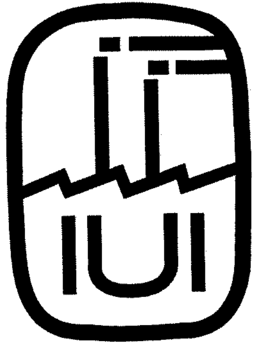

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WELFARE-STATE DYNAMICS

BY ASSAR LINDBECK

Welfare-State Dynamics

Assar Lindbeck

The Institute for International Economic Studies and IUI

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Assar Lindbeck:

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This paper deals, in a general way, with achievements and problems of welfare-state arrangements in Western Europe. These arrangements naturally differ among countries. In particular, the extent to which countries rely on four basic institutions -- the state, the firm, the family and the market -- varies greatly. This is the case both for systems of income security, i.e. transfers over the life-cycle, and for provision of various types of services, such as health care, childcare and old-age care.

With respect to income security, the most important difference between countries is probably between the reliance on a *common safety net*, i.e. flat-rate benefits tied to specific contingencies; *means-tested benefits*, i.e. benefits that are lost by higher income; and *income protection*, i.e. benefits that rise by higher income in the past. With respect to services to households, the most important difference is probably between countries in which the government provides such services, such as in the Nordic countries, and countries in which these services are mainly provided by the family or the private market.

Another important distinction is between corporatist welfare states, where benefits are connected to labor contracts, and universal welfare states in which benefits are tied to citizenship. This distinction is blurred, however, by recent tendencies in corporatist welfare states to extend coverage to citizens who have a rather weak attachment to the labor market, and in universal welfare states to tie benefits to previous or contemporary work under the slogan "workfare" rather than "welfare". The degree of generosity of benefits is another important distinction.

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[1] Several points in this paper are developed in more detail in the following four papers: "Incentives in the welfare state -- Lessons for would-be welfare states", lecture given at the International Economic Association Congress at Tunis in December 1995, MacMillan (forthcoming); "The Future of the European Welfare State -- within the Economic and Monetary Union", the 19th Congress of the Instituto Espanõl de Analistas Financieros in Barcelona, September 1996; "Full Employment and the Welfare State", Frank E. Seidman Award Lecture, Memphis, September 1996; and "The West European Employment Problem", *Weltwirtschaflicchtes Archiv*", December, 1996.

Naturally, the lower the benefit levels in the compulsory state-operated systems, the stronger the incentives for citizens to complement these systems with voluntary market solutions, in the form of private saving and private (though possibly collective) insurance arrangements.

While acknowledging these differences in welfare-state arrangements between nations, this paper will mainly deal with issues that are common to most countries in Western Europe. The emphasis will be on "dynamic" issues, i.e. achievements and problems of the welfare state that evolve over time, often with important interaction between several different variables. Let me begin, however, with a number of more familiar "static" aspects.

I. Static aspects

The most obvious *achievements* of the modern welfare state are probably (i) to redistribute income over the life cycle of the individual, and in this context equalize the distribution of yearly income between individuals and households; (ii) to reduce income risk; (iii) to stimulate the consumption of various social services, often with strong elements of investment in human capital; and (iv) to mitigate poverty. In some countries, welfare-state arrangements have also (v) equalized the overall distribution of disposable lifetime income, i.e. wealth, among individuals, and also the distribution of specific social services. This enumeration of achievements illustrates the common view that welfare-state arrangements may be motivated on both efficiency grounds (the first three achievements just mentioned) and distributional grounds (the last two).

How, then, can we be sure that similar redistributions of income over the life cycle, reductions of income risks, and investment in human capital would not have taken place even *without* welfare-state arrangements, i.e. on a voluntary basis? The "paternalistic" answer, obviously, is that many individuals are myopic, and that they would therefore not have chosen equally elaborate economic security on their own. Economists, however, tend to emphasize various deficiencies of voluntary market solutions to problems of economic security. The most obvious examples are perhaps difficulties in borrowing with human capital as collateral, and high administrative costs of voluntary insurance policies. Compulsory social security may also overcome tendencies towards free-riding by individuals who expect the government to help them out if they encounter economic difficulties in the future. It is also a method to prevent

"cream-skimming" by insurance companies when they are able to identify low-risk individuals, and a technique to avoid adverse selection when insurance companies are *not* able to make this kind of identification. There is also general agreement among economists that various positive externalities of investment in human capital tend to make such investment suboptimal without government interventions, for instance in the form of loan guarantees and subsidies to pre-natal care, education and perhaps also childcare.

But how do we know that welfare-state arrangements have in fact equalized the distribution of disposable income among individuals? One piece of evidence is that the dispersion of disposable income in most OECD countries is much smaller than the dispersion of factor income -- and this holds not only for the overall income distribution but also for its lower tail. Moreover, there is very little evidence that benefits and taxes, designed to equalize the distribution of disposable income, have been shifted to factor prices, making the distribution of factor income more dispersed. Indeed, in most countries, the factor-income distribution among citizens in active working age tended to become *more even* during the period when the welfare-state arrangements were being built up in the first decades after World War II.

The most widely discussed *problem* regarding welfare-state arrangements probably concerns the "static" efficiency costs associated with the financing of the welfare-state, i.e. distortions generated by various tax wedges, which are often measured by the "marginal costs of public funds". My only point on this well-known issue would be to emphasize the *pervasiveness* of such disincentive effects. In addition to frequently studied (substitution) effects against hours of work, and somewhat less frequently studied effects against private saving and investment in physical capital, it is also important to consider the effects on, for instance, do-it-yourself work, barter of goods and services, the intensity and quality of work, investment in human capital, the choice of job, the allocation of investment in real and human capital, tax avoidance, tax evasion, etc. Unfortunately, our empirical knowledge of these matters is fragmented, sometimes even anecdotal. In the United States, the "marginal costs of public funds" are often estimated at about 1.2-1.3 dollars per dollar of additional spending. This means that higher government spending can be motivated if it is believed to be worth more than 1.2-1.3 dollars to society per extra dollar spent. In Sweden during the 1980s, the marginal costs of public funds

have usually been estimated at between 1.5 and 2.5 dollars. Such studies are, however, rather unreliable. Moreover, they cover only a very limited number of distortions, often only the effects on hours of work, which means that the *actual* costs may be considerably higher.

Distortions, directly connected with welfare-state *benefits* are no less pervasive. Not only are means-tested benefits bound to create "benefit wedges", i.e. *implicit* tax wedges, resulting in poverty traps for some low-income groups. The most severe problem inherent in various benefit systems is probably that, like private insurance, they are plagued with moral hazard, as the individual is able to adjust his(her) own behavior to qualify for benefits. Outright "benefit-cheating" is also bound to occur. Among major welfare-state arrangements, problems of moral hazard and cheating seem to be particularly pervasive in the case of sick benefits, work-injury benefits, financial support to single parents (read: mothers), subsidized early retirement (disability pensions), and unemployment benefits.[2]

There are, of course, strong social and humanitarian reasons for being generous to individuals with low incomes, regardless of whether this is a permanent or temporary situation. Indeed, that is one reason why welfare-state arrangements have been built up in the first place. However, a basic dilemma is that the more generous the welfare state is to people who are sick, the more individuals will stay away from work even when they are healthy (but perhaps tired or bored); the more favorable the conditions for subsidized early retirement pensions, the more individuals will choose to live on such pensions; the more generous we are to the unemployed, the higher long-term unemployment is likely to be; and the more generous we are to

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[2] Some figures for Sweden may illustrate the issue. For instance, in the 1980s, when the replacement ratio in the sick-benefit system was above 90 percent of previous income (up to a ceiling), people stayed away from work for alleged sickness about 25 days per year on average. In connection with lower compensation levels and stricter social control (after employers took over the payments of benefits for the first two weeks), the number of sick days has fallen dramatically, probably to 11 days. The deep recession in the early 1990s also appears to have contributed to this development. When the administrative controls were relaxed in the work-injury system (with 100 percent replacement rates) around 1980, government spending for work-injury insurance increased by a factor of four in real terms after a few years.

The number of individuals receiving subsidized early retirement (originally designed for disabled persons) amounted to about 8 percent of the labor force in Sweden in the 1980s -- long before full employment broke down. (The figure is higher in some other countries, such as Italy and the Netherlands.) Generous compensation levels for the unemployed in Sweden did not constiute a serious problem as long as unemployment was very low. But it became a problem when total unemployment (open unemployment plus individuals in Labor Market Board activities) reached about 13 percent in the early 1990s.

single mothers and their children, the more single mothers we are likely to have in the long run. The difficult problems, therefore, is how to strike a balance between the social value of income protection and redistribution on the one hand, and the risk of moral hazard, cheating and tax distortions on the other hand.

However, rather than dwelling on these "static" aspects, I would like to concentrate on effects of a more *dynamic* nature. By that I mean effects that evolve over time and interact strongly with each other, possibly in the form of virtuous or vicious circles.

II. Dynamic achievements

Starting with dynamic *achievements*, it is likely that government subsidization of investment in human capital results not only in a rise in the future *level* of GDP, but also in faster long-term GDP *growth*, as asserted by contemporary theories of "endogenous growth". This should be the result not only for education and general health care, but also for policies that mitigate child poverty and provide specific social services such as pre-natal care and better nutrition for mothers and children. Indeed, improvements in these fields seem to be transmitted over generations within the family (Haveman and Wolfe, 1993).

Another potentially important dynamic contribution of welfare-state arrangements is to bring various minority groups into ordinary work, and hence to mitigate what is often called "social exclusion", manifested in long-term open unemployment, withdrawal from the labor force, or highly unstable and uncertain job prospects. This contribution presupposes, of course, that long-term benefit dependency can be avoided. This is more likely to be the case if the policy relies on work-oriented welfare-state arrangements, so-called "workfare", than on pure transfer payments.

Policies that counteract "social exclusion" may also, in a long-term perspective, mitigate the development of cultures of criminal behavior such as street crime, burglary, physical violence and drug addiction; cf. Hagen (1994). Poor labor-force attachment is, in fact, often regarded as a key factor that embeds crimes in poor neighborhoods; cf. Wilson (1987). Indeed, it is often argued that compared to the United States, the more ambitious welfare-state arrangements in Western Europe help

explain the smaller incidence of such phenomena in the former area; cf. Coder, Rainwater and Sweeding (1989); Jäntti and Danziger (1994).

The emergence of long-term dynamic effects such as these was already a basic notion in Gunnar Myrdal's *An American Dilemma* (1944, Appendix 3), where he emphasized the possibilities of what he called processes of "cumulative causation" between variables such as "employment, wages, housing, nutrition, clothing, health, education, stability in family relations, manners, cleanliness, orderliness, trustworthiness, law observance, loyalty to society at large, absence of criminality, and so on". Long-term productivity-enhancing welfare-state policies, and policies that stimulate labor-force participation in the private sector, also expand the tax base in the long run. This would help finance the welfare state in the first place -- an obvious example of a virtuous circle.[3] Once again, such effects presuppose that welfare-state policies do not result in long-term benefit dependency. Labor supply in some countries is also enhanced by tying the individual's right to social benefits to work -- to *previous* work in the case of pensions, sickness benefits and paid maternity leave, and to *current* work in the case of subsidized childcare.

It has also been argued that an even distribution of income mitigates social conflicts (Alesina and Rodrik, 1994), and reduces the political pressure to redistribute disposable income further by way of distortionary political interventions (Meltzer and Scott, 1981; Persson and Tabellini, 1994). Another common view is that welfare-state arrangements make citizens more willing to accept reallocation of resources in response to changes in technology, product demand and international competition -- and even perhaps contribute to making citizens more sympathetic to the market system. This argument is based on the idea that individuals cling less to previous jobs if society provides a solid safety net.

Welfare-state policies may also have profound long-term consequences for the role of the family in society. Some family-oriented welfare states on the European continent tend to support the traditional family, in the sense that married women are encouraged to work in their homes rather than in the open market. Examples of such countries are Austria, the Netherlands, Switzerland, and to a considerable extent also

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[3] For recent emphasis on positive interrelations between social achievements and economic efficiency, see, for instance, Glyn and Miliband (1994).

Germany. This result is accentuated by high marginal tax wedges, which favor household work rather than work in the market.

The consequences for the family are more complex in "individual-centered" welfare states, e.g. the Nordic countries. High marginal tax rates, also in these countries, inevitably create substitution effects in favor of household work. But incentives in the opposite direction are created in several of these countries by the subsidization of childcare, medical care and the care of the elderly outside the household. In some countries, labor-force participation of married women is also stimulated by the separate assessment of income taxes for husband and wife, which lowers the marginal income tax rate for the "second" income earner in the household. Another example is positive income (or rather liquidity) effects on labor supply by a combination of high average tax rates and the provision of benefits "in kind" that cannot be transformed into money income, which often makes it difficult to finance the family on the basis of one income earner only.

Thus, in countries with a combination of high marginal tax rates, strict work requirements and subsidized childcare outside the home, labor-force participation may very well be high for married women. But the average number of working hours per year per individual would be expected to be rather low, in particular if the benefit systems are far from actuarially fair. Strongly subsidized childcare and old-age care may also keep up the birth rate in such societies.

It is, of course, a question of values whether we are in favor of family-oriented or individual-oriented welfare states -- or if we prefer, in conformity with non-paternalistic principles, to opt for welfare-state arrangements that are intended to be neutral with respect to the division of labor between household work and market activities, as well as to the division of work between family members.

III. Dynamic problems

The dynamic achievements of the welfare state should be compared to various dynamic problems. For instance, the positive effects of the subsidization of investment in human capital are counteracted by the reduced return on such an investment because of marginal taxes on labor income, in particular if the tax system is progressive. Similarly, broad marginal tax wedges on the return on physical assets tend to reduce the accumulation of such assets. It is, by contrast, often argued that

policies with negative effects on domestic saving do not harm domestic investment in physical assets in a world of free international capital movements. This, I believe, is a mistaken view. One reason is that there seems to be a home bias regarding the supply of funds to physical investment, in the sense that foreign saving is not a perfect substitute for domestic saving when it comes to the financing of domestic investment. In particular, it is likely that small and medium-sized firms are favored by domestically supplied financial capital -- equity capital as well as loans -- because of various information problems in capital and credit markets. For instance, providers of financial capital require detailed knowledge of the entrepreneurs to whom they supply funds, and this knowledge is difficult to acquire "by long distance". A more important point is perhaps that private entrepreneurs, particularly small ones, are likely to have preferences for capital that is controlled either by themselves or by people whom they know. Thus, both capital taxes that reduce the return on private saving, and welfare-state arrangements that reduce the need for the household to save, would be expected to thwart the entry and growth of small private firms.

More wide-ranging dynamic problems may also arise in connection with welfare-state policies. I have hypothesized elsewhere (Lindbeck, 1995b; Lindbeck, Nyberg and Weibull, 1995) that the full realization of various disincentive effects of taxes and benefits is likely to be delayed because habits and social norms constrain individual behavior. Before the build-up of generous welfare-state arrangements, work and saving were crucial for the living standard of the individual, indeed often even for his survival. It may be hypothesized that today's habits and social norms are, at least partly, a result of incentive and control systems in the past. However, as increased marginal tax wedges and more generous benefits in recent decades have reduced the return on work, and also made individual saving less imperative, it is likely that habits and social norms gradually adjust to the new incentive system. Moreover, as more individuals abandon previously obeyed social norms, it will be easier for others to do the same. In other words, is likely it that interaction between economic incentives and social norms contributes to a dynamic process by which individuals gradually adjust their behavior to a new incentive structure. Such delayed effects were probably not anticipated by politicians when today's welfare-state arrangements were decided. Therefore, it is tempting to argue that the welfare state

will easily "overshoot", in the sense that welfare-state spending will expand more than politicians had originally planned (Lindbeck, 1994a).

In the previous section on “dynamic achievements” of the welfare state, I mentioned that welfare-state arrangements may raise the acceptance among citizens of continuing reallocation of labor. However, reallocations is often resisted even in advanced welfare states (including in my own country, Sweden), and citizens ask for regional subsidies to allow them to stay where they are. Moreover, we cannot really be sure that reductions in income inequality, when brought about by policy actions, will necessarily mitigate social conflicts and reduce the political pressure for further redistributions through taxes, transfers and regulations. The “appetite” for redistributions may even *increase* by the amount of redistributions implemented earlier. One reason is that such policy actions politicize distributional issues by making people believe that income differences, rather than constituting an indispensable element of a well-functioning market system, are “arbitrarily” determined in the political process. This is, in fact, my own interpretation of the Swedish experience of redistribution policy after World War II. Indeed, it seems that the political discussion in Sweden has increasingly focused on remaining inequalities, and the demands to reduce them, regardless of how small they have become.

So far I have dealt with problematic *behavior adjustments* in connection with welfare-state arrangements. Another potentially serious “dynamic” problem is that the welfare state is *not very robust* to macroeconomic and demographic shocks. More specifically, it is obvious that the welfare state has been financially undermined by the slowdown of long-term GDP growth of the last two decades. After all, the welfare-state arrangements decided on during the first decades after World War II were based on the assumption of fast economic growth, probably around four percent per year. The architects of the modern welfare state also based their decisions on over-optimistic expectations concerning the demography. Serious problems have therefore been created by the rising life expectancy of old people. The welfare-state crisis became *acute* in some countries in the 1980s and early 1990s in connection with strongly negative, macroeconomic shocks which threw large groups of citizens into various safety nets, and induced others to withdraw from the labor force. These developments may also have speeded up the earlier mentioned long-term weakening of social norms against living on various types of benefits.

If these hypotheses make sense, it is important to take early warning signals about disincentive effects and lack of robustness seriously, rather than to wait until academic research has shown, without doubt, that the welfare state is in trouble. The problem is rather similar to the emergence of environmental disturbances, which often also build up only gradually, but may be suddenly speeded up by abrupt shocks. In both cases, it is dangerous to wait until problems have conclusively been proven to exist, as it takes time to reverse the process.

Traditionally, "automatic" budget responses to fluctuations in GDP have been assumed to stabilize aggregate employment by keeping up the disposable income of households during recessions. There is some concern today, however, that the automatic stabilizer may turn into an automatic destabilizer in *deep* recessions in countries with exceptionally generous welfare-state arrangements. The reason is that galloping government debt may create great uncertainty both among lenders and households regarding the ability of the government to live up to its previous commitments. As a result, lenders are likely to require higher interest rates on their loans to the government, and households may increase their saving in the middle of a deep recession. However, it is likely that the automatic fiscal stabilizer functions as traditionally assumed during "normal" business fluctuations.

Recent employment experiences in Western Europe also suggest that *the equilibrium unemployment rate*, i.e. the rate at which the aggregate wage (or price) increase is constant, has been raised by generous welfare-state arrangements. These arrangements are also likely to have made high unemployment more *persistent* after unemployment-creating shocks. The reasons for these effects are not only that the jobless workers are encouraged to search longer when they are entitled to generous unemployment benefits for longer periods of time. Workers also tend to become more aggressive in their wage demands when the incomes received when out of work are higher.

Some welfare-state arrangements also tend to reduce the hiring of labor. An example is strict job-security legislation that tends to stabilize the employment level at whatever levels that happen to exist. Strict job-security legislation, i.e. high costs of hiring and firing workers, also raises the market powers of those who already have a job, so called "insiders" relative to "outsiders" i.e. workers without a job. This also tends to boost the real wage rate, as insiders are then able to push up their wages

above the reservation wage of outsiders without losing their jobs. High minimum wages, rigid relative wages, and wide tax wedges also tend both to raise equilibrium unemployment and to increase unemployment persistence.

IV. Marginal reforms

On the basis of accumulated, though highly fragmented, evidence from various countries, it should be clear that the welfare state is experiencing serious problems, and that there is a strong case for welfare-state reforms. The only relevant question is *how* to bring them about. Indeed, reforms and retreats are already under way in several OECD countries. I will start with what may be called "marginal" reforms, and then shift the focus to more "radical" ones. Marginal reforms often aim to reduce tax and benefit wedges, to mitigate moral hazard, to fight cheating with taxes and benefits, and to make the existing system more robust to shocks. Radical reforms on the other hand, aim to overhaul the basic structure of the welfare-state arrangements.

Perhaps the most obvious marginal reform would be to cut benefit levels. Stronger actuarial elements in various social security systems would also help reduce economic disincentives, as the marginal tax wedges would then shrink. It is important to note that the systems can be made more actuarially fair without shifting to funded systems. Strong actuarial elements can also be introduced in the context of pay-as-you-go systems. Future benefits "simply" have to be tied to the value of previously paid contributions. Such actuarial, contributions-defined pay-as-you-go systems are perhaps easiest to achieve for old age and early retirement pensions.[4]

It is also useful to have the same replacement rates in all benefit systems between which the individual can move at his own discretion. Otherwise, some individuals will simply choose to apply for the most favorable type of benefit. Well-known examples are shifts between sick-leave, work-injury benefits and disability pensions. Strict eligibility requirements for receiving benefits, and stiff controls that these requirements are satisfied, are also important. The need for controls is, of course, smaller, the lower the benefit levels, and vice versa. There are, however,

[4] In a system of work-injury benefits, actuarial elements may be introduced by varying the contributions from firms in accordance with work-injury risks ("experience rating.") In the unemployment benefit system, actuarial elements may be instituted by differentiating the fees by sectors and professions in accordance with unemployment risks.

practical limits to controls, which are probably more effective against cheating than against moral hazard.

To avoid overinsurance, it is also useful to put caps on *total* insurance benefits in each system i.e., on the levels of compulsory *plus* private insurance benefits. Otherwise, the compulsory system may be exposed to negative external effects via moral hazard and cheating in the voluntary system. Such caps are not necessary in the old-age pension system, however, as moral hazard hardly arises in this case.

When considering methods that would allow welfare state arrangements to better adjust to shocks in demography and productivity, a basic issue is the extent to which such adjustments should be automatic or discretionary.[5] In a pension system, for instance, an obvious way to achieve *automatic* adjustments to demographic shocks is to tie the normal pension age to the life expectancy of the population. To provide automatic protection against a slowdown in productivity growth, the pension benefits could be formally tied to the per capita disposable income, or per capita consumption, of the active population (see Merton, 1983). Similar automatic adjustment mechanisms may also be constructed for other parts of a social security system. For instance, either the contribution, or the benefits of an unemployment insurance system may be automatically tied to the unemployment rate. In a sick-pay system, contributions and benefits may be formally tied to the number of sick days either for specific groups of people or for the population as a whole. Automatic adjustments have the advantage of being somewhat more predictable than discretionary adjustments. Automatic adjustment mechanisms may, therefore, reduce the risk of discretionary political interventions, i.e. they may reduce the "political risks".

An obvious weakness of automatic adjustment mechanisms of this aggregate type is that they may make it difficult to establish a tight "actuarial" relation between contributions and benefits for the individual. *Relative* benefits for different individuals could, however, still be tied to previously paid contributions, even if *average* benefits are tied to the average disposable income of the contemporary working population.

It is important to realize that reforms in the social insurance systems have wide effects in society. For instance, policies that raise the pension age, which is an important way of preventing the pension system from collapsing in some countries, are likely to increase the supply of labor in the 55-70 age group. If these people are to

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[5] This issue is discussed in Diamond (1995).

get jobs, however, the functioning of the labor-market, including the formation of relative wages has to be much more flexible. The institutional obstacle to part-time work must also be reduced to prevent many individuals in this group from being unemployed.

Incentive problems also extend to the provision of *social services*, in the sense that it has proven difficult to achieve efficiency and freedom of choice when the government monopolies provide such services. Services also suffer from "Baumol's Law" according to which the costs of many types of labor-intensive services tend to increase relative to the costs of goods of services for which productivity growth is faster. This will create even more severe financial problems for the welfare state, and force politicians to state their priorities more carefully. Obvious ways of mitigating these problem are *either* administrative reforms of public-sector agencies *or* the opening up of competition with private and cooperative institutions -- or both. The first option includes methods such as administrative decentralization, cash limits and comparison of the performance of different units in the public sector (i.e., "benchmark competition"). The second option requires free entry and an end to the discrimination of actual and potential competitors of public-sector agencies. To mitigate distributional problems in connection with freer competition, a voucher system is perhaps the most obvious device.

Some of these welfare-state reforms are also likely to reduce long-term unemployment. The most obvious example is perhaps less generous unemployment benefits, including lower replacement ratios, shorter benefit periods and stronger actuarial elements in the financing of the system. Less rigid job-security legislation would be expected to have similar effects in countries with heavy unemployment.

Many of the marginal reforms discussed here may well have distributional consequences that are not happily received by the general public. There are, however, well-known methods to mitigate some of these consequences. These methods include lower income taxes, or so-called "work-in-benefits" for people who otherwise may become "working poor"; reduced payroll taxes for low-productivity workers; tax-favors, or subsidies, for the purchases of labor-intensive household services; the option of transforming unemployment benefits to vouchers by which unemployed workers can "buy" jobs from firms; subsidies for the training of unemployed workers, and perhaps also low-productivity workers in general; apprenticeship systems for the

young, etc. Each of these measures are connected with various drawbacks, but these have to be compared with either not being able to reform the welfare state at all, or with a much wider dispersion of disposable income.

V. Radical reforms

The considerations above focused on marginal reforms within an approximately given *structure* of welfare-state arrangements. More recently, however, there has also been some discussion of changes of *the basic structure* of the welfare state.

Examples of radical alternatives are (i) to replace a system of income protection with a safety net that is common to all (flat-rate benefits); (ii) to shift from a pay-as-you-go to a funded social insurance system, possibly combined with partial or total privatization, while keeping insurance compulsory; (iii) to replace a complex social security system, in which benefits are tied to specific contingencies, with a "negative income-tax" (a so-called "gradient system"); or (iv) to replace a traditional social security system with actuarially based lifetime "drawing rights", i.e. forced-saving accounts, whereby an individual is free to draw, at his own discretion, on an individual account which is comprised of compulsory fees accumulated over his working-life.

Each of these radical reforms has specific advantages and drawbacks. A shift to a *common safety net*, i.e. the "back to Beveridge strategy", has the advantage of being financially inexpensive for the government. Such a system is also attractive if we want individuals to take considerable personal responsibility in the form of voluntary saving and insurance policies, which is often believed to reduce the risk of individuals becoming "passive". A clear disadvantage of this strategy is that the administrative costs are higher in private insurance systems than in compulsory social insurance systems.

Funded systems not only have the advantage of being (more or less) actuarially fair (which means that wide tax wedges are avoided). They are also likely to have a favorable effect on aggregate national saving, at least during a period of transition. It is also reasonable to assume that subjectively felt property rights are stronger in funded systems than in a pay-as-you-go system, in the sense that the risk of political intervention is smaller. Thus, a funded system is probably politically more stable than a pay-as-you-go system. However, the individuals would instead be exposed to more

capital-market risks. It is also important *when* a shift to funding is implemented. An abrupt rise in aggregate national saving in the midst of a deep recession would only serve to worsen the recession. It is also important that a rise in aggregate saving is combined with policies that encourage physical investment or a rise in the current account surplus, or both.

In addition to well-known transition problems (such as some generations having to finance two parallel systems), a government-implemented funded system also raises the difficult issue of who should administrate and control the funds. It is *theoretically* possible for the funds to be managed in such a way that their managers, and hence also politicians and public-sector bureaucrats, do not interfere in either the allocation of the assets or the control of the firms in which the funds are invested. Theoretically, for instance, it may be possible to legislate that the funds should hold "market portfolios", or invest only in mutual funds.

But it is naïve to believe that future politicians will necessarily adhere to such rules. They can simply amend legislation in the future so as to control the funds and/or exert power over firms in which the funds have shares. In other words, there is a great risk that a funded, government-operated social security system will, *in reality*, sooner or later develop into a system with strong government control of both capital markets and individual firms. It is much easier for politicians to use an *instrument* that already exists, i.e. government-created funds, to exercise power over the capital market and firms, than to engage in "open" socialization with the *explicit* purpose of taking control of the private sector.

The Swedish experience is instructive from this point of view. When the supplementary pension system was introduced in Sweden in 1959, it was explicitly stated that the buffer funds created by the new system should *not* be used to buy shares in private firms. Nevertheless, new decisions have been taken over the years to do just that. Moreover, Swedish politicians have not chosen index funds or mutual funds, and the government-appointed boards of the funds have, in fact, used the voting rights of the shares held by the buffer funds to intervene in firms. From time to time, politicians and labor union leaders have also suggested that the pension funds should buy more shares and be used more systematically as instruments for centralized “industrial policies”. Those who want to limit the risk of future

socialization of firms, therefore, have good reason to object to a shift to a government-operated *funded* social-security system.

What about a shift to a *negative income tax*, which is a popular idea among some economists? One main advantage would be that extremely high implicit marginal tax rates, i.e. poverty traps, may be avoided for low-income earners. But such a system is very expensive because of the thickness of the left tail in the factor-income distribution in most countries, which requires the imposition of quite high tax rates on the rest of the population. As a result, the marginal tax distortions would simply move up along the income distribution, which may create more incentive problems than it solves.

There is, however, an even more serious problem associated with a negative income tax. It may create new generations of "drifters", living on government handouts. Thus, a negative income tax may, over time, result in a demise of habits and social norms in favor of work and saving (for instance, among the young generation). Such risks are probably smaller in the case of social security systems in which the benefits are tied to well-defined contingencies. (Lindbeck, 1994). A negative income tax may, therefore, also be a "hippi subsidy".

A system of *drawing rights*, finally, would allow the individual to draw on an account in the public sector for well-defined contingencies, for instance, in connection with education, training, sickness or unemployment, though less would then be available later on, ultimately for pensions (Fölster, 1995). However, such a system requires complementary risk insurance, as different individuals are exposed to quite different risks -- sickness, permanent invalidism, unemployment, etc. It would also be necessary to put a strict ceiling on how much the individual is allowed to draw before retirement age -- to avoid myopic behavior and free-riding. Experiences in Singapore and Chile suggest that a system of this type is at least administratively feasible.

Some of these radical reforms may also have distributional consequences that are not regarded as acceptable. Complementary redistributional reforms will then be necessary, such as those discussed at the end of the previous section.

VI. *Consequences of EU and EMU*

So far, I have discussed the welfare state in a *national* perspective only. How, then, does increased international economic integration influence the functioning of

the welfare-state? More specifically, what are the consequences of the European Union (EU) and a future Monetary Union (EMU) for the West European welfare states?

One important implication for national welfare-states of free mobility of financial capital between member states is that an individual country cannot finance its own welfare-state spending by considerably higher taxes on capital than those existing in other countries. As labor is much less mobile than capital, it is possible to let taxes on labor income deviate more. However, it is likely that labor mobility will increase in the future, which will make it more difficult for a national government to press down after-tax wages much below what corresponding workers receive in other countries, in particular for well-trained labor with an international labor market and good knowledge of foreign languages.

The establishment of a *monetary union* will have additional consequences. Such a union cannot function well without increased mobility of labor over the national borders and more flexible real and relative wages. Otherwise economic shocks will result in even more serious unemployment problems than those already existing in Western Europe today. Thus, individual countries within a monetary union have to take strong measures that facilitate both international labor mobility and flexible real and relative wages. But if countries succeed in raising labor mobility, this will further constrain the national autonomy in distributional policies. In this sense, a monetary union will indirectly further constrain the redistributional ambitions of national welfare-state arrangements. If countries instead fail to raise international labor mobility and flexibility of real and relative wages, the shift to a monetary union is more likely to accentuate the serious unemployment problem of Western Europe.

Increased international mobility of labor also necessitates some coordination of the national *benefit systems*. For instance, it will be necessary to prevent individuals from adjusting their geographical location over their life cycle on the basis of differences in the national benefit systems by choosing to live in low-tax nations when young and healthy, and in countries with high benefits and highly subsidized old-age care and health care after retirement. A basic policy issue, therefore, is whether individuals should be allowed to carry their "earned" benefits with them wherever they move within Europe, or if they should receive the same benefits as other individuals in the country in which they are living at that time. The first alternative is

obviously more compatible with the idea of actuarially fair systems than the second alternative. It is easier to implement the first alternative for social insurance benefits than for public services, such as health care and old-age care. Another example of a necessary coordination of national rules concerns measures to ensure the protection of workers' pension rights in relation to supplementary and occupational schemes when they move to another member state.

It is likely, however, that the European Union will, in fact, try to harmonize national welfare-state rules much more than is really necessary for these various reasons. The official argument for such harmonization is that this is necessary to prevent "social dumping". The idea seems to be that international competition is distorted if working conditions differ among countries. This is, however, a rather dubious proposition since the *total* production costs is what is important. How these are *distributed* on wage and non-wage costs is actually immaterial from the point of view of international competitiveness. If the determination of wages can be left to national agents and institutions, so can non-wage costs.

Nevertheless, a process of harmonization of welfare-state arrangements has already started within the European Union -- as an element of the "social dimension". Examples are contemplated restrictions on temporary and part-time work; more generous rules for parental leave; regulations that limit the rights of firms to "contract-out" work; rules for the placing of a worker with another company or in another plant in another member country, etc. Whatever arguments there may be for each of these interventions, the overall effect will be further to reduce flexibility in the European labor markets, making it even more difficult to reduce mass unemployment.

VII. *In conclusion*

Reforms of the welfare state have to be designed *both* to make it more robust to exogenous shocks, *and* to reduce problems of disincentives, moral hazard and cheating. The difficult problem is how this can be done without seriously damaging the achievements of the welfare state. Thus, it is important to find a proper combination of redistribution, insurance and incentives.

In view of these complex considerations, it is natural that welfare-state reform proposals include *combinations* of different elements. The most celebrated

combination in contemporary reform proposals is perhaps a "three-pillared system" consisting of:

(i) Tax-financed flat-rate benefits, i.e. a safety net, at the "bottom" for well-defined contingencies such as sickness, unemployment and old age. Such a system, of course, has then to be combined with discretionary social assistance for people, who, for various reasons, cannot support themselves;

(ii) A supplementary system of mandatory social insurance designed for income-protection, with strong actuarial elements in order to minimize tax wedges. This system may include some funding, provided it is possible to guarantee *both* individual ownership of the assets *and* private management of the funds, outside the reach of politicians.

(iii) Voluntary saving and insurance policies "at the top", which may include both collective and individual insurance.

The first pillar, which may be strongly redistributive, need not be *institutionally* separate from the second, more actuarial, pillar; the two may be administratively combined. However, it is important that the two first pillars are constructed in ways that make them robust to shocks of economic growth, changes in demography and political interventions. Methods to achieve this have been discussed in the paper.

A three-pillared system of this type would also pool political risks and market risks. This is perhaps as much economic security as can be achieved in an uncertain world. When such reforms are designed, it is also important to design the system in such a way that the serious unemployment problem in Western Europe is mitigated, rather than accentuated. I have indicated how this may be brought about.

The increased heterogeneity of the population in many countries also requires that *social services* in the future become better adjusted to the needs of the individual. This can only be achieved if the "consumers" of such services are given a greater say, i.e. if they can exert influence both by voice and exit. The latter, of course, requires alternatives, i.e. competition. Moreover, in the future the elderly will be much more choosy than former generations of elderly people -- partly because they are better educated and healthier. They will also have considerable financial resources at their disposal, which will enable them to pay for services and accentuate their insistence on choosing themselves.

To summarize: the European welfare states are confronted with serious problems. Reform proposals are likely to abound. There is, however, a tendency among some adherents of generous welfare-state arrangements to shut their eyes to the serious problems that the welfare state is likely to be confronted with in the future. It must, however, be wiser to reform the welfare state now, than to wait until the problems have become more serious. Indeed, if current and expected future problems regarding the welfare state are not mitigated soon, its economic foundations may crumble. Even more drastic reforms and retreats of various welfare-state arrangements would then be necessary.

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