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Yes, There Are Hayekian Welfare States (At Least in Theory)

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LINK TO ABSTRACT

Many economists tend to be skeptical towards government intervention. There are several reasons for such skepticism, but all reasons do not apply to all types of interventions. This note identifies two common but very different lines of argumentation against government interventions: the Hayekian knowledge problem and the problem of distortionary taxation. While many government programs suffer from both problems, there are exceptions. In particular, there is a possibility of what I will call Hayekian welfare state programs, which require high levels of public expenditure but do not suffer severely from the Hayekian knowledge problem, and where taxes and benefits are designed to minimize distortions. I propose that the correlation between economists' views on the regulatory state and the welfare state, as presented by Daniel Klein (2015), is partly a result of the survey questions failing to capture the possibility of a Hayekian welfare state.

Two reasons for opposing government intervention

There are different types of government intervention, and there are different reasons for opposing (or favoring) such intervention. Consider two of the most common reasons for opposing government intervention: The neoclassical problem of distortionary taxation, and the Hayekian knowledge problem.

The neoclassical reasons, taught in textbooks, are based on the fact that public funds are raised by taxation and entail excess burdens: The cost of raising x

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dollars for public spending will exceed x dollars by some amount that depends on the type of taxes used. Theoretically, the size of the excess burden is proportional to the tax rate squared, suggesting that, from an efficiency point of view, low taxes are much better than high taxes (Stiglitz 2000, ch. 19).[2]

The Hayekian reason comes from the view that the information necessary for the government to succeed with any government intervention exists "solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess" (Hayek 1945, 519). Even under the unlikely scenario that the government is fully informed at one point in time, this information is likely to become obsolete in a rapidly changing world. When the government has incomplete information about preferences and circumstances of the actors in society, centrally planned interventions imposed by force may do great harm.

There are, of course, qualifications and counter-arguments to both reasons. In some situations the knowledge problem may be less severe, and the alternative—voluntary, spontaneous action—may suffer from severe collective action problems. Similarly, there may be situations when taxes are not terribly distortionary and where public funds are used in ways that redeem the distortionary effects.

At this point, I do not wish to claim anything about the relative strength of the various arguments. But I do suggest that the two reasons are conceptually very different, and that there are types of government intervention that would suffer substantially from the neoclassical problem but much less from the Hayekian problem, and vice versa. Some examples might clarify the idea.

Four examples of government intervention

Using the two reasons for opposing government intervention described above, government programs can be classified in two dimensions: the amount of knowledge needed and the amount of public funds needed. Programs that require a lot of funds need high taxes and are vulnerable to the neoclassical distortion problem. Programs that require a lot of knowledge are vulnerable to the Hayekian knowledge problem.

Table 1 gives examples of government interventions that differ in the two dimensions. Intervention types A and B include government programs that require

2. The neoclassical distortions are sometimes of substantial magnitude. In a welfare state with high average taxes, the marginal cost of public funds raised from progressive income taxes may well be six times the amount raised, as for Sweden during its most extreme period around 1980, as shown by Hansson (1984). U.S. estimates average around $1.40 for an additional tax dollar (Bohanon et al. 2014, 281-284).

relatively little public funds but that differ a lot in how much knowledge the government needs to implement the programs successfully: Type A interventions require relatively little knowledge, and Type B interventions require much knowledge.

TABLE 1. A typology of government interventions

		Knowledge needed	
		Relatively little	A lot
Level of public funds needed	Low	Type A. *Example: Income-tested welfare*	Type B. *Example: Seed capital and encouragement of entrepreneurs*
	High	Type C. *Example: Pension schemes and social insurance*	Type D. *Example: Keynesian stabilization policies*

An income-tested welfare program, which is an example of Type A, will enjoy majority support if a majority of voters would be willing to contribute to such a program provided that everyone is actually contributing, and it might actually be justified under the Pareto criterion if everybody has such preferences. For those who care about Benthamite utility, the circumstances under which such a program will increase total utility are probably not very strong; basically, if everyone has decreasing marginal utility of income, there are utility gains created by redistribution that must exceed the costs of redistribution.

There are, of course, plenty of opportunities for governments to fail also with programs of Type A. In the case of income-tested welfare, the level guaranteed by the program might be set too high, in which case the work disincentive effects may dominate. Still, as several scholars have noted, Hayek goes beyond the idea of income-tested support and argues for a basic income guarantee in *Law, Legislation and Liberty*:

> The assurance of a certain minimum income for everyone, or a sort of floor below which nobody need fall even when he is unable to provide for himself, appears not only to be wholly legitimate protection against a risk common to all, but a necessary part of the Great Society in which the individual no longer has specific claims on the members of the particular small group into which he was born. (Hayek 1981/1979, 55)[3]

Type B contains programs that require a lot of knowledge but that still do not require high taxes. Examples include public encouragement of entrepreneurs, public seed capital, and any program that requires the government to pick winners. In this case, there is consensus that the government is faced with a very difficult

3. On Hayek and parts of the welfare state, see also Nell (2013, especially ch. 3 by Daniel Kuehn) and von Weizsäcker (2003).

task that requires a lot of knowledge, and the most critical would probably recommend that the government does not even try.

Types C and D contain programs that require a lot of public funds, but that differ in their knowledge requirements. Similar to income-tested welfare, pension schemes are basically motivated by decreasing marginal utility of consumption, but with particular attention to the need for smoothing consumption over one's lifecycle, in effect creating an insurance scheme to account for the uncertain longevity most people face. Successful design of pension schemes and social insurance require that moral hazard problems and adverse selection are accounted for. Needless to say, these are non-trivial issues, but compared to the knowledge needed for governments to successfully implement the Type D example—Keynesian stabilization policies—social insurance arguably is less challenged by the knowledge problem.

Why don't economists argue in favor of the welfare state and against the regulatory state?

Finally, I offer two thoughts on the idea that very few economists share my position of being rather friendly towards a well designed welfare state and skeptical about most government regulations.

First of all, regarding the evidence put forward by Klein, I am not convinced that the correlation shown is very sound. Upon examining the three survey questions used by Klein (2015, 6-9) to construct his "Welfare State" index, I believe that two of the three questions are at least slightly biased against the welfare state. In Klein's question 23, both the phrases "transfer and aid programs" and "tax progressivity" suggest a welfare state with a substantial degree of vertical income redistribution from rich to poor. Such a welfare state not only will create more severe distortions than a welfare state that provides risk-pooling social insurance schemes financed by proportional taxes, but it will also be more vulnerable to the knowledge problem.[4] The effect will be that if there are economists who for Hayekian reasons oppose most regulations but are more enthusiastic about social insurance, their existence will not be revealed by this set of questions. I suspect that the mentioning of Medicaid, in Klein's question 25, had a similar effect.

Secondly, I believe that, when it applies, the Hayekian argument against government intervention is much stronger than the neoclassical argument. The

4. It might be noted that while countries with big, universal welfare states unsurprisingly have higher average taxes, they are also typically less progressive than in countries with smaller welfare states (cf. Bergh 2014).

commonly held view that neoclassical economics as taught in a typical Econ 101 course is anti-government is highly debatable. If a professor is honest about the circumstances under which markets can be expected to allocate resources efficiently, the standard economics course is much more interventionist than it is pro-market. As discussed by James Gwartney (2012), most introductory economics textbooks devote much more attention to market failure than they do to political failure. One could add that they also do not do justice to the Hayekian knowledge problem, if they treat it at all. The neoclassical analysis consists largely of a set of blueprints for supposedly welfare-improving government interventions. But taking the knowledge problem seriously should lead to a highly skeptical view of knowledge-intensive government interventions. Most of what Klein (2015) includes in his "Business Regulation" index falls under this category. The Hayekian argument has the power to turn people into rather convinced and passionate opponents of government interventions.

Perhaps the typical Hayekian economist assumes that government interventions that require more funds also require more knowledge, and that the Hayekian knowledge problem implies that smaller government (in terms of expenditure relative to GDP) is always preferable. My position, however, is that deploying this simplifying assumption is a major error. There are government programs that require a lot of funds without being very vulnerable to the Hayekian knowledge problem. A welfare state consisting only of such interventions and otherwise characterized by low levels of regulation and high levels of economic freedom—a Hayekian welfare state—could theoretically exist.[5] If I am right, many economists would be sympathetic to such a welfare state.

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5. It could be argued that some Nordic countries have, at times, come fairly close; see Bergh (2014) on the case of Sweden.

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