the common political-economy hypothesis that a combination of *specific* benefits and *general* taxes generates strong pressure for continuous expansion of government spending, and that this tendency is accentuated by the recursive (sequential) nature of spending decisions (Lindbeck, 1993). Moreover, it is not clear that the political demand for redistributions will fall by reducing the inequalities in disposable income, as suggested by the median voter theory of redistribution policy. "The political taste" for redistribution may instead *rise* as a result of previous redistributions. One reason is that a very active redistribution policy focuses the political debate on distributional issues and that people then may become more aware of existing inequalities. Another is that tolerance of income inequality may very well fall when it becomes apparent that the distribution of income is to a large extent determined by "arbitrary" political decisions rather than by market forces. Voters could also be expected to support politicians who propose to legislate for shorter working hours and longer vacations, when tax distortions make leisure less expensive for the individual. As the enactment of such legislation may take considerable time, here is another reason why the disincentive effects on work of wider tax wedges may be delayed. Moreover, when non negligible disincentive effects finally emerge, and the tax base is eroded, the government may be forced to raise tax rates further to balance the budget, with a new round of disincentive effects as a consequence, and so on.

Adjustments of individual behavior to various welfare-state arrangements depend, of course, not only on the generosity of the benefit systems, but also on the administrative control of the beneficiaries. If a major unemployment-generating macroeconomic shock shifts large groups of people onto various safety nets, there may, however, not be enough administrative resources for efficient control.

Administrators may also find it unpleasant to be harsh to beneficiaries, including unemployed workers, when there are very few jobs around. Thus, endogenous changes in habits, social norms, attitudes and ethics may emerge with time, not only among potential beneficiaries but also among the administrators of the systems. And with less efficient controls it becomes even more tempting for some individuals to exploit and abuse the systems, which means even more people to control, and so on. Moreover, the "critical mass" effect mentioned above means that when many individuals have been pushed onto various safety nets, habits and social norms that normally discourage people from remaining on these nets are likely to weaken. The day the "Lutheran ethic" subsides in the population, and "Prussian discipline" ceases to be exercised by the controlling administrators, the welfare state is in trouble.

All this means that benefit systems that function reasonably well during prolonged periods of full employment, may run out of control as a result of a major macroeconomic shock, providing an illustration of the "ketchup effect" mentioned above. More specifically: to be sustainable a generous welfare state presupposes a national economy with high productivity, a large share of the population at work in the market sector, general adherence to norm that condemn the exploitation of the benefit and tax systems, and strict administrative controls. But in advanced welfare states forces may emerge that undermine all these prerequisites, either endogenously or as a result of exogenous shocks. Analytically such developments may be handled either as the existence of multiple equilibria or as "vicious circles".[2]

This discussion evokes something of a welfare-state paradox. It is often asserted that welfare state arrangements, unlike private insurance schemes, shield the individual from the consequences of non-insurable macroeconomic shocks. Precisely such shocks may, however, contribute to undermine the welfare state itself by pushing large parts of the labor force onto various safety nets for prolonged periods.

IV. Policy risks

For these various reasons the government may sooner or later be forced to reform or unwind the welfare state, that is to renege on its previous welfare-state commitments. This is bound to create serious problems for the population, as welfare-state entitlements may be regarded as long-term contracts between the government and the citizens. A 60-year-old who is told that the government cannot live up to its earlier promises of sick payments, unemployment benefits or pensions will find it difficult to relive his life for the purpose of saving and buying annuities for himself! Thus, welfare state policies not only mitigate market risks but may also create new types of risks in the form of unpredictable changes in politically determined rules, or "rule instability" (Lindbeck, 1994a). It is partly awareness of this problem that often induces politicians to respond to welfare-state crises by reducing the real value of welfare-state benefits only gradually by "deindexation", rather than by abrupt discretionary reductions in benefits. This means, however, that an oft-repeated argument for state security systems has to be modified, namely that unlike private insurers the state is able to protect the real value of insurance benefits against inflation.

Welfare-state arrangements may, however, lead not only to the replacement of market risks by rule instability, i.e. greater uncertainty on the part of the individual about exogenous data. Unstable rules may also create new types of market risks, as disturbances from the political system are bound to influence people's behavior in various markets. Two examples have already been mentioned: that galloping government debt may dramatically raise interest rates, and also generate instability in the household saving rate. Another example is that price controls tend to create uncertainty about the availability of goods and services. For instance, rent control and the resulting excess demand for apartments generates uncertainty about the chances of getting an apartment among those who do not already have one. Similarly, a public-sector monopoly on the provision of rationed social services at controlled prices, possibly even at zero-prices, generates uncertainty about the availability of such services -- a kind of "service lottery" (stochastic rationing). These uncertainties will be accentuated if a deterioration in the national economy, and in the financial position of the public sector, induce the government to cut down not only transfer payments but also various social services.

V. Retreats with irreversibilities

If a large group of the population has already abandoned previously prevailing habits and social norms, a drastic strengthening of incentives and controls may be necessary to restore previous behavior. Indeed, it may be necessary to be much more harsh towards people -- by way of low benefits levels, considerable co-insurance, strong actuarial elements, and strict controls -- than if the benefits had not been so generous to begin with.

However, in the same way that the combination of specific benefits and general financing, strengthened by the recursiveness of the spending process, all help to explain the expansion of the welfare state, the same factors also help to explain why it is politically difficult to reverse the process. An unwinding of welfare state spending could be expected to be particularly difficult in societies where a large share of the electorate is financed by the public sector, i.e. is tax-financed rather than market-financed. To take an extreme example: in the early 1990s, a majority of the adult population in Sweden received practically their entire income from the public sector, either by way of transfer payments or as factor incomes from public-sector employment (apart from state-owned corporations). Is this "a point of no return" for public sector spending? Or is it possible to get the support of some tax-financed groups of the population to cut the benefits for other groups? Perhaps is a severe economic crisis -- e.g. with a galloping public sector debt -- necessary to convince the beneficiaries that it is better to start to reform and unwind the welfare state immediately, rather than to take the risk that benefit levels will have to be cut even more drastically in the future.

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Footnotes

* Assar Lindbeck is professor of the Institute for International Economic Studies, Stockholm University, S-106 91 Stockholm, and research associate at IUI Stockholm.

[1] These two aspects on individual behavior are considered in a paper by Akerlof (1980) on "social customs", as applied to real wages and unemployment.

[2] For an analysis of multiple equilibria of unemployment due to endogenous administrative controls -- though without concern for habits and social norms -- see Ljungquist and Sargent (1994). Akerlof's model of social customs also generates multiple equilibria (Akerlof, 1980)