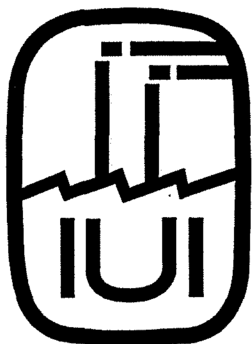

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INCENTIVES IN THE WELFARE STATE: Lessons for would-be welfare states

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This paper deals with economic incentives and welfare-state arrangements in OECD countries. It also offers some lessons for would-be welfare states. The welfare-state arrangements differ, of course, among OECD countries. In particular, there is wide variation in the extent to which countries rely on four basic institutions - the state, the firm, the family and the market. Countries also differ in their reliance on (i) a common *safety net* in the form of flat-rate benefits tied to specific contingencies; (ii) *means-tested benefits* for low-income groups; and (iii) *income protection*, i.e., benefits that are positively linked to previous income. Another distinction is between *corporatist* welfare states, where benefits are tied to labor contracts, and *universal* welfare states in which benefits are conditioned on residence or citizenship. This distinction is in reality blurred, however, by recent tendencies in corporatist welfare states to extend coverage to individuals who have very 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. Of course, the lower the benefit levels in the compulsory systems, the stronger the incentives for citizens to add voluntary (market) solutions, in the form of private saving and private (individual or collective) insurance arrangements.

This paper emphasises what may be called "dynamic" incentive issues, i.e., incentive effects that evolve over time. The discussion also covers the interplay between incentives and social norms among individuals, including endogenous changes in these norms. I will also consider endogenous adjustments in political behavior. This approach makes it necessary to move outside conventionally defined "economic analysis". Let me begin, however, with some more familiar "static" aspects of welfare-state incentives.

1. 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 equalise 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 may also (v) equalise the overall distribution of disposable lifetime income, i.e., wealth, among individuals, as well as the distribution of specific social services. This enumeration 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 more or less the same efficiency gains would not have taken place *without* welfare-state arrangements, i.e., on a voluntary basis? The "paternalistic" answer, of course, is that many individuals are myopic, and that they would therefore not have chosen equally elaborate economic security on their own. Economists, however, usually emphasize various deficiencies of voluntary market solutions to problems of economic security. The most obvious ones are perhaps difficulties in borrowing with human capital as collateral and the high administrative costs of voluntary insurance policies. Compulsory social security is, as we know, also rationalised as (i) a way to overcome tendencies towards free-riding by individuals who expect the government to help them if they encounter difficulties; (ii) a method to prevent "cream-skimming" by insurance companies if they are able to identify high-risk individuals; and (iii) a technique to avoid adverse selection when insurance companies are not able to make such identification, or when some individuals find out that they, or their children, are low-risk cases (and therefore withdraw from voluntary insurance schemes that cover also high-risk individuals). There is also general agreement among economists that various positive externalities of investment in human capital tend to make such investment suboptimal, and that these problems may be mitigated by government loan guarantees and subsidies to education.

But how do we know that welfare-state arrangements, in fact, also equalise 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 that this holds for the overall distribution as well as for its lower tail.[2] The weak point of this evidence is, of course, that it neglects the general equilibrium effects

of taxes and benefits on factor income, via various behavioural adjustments - and that these effects have turned out to be difficult to calculate empirically. There is, however, some supporting evidence. For example, in most countries, the factor-income distribution among citizens in active working age did not become more uneven when today's welfare-state arrangements were being built up during the first decades after World War II. (Factor incomes for pensioners have, of course, fallen after the introduction of compulsory pension systems.)

It is, however, important to emphasize that these various *rationales* for building up welfare-state arrangements do not, by themselves, *explain* why these arrangements have actually been made. Such explanations would require an analysis of the political processes that have generated these outcomes. Moreover, the achievements referred to above do not mean that the specific forms of the welfare-state arrangements in various OECD countries have been particularly efficient; in fact, the opposite is often the case, as will be discussed below.

The most widely discussed *problem* with welfare-state arrangements probably concerns the "static" efficiency costs associated with the *financing* of the welfare-state, and hence with various tax wedges - often measured by the "marginal costs of public funds".[3] My only point on this well-known issue is 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 on 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 and tax evasion. Unfortunately, our knowledge of these matters is fragmented, sometimes even anecdotal; this does not, however, mean that it is without value.

Distortions that are directly connected with welfare-state *benefits* are probably no less pervasive. Not only are means-tested benefits bound to create "benefit wedges", i.e., *implicit* tax wedges, including poverty traps. The most severe problem inherent in various benefit systems is probably that, like private insurance, they are plagued with moral hazard because the individual is able to adjust his 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, housing subsidies, economic support to single parents (read: mothers), subsidized

early retirement (disability pensions), and unemployment benefits. In particular, the number of beneficiaries tend to rise by with the generosity of the benefits due to moral hazard and cheating. On these matters, we have plenty of fragmented empirical indications that substantial problems have emerged. [4]

2. DYNAMIC ACHIEVEMENTS

Rather than dwelling on "static" aspects like these, I would like to concentrate on incentive effects of a more *dynamic* nature, in the sense that the effects accumulate only gradually, and that they interact strongly with other factors over time, possibly in the form of virtuous or vicious circles.

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

Another potentially important dynamic contribution of welfare-state arrangements is to bring various minority groups into ordinary labor-market activities, 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 that long-term benefit dependency can be avoided, which is more likely to succeed if the policy relies on work-oriented welfare-state arrangements, so-called "workfare", than on pure transfer payments. As an illustration, the main reason for the high and long-term dependency on income transfers among single mothers in the United States is probably not that these benefits are particularly generous, but rather that they are not consistently and effectively combined with requirements for work or education - and organized child care.

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 neighbourhoods, cf. Wilson

(1987). Indeed, it is often argued that the more ambitious welfare-state arrangements in Western Europe than in the United States help explain the smaller incidence of such phenomena in the former part of the world; 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 positive (or negative) 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".

Both long-term productivity-enhancing welfare-state policies and policy actions that stimulate labor-force participation in the private sector, for instance among married women and various minority groups, also tend to expand the tax base in the long run, which helps finance the welfare state in the first place - an obvious example of a virtuous circle.[5]

It has also been argued that an even distribution of income mitigates social conflicts (Alesina and Rodrik, 1994), and that it tends to reduce the political pressure to redistribute disposable income further by way of distortionary political interventions (Meltzer and Richard, 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 contribute to making citizens more sympathetic to the market system.

Several of these asserted dynamic consequences of welfare-state arrangements may be regarded as improvements in the system of *property rights*, in the sense of assuring private agents that they can retain a large and stable fraction of the return to their own effort (Rebelo, 1991; Cashin, 1995). Of course, the taxes that finance the welfare-state, in particular unpredicted changes in the tax rules, have effects on property rights in the opposite direction.

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 Germany.

The consequences for the labor-force participation of married women are more complex in "individual-centred" welfare states, e.g., in the Nordic countries.[6] It is unavoidable that

high marginal tax rates create substitution effects in favor of household work, i.e., against work in the open market. But incentives in the opposite direction are created by subsidies to care of children, the sick and the elderly outside the household, i.e., positive cross-substitution effects on labor supply. In some countries, labor-force participation of married women is also stimulated by separate assessment of income taxes on husband and wife, which lowers the marginal income tax rate for the "second" income earner in the household. Another example is positive "liquidity effects" on labor supply due to 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. 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, to *current* work in the case of subsidized child care, and to the willingness of the individual to be available for *future* job offers in the case of unemployment benefits and social assistance.

All this means that the welfare-state has quite ambiguous consequences for the labor market. In countries with a *combination* of high marginal tax and benefit wedges *and* strict work requirements, labor-force participation may very well be high, in particular for married women, but the average number of working hours per year of individuals may be rather low, in particular if the benefit systems are far from actuarially fair.[7] Strongly subsidized child care and old-age care may also result in a high birth rate in such societies - even for highly educated females.

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, and to the division of work between family members.

3. DYNAMIC PROBLEMS

The dynamic achievement of the modern welfare state discussed above should, of course, be compared with various dynamic problems. An obvious example is that the positive effects of subsidies on investment in human capital are counteracted by the reduced return on such investment because of the marginal tax and benefit wedges on labor income. The more

progressive the tax system, the greater the probability that the *net* effect of these conflicting forces will be negative.

There appears to be broad agreement that high marginal tax wedges on the return on *physical assets* - in the absence of full loss-offset - will reduce the accumulation of such assets. A more important point is perhaps that high marginal tax rates on capital tend to distort the *allocation* of capital on different uses. The reason is various asymmetries of the taxation of different types of assets and asset holders that characterise the tax system in all countries. High tax rates create a strong leverage in these asymmetries. 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 with free international capital mobility. This is, I believe, 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 favoured 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". Moreover, private entrepreneurs, probably 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 deter private incentives to save, and welfare-state arrangements that reduce the need for household saving, would be expected to thwart the entry and growth of small private firms - also in countries with free international capital mobility. As a result, the level of GNP can be expected to fall, as will its rate of growth at least during a period of transition to a new steady-state growth path. Capitalism cannot exist without capitalists, and these will emerge only if there is domestic private saving.

More wide-ranging dynamic problems may also arise in connection with welfare-state policies. I have hypothesized elsewhere (Lindbeck, 1995; and Lindbeck, Nyberg and Weibull, 1995) that full realization of various disincentive effects of taxes and benefits is likely to be delayed because habits and social norms, at least for a while, constrain individual behavior. In this sense, social norms function as a form of "social capital". 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. But as increased marginal tax and benefit wedges have recently reduced the return on work, and made individual saving less imperative, it is likely that habits and social norms have gradually adjusted to the new incentive system. To begin with a few ("entrepreneurial") individuals may start breaking previous norms. As more and more individuals abandon previously obeyed social norms, the easier it will be for others to follow suit. In other words, it may be hypothesized that the social nature of norms can contribute to a dynamic process by which different individuals *gradually* adjust their behavior to a new incentive structure, as earlier obeyed norms are abandoned. If these delayed effects are not anticipated by politicians when welfare-state arrangements are established, the welfare state will easily "overshoot", in the sense that the disincentive effects will become greater than politicians would have tolerated initially (Lindbeck, 1994a).

It is also important to avoid the naïve belief that all types of social problems and conflicts can be effectively mitigated by welfare-state arrangements. Today, even the most advanced welfare states experience - indeed often *increasingly* so - pockets of poverty, social problems in connection with unemployment, unstable family relations, brutal urban environments, drug abuse, crime, etc.

Certain kinds of economic crimes are even *enhanced* by high marginal tax rates. The reason is, of course, that the return to economic crimes is usually tax exempt, which means that honesty becomes "expensive" in high-tax societies. This is bound to have negative effects in a long-term perspective on the supply of honesty. This is serious not only from an ethical point of view. Honesty may also be regarded as an important collective capital good in society - another example of how "social capital" may depreciate if the incentive to keep it up deteriorates. As a result, some citizens (with weaker social norms than others) will certainly be tempted to cheat on taxes or benefits, work in the underground economy or even commit outright economic crimes. This is another example of how induced changes in social norms may, over time, create serious problems for the welfare state: an initially rather honest civilisation may become increasingly dishonest because of the increased costs of honesty. I am afraid that this has already begun to happen in the high-tax Nordic countries in recent decades.

I hypothesized above that some welfare-state arrangements may raise the acceptance among citizens of continuing reallocation of labor. Nevertheless, we may note that resistance to such reallocations often emerges also in advanced welfare states. For instance, generous

benefits mean that people may choose to stay were they are rather than shift to other jobs and geographical locations. We cannot even be sure that reductions in income inequality, when brought about by policy actions, will always mitigate political pressure for further redistributions through taxes, transfers and regulations. The "appetite" for redistributions may even *increase* by the amount of redistributions implemented earlier. A reason may be that such policy actions tend to politicise distributional issues, and make people believe that income differences are "arbitrarily" determined in the political process, rather than constituting an indispensable element of a well-functioning market system. This is, in fact, my own interpretation of the Swedish experience of redistribution policy after World War II. It would seem 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. Thus, the often asserted negative relation between income inequality and distributional conflicts may not be monotone. However, this observation may not be a *general* pattern in the political process; the US experience may be a counterexample.

The possibilities of the emergence of such hazardous dynamics mean that viscous circles, and not just virtuous ones, may be generated by welfare-state arrangements. If the viscous ones, at some point in time, start to dominate, the welfare state may be undermined in the long run due to a combination of exploding welfare-state spending and an erosion of the tax base. A basic dilemma of the welfare state is exactly this: the more "humane" it tries to be, the greater is the risk that it undermines its own economic foundations in the long-run, and that it will not be able to live up to its promises.

The economic problems of the welfare state have, of course, been accentuated by the slowdown of long-term GDP growth during the last two decades, as well as by higher life expectancy. Both these developments may, in fact, have been boosted by the welfare state itself. We also know that the welfare- state crisis became *acute* in some countries in the 1980s and early 1990s in connection with strongly negative, short-term macroeconomic shocks, which threw large groups of citizens onto various safety nets, and induced others to withdraw from the labor force. These developments may also have speeded up the long-term weakening of social norms against living on various types of benefits (Lindbeck, 1995).

If this is correct, it is important to take the warnings about the risk of delayed disincentive effects seriously. The problem is rather similar to environmental disturbances, which often also build up gradually with delayed effects. In both cases - the welfare state as

well as the environment - the conclusion must be that the risks of serious, delayed and partly irreversible damage should make us cautious.

4. LESSONS FOR WOULD-BE WELFARE STATES

What, then, are the most important lessons for would-be welfare states - including both former socialist states, the so-called FSS countries, and middle-income countries outside Europe? These lessons have to be formulated, of course, against the background of both the previous welfare-state arrangements in these countries and the social problems that exist today.

Prior to their collapse, *the socialist countries* provided often quite elaborate "cradle-to-grave" welfare states. Administration of these benefits, however, was often closely tied to the employment contract - partly by job guarantees, partly by employment-related benefits, including generous family benefits of various types (Krumm, Milanovic and Walton, 1994; Atkinson and Micklewright, 1992; Barr, 1994). Subsidies and direct provision of goods and services were frequently also tied to firms. Such arrangements are obviously not conducive to an emerging market system, as firms are then unable to give employment guarantees; nor can they easily finance social spending. It is also difficult to create a flexible labor market when benefits are tied to specific firms.

For these reasons, it is hardly surprising that the governments in these countries have gradually taken over more of both the financing and the administration of welfare-arrangements. Indeed, as unemployment benefits and social assistance hardly existed during the socialist period, such systems had to be constructed largely from scratch.

Several countries in *Latin America* also build up rather generous welfare states during the first decade after World War II (or even earlier). Often, however, the systems turned out to be unsustainable; cf. Mesa-Lago (1994). This has shown up in huge imbalances between revenues and spending in the social security systems in various years, and in expected aggregate actuarial imbalances of the systems over an extended future time span. This may be regarded as a result of the tensions between the generosity of the benefit systems and the limited economic resources of the countries concerned.

The "dependency rate" of the benefit systems - i.e., the ratio of individuals living on transfers to those living on factor income - is often about the same in the FSS countries and in several middle-income countries outside Europe. The proportion of citizens above the age of 60 or 65, however, is usually much higher in the FSS countries. Indeed, this proportion today

is about as high as in most OECD countries, where the ratio between the number of individuals of working age and pensioners is often as low as about two, and is likely to fall even further in coming decades. A low retirement age in the FSS countries during the socialist period - often 60 years for men and 55 for women - has accentuated the problem. This means that welfare-state spending in these countries is to a large extent directed towards consumption for the elderly rather than towards investment in human capital among the young. The situation is quite different in several middle-income countries outside Europe, in particular in Pacific Asia, where the elderly, so far, comprise a much smaller fraction of the entire population.

When drawing on the OECD experience, it is important to recall that the generous welfare-state arrangements in these countries emerged only after about a century of successful economic growth. It is not self-evident that these countries would have been equally rich today if they had tried to set up comprehensive and generous welfare-state arrangements during the first decades of this century. These arrangements were also, to begin with, quite selective, i.e., strongly targeted, before comprehensive and "universal" welfare states were established after World War II. Therefore, it is probably prudent for builders of future welfare states to limit their ambitions during the coming decades - not only so as to finance the systems, but also to avoid serious disincentive effects during the early phases of their economic development.

It is also interesting to note that the recently successful economies in Pacific Asia, in terms of economic growth, have waited quite a long time before even contemplating the construction of elaborate welfare-state arrangements. One important reason why this has been feasible is, of course, that extended families are still an important source of income security in these countries.

There are, of course, a strong social case for building up, or improving, welfare-state arrangements today also in middle-income countries, including the FSS-countries. The political forces that work in that direction are also strong. The most important *positive* lesson from the welfare-state experience in the OECD countries may be drawn from the above-mentioned achievements in terms of economic security and the mitigation of poverty. When trying to transmit this experience to would-be welfare states, it is important, however, to get the priorities "right" from the beginning. A trade-off certainly exists between increasing economic security for the majority, on the one hand, and mitigating poverty for a minority, on the other hand. Income security for the majority may be important for political stability, as

well as for a wide acceptance of continuing adjustments of relative wages to efficiency criteria. Ethical considerations instead motivate a concentration of resources on relieving the poverty of those who are worst off in society. Moreover, many observers of conditions in middle-income countries today probably agree that *both* these ambitions are more important than equalising the overall distribution of income, as measured, for instance, by the Gini coefficient. Both ethical considerations and concern for social and political stability provide, however, arguments for avoiding small groups of citizens becoming rich *on the basis of socially dubious activities*. To mitigate this problem requires, however, actions outside the area of welfare-state arrangements.

A special problem when trying to safeguard the incomes of the poorest segments of the population in the FSS countries is that the difference between the minimum benefits required to avoid severe poverty and the lowest wages in society tends to be very small in such countries. For instance, while the ratio of minimum wages to the social- assistance income level is often two, three or even four in the OECD countries, it is not much higher than unity in some FSS countries (Krumm *et al.* 1994, Table 2).

It is hazardous to suggest designs for the build-up of welfare-state arrangements in the middle-income countries. On the basis of experience in various OECD-countries, and the situation that exists today in various middle-income countries, it may, however, be a good idea for these countries to concentrate, at least to begin with, on *four types of welfare-state arrangements*:

(i) Strictly targeted support for the poor, in the form of means-tested social assistance, partly perhaps "in kind" to limit the negative effects on work. A basic reason for this proposal is, of course, that such support is rather inexpensive.

(ii) A rather low safety net in the form of flat-rate benefits tied to specific contingencies such as sickness, work injury, unemployment and old age. Again, a reason for the proposal is that it is important to limit the financial costs for the government. Another reason is to limit the risks of serious disincentive problems, in particular in a long-run perspective.

(iii) Subsidies of services with strong elements of investment in human capital, such as prenatal care, maternity care and education - in particular for low-income groups. A main reason is, of course, to stimulate economic growth, but also to improve the position of low-productivity groups in the long run.

(iv) *Temporary*, rather than permanent, support for the unemployed, in the form of once-and-for-all severance pay when employees are laid off, assistance for individuals to

become self employed or start small firms, temporary public works programs, and temporary training programs tied to firms, instead of relying on permanent measures such as regular public-sector employment, public- works programs of long duration, or early retirement. A rationale for this proposal is, of course, to avoid permanent expansion of public-sector employment and to mitigate tendencies to unemployment persistence.

As total government spending already hovers around 50 percent of GNP both in several FSS countries and in some Latin American countries, i.e., somewhat above the OECD average, it may even be advisable to *wind down* some benefit programs. The reason is not only to avoid financial difficulties for the public sector. Another reason is that quite strong incentives to work, save and invest may be necessary now in order to *restore* economically and socially efficiently behavior of individuals in some of these countries. In particular, as it is likely that such habits and norms have already been seriously damaged due to the poor incentive system in these countries during recent decades. It may also be particularly important in these countries to keep marginal tax rates rather low so as to combat the severe problems of economic crime.

Moreover, the truism that capitalism requires capitalists, and hence also private saving, is particularly important in the FSS countries, as there is very little accumulated private saving. It is, therefore, important that the new welfare-state arrangements in these countries are constructed in ways that do not harm private saving more than "necessary".

5. MARGINAL REFORMS

Reforms and retreats of various welfare-state arrangements are under way in several OECD countries. The reform debate in these countries is also of interest for would-be welfare states. Let me start with what may be called "marginal" reforms, subsequently shifting the focus to more "radical" reforms. The former often aim at making the systems less generous, largely to avoid moral hazard and cheating, as well as to make the arrangements financially sustainable in a long-term perspective, while radical reforms aim at overhauling the basic structure of the welfare-state arrangements.

The most obvious marginal reform is perhaps to reduce benefit levels - not only in order to improve the financial position of the government, but also to provide coinsurance, and hence to mitigate moral hazard and to restore economic incentives. Stronger actuarial elements in social security systems would also improve economic incentives, as (implicit) marginal tax wedge would then be reduced. It is important to note that strong actuarial

elements are feasible also in the context of pay-as-you-go systems, by tying future benefits 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.[8] In some countries, such as Germany, strong links already exist between contributions and benefits.

Another problem in several countries is that individuals tend to shift between different benefit systems depending on which is the most favorable one. It is, therefore, useful to have the same replacement level in all benefit systems between which the individual can move at his own discretion - such as the sick-leave, work-injury, early retirement or unemployment benefit systems. Strict eligibility requirements for receiving benefits, and stiff controls that these requirements are satisfied, are also important, though the need for controls is smaller, the lower the benefit levels. There are, of course, practical limits to controls, which are probably more effective against cheating than against moral hazard.

To avoid over-insurance, it is also useful to put caps on total insurance benefits, i.e., on the total level of compulsory *plus* private insurance benefits. Otherwise, the compulsory system will be exposed to negative external effects by 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.

Another important problem is how to construct welfare-state arrangements that are reasonably robust to shocks due to demographic factors or productivity growth. A basic problem in this connection is the extent to which such adjustments should be automatic or discretionary.[9] In a pension system, for instance, an obvious method to achieve *automatic* adjustments to demographic changes is to tie the normal pension age to the life expectancy of the population. In order to provide a pension system with automatic protection against a slowdown in productivity growth, the pension benefits can 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 contributions or the benefits of an unemployment insurance system may be automatically tied to the unemployment rate. In a sick-pay system, the contributions and benefits may be formally tied to the number of sick days in the population as a whole, etc. There are, of course, limits to such automatic adjustments of benefit levels if we are anxious to avoid creating severe hardship for some individuals.

Automatic adjustments have the advantage of being more predictable, and perhaps also politically easier to implement, than discretionary adjustments. In other words, automatic adjustment mechanisms may reduce the risk for discretionary political interventions in the rules of benefit systems, i.e., "political risks" may be mitigated. It also becomes easier to keep the systems outside the yearly budget process, which is also likely to reduce the frequency of political intervention in the rules. A weakness of automatic adjustment mechanisms of this aggregate type is, of course, 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 (consumption) of the contemporary working population.

Incentive problems also extend to the case of the provision of *social services*, in the sense that it has turned out to be difficult to achieve efficiency while simultaneously guaranteeing freedom of choice when the government provides such services. The obvious way of dealing with this problem is either administrative reforms of public-sector agencies or the opening up of competition with private and cooperative institutions. The first option includes methods such as administrative decentralisation, cash limits, better measurement of performance, 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 to public-sector agencies. To avoid distributional problems in connection with freer competition, a voucher system is perhaps the most obvious device.

Would-be welfare states should consider options like these at an early stage. It has turned out to be politically difficult to achieve the twofold objective of reforming the operation of government agencies and letting in competition, after the production of such services has already been monopolised by public-sector agencies. Serious protests from public-sector employees are more likely as a response to *cuts* in existing services and employment than to restrains in the build-up of such services in the first place.

6. 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 *radical reforms*, i.e., changes in the basic structure of the welfare state. That

discussion may also be of interest for would-be welfare states. Indeed, it should be easier to choose between alternative structures when a system is being built up, than to reform an old system to which people have already adjusted their lives. After all, social security systems are implicit long-term contracts between the government and the citizens and the political and social costs of breaking these contracts may be very high.

Examples of recently proposed radical alternatives are (i) to replace a system of income protection with a safety net that is common to all (flat-rate benefits), or vice versa; (ii) to shift from a pay-as-you-go to a funded social insurance system, possibly combined with partial or total privatisation, 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 the individual himself to take considerable responsibility in the form of voluntary saving and insurance policies, which is often believed to reduce the risk that individuals will become pacified. The types of welfare-state benefits for which this type of arrangement would be feasible are transfer programs rather than services such as health-care. A disadvantage of this strategy is, of course, that the administrative costs will often be higher than in existing social security systems.

An advantage of *funded systems*, as compared to pay-as you-go systems is that the return to the individual's contribution is likely to be higher. (This assumes that the real return on a portfolio of assets is higher than the growth in the tax base of the pay-as-you-go system.) Aggregate national saving would also be expected to be higher, in particular during a transition period. It is also reasonable to assume that property rights are stronger in funded systems than in a pay-as-you-go system, in the sense that the political risks would be expected to be smaller, even though individuals would, of course, instead be exposed to more capital-market risks. In terms of an important concept in social psychology, the hypothesis is here that the political risks are smaller if the benefits are "framed" in terms of the right to one's own saving rather than having vague "rights" to transfers financed by others.

In addition to well-known transition problems, 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 it may, for instance, be possible to legislate that the funds should hold "market portfolios", or invest only in mutual funds.[10]

But it is extremely naïve to believe that future politicians will necessarily stick to such rules. They can simply amend legislation in the future so as to control the composition of the funds and/or to exert power over firms. There are, in other words, severe risks 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 firms, than to engage in "open" socialisation 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 be used as instruments for centralized "industrial policies".

Those who want to limit the risk of future socialisation of firms, therefore, have good reason to object to a shift to a government-operated *funded* social-security system. This warning should be of particular interest for the FSS countries, as the citizens in these countries may be particularly anxious not to wind up in a socialist system again, after recently having escaped such a society.

What about a shift to a *negative income tax*, which is a popular idea among many economists? A main advantage would be that extremely high implicit marginal tax rates, i.e., poverty traps, may then 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 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 with a negative income tax. It may create new generations of "drifters", living on government handouts, as the benefits in such systems in fact constitute "individual rights", rather than serving as income support based on specific contingencies. A negative income tax may, over time, result in a demise of habits and social norms that enhance work and saving, for instance among the young generation - even more so than social security systems in which the benefits are tied to well-defined contingencies. (Lindbeck, 1995) Considering that the FSS countries have been plagued with serious incentive problems for decades, it would seem that a shift to a negative income tax would be even more hazardous in these countries that in the rich OECD countries.

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). An advantage of such a system, if it is made strongly actuarial, is that it helps keep down marginal tax wedges. 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. From the point of view of economic incentives, the main advantage of a system with drawing rights, as compared to an actuarially fair pay-as-you-go system, seems to be that the less an individual has used other social systems earlier in his life, the higher his pension. In this way, a system of drawing rights pools accumulated saving for different types of contingencies, and hence also increases the freedom of choice for the individual. Experiences in Singapore and Malaysia suggest that a system of this type is at least administratively feasible.

7. IN CONCLUSION

When welfare-state arrangements are constructed or reformed, it is important to find a proper combination of redistribution, insurance and incentives. It is also important to choose a system that is reasonably robust to economic, demographic and political risks. In view of these complex considerations, it is natural that recent radical welfare-state proposals have

included *combinations* of different elements. The most celebrated combination 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 - 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 minimise tax wedges - possibly also some funding, provided it is possible to guarantee *both* individual ownership of the assets *and* privately operated funds; and, finally, (iii) voluntary saving and voluntary 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.

A three-pillared system of this type would pool political risks and market risks. This is perhaps as much economic security as can be achieved in an uncertain world. To bring this about, however, requires not only profound economic analysis, proper insurance techniques and competent administration. It also, and perhaps above all, requires a good understanding *of political behavior*. This is the case both when we try to understand how the present welfare-state problems have arisen, and when we consider reforms to mitigate these problems.

For instance, while the huge expansion of welfare-state spending after World War II certainly reflects high and rising demand among citizens for economic security and redistributions, the process cannot be fully understood without insights into the process of competition for votes among political parties. A traditional view of this issue is, of course, that government spending is stimulated by the fact that benefits are usually *specific*, while the financing of them is usually *general*. This view of the political process also helps explain why it is difficult to rewind government spending later on, in particular if individuals have already adjusted their behavior, indeed their lives, to the benefit systems. An extreme example is a country where the majority of the electorate, as in Belgium, Norway and Sweden today, is tax financed - either by living on transfers or by being employed in government-service production. Is this a point of no return?

For these various reasons, reforms and retreats of the welfare state may be politically very difficult - that is, if the country is not blessed with politicians with "suicidal instincts", or if a serious financial crisis in the government does not "force" politicians to reform and reduce welfare-state spending. A large "package" of several simultaneous spending and tax cuts may also be easier to implement than a series of specific reforms. In the former case

everybody would be a winner on some accounts and a loser on others. Indeed, if the package is large, it may even be impossible to identify winners and losers. This probably makes it easier politically to cut government spending, and hence to prevent an even more serious crisis for the welfare state in the future. The idea is, then, not to abolish the welfare state, but rather to make it sustainable in a long-term perspective.

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Notes

[1] I am grateful for comments on an earlier draft by Anders Björklund, Michael Bruno, Peter Diamond, Ulf Jakobsson, Hans-Werner Sinn and K.G. Scherman. Julie Sundquist has improved the language.

[2] While the Gini coefficient for the overall distribution of yearly factor income of households is typically about 0.40-0.45 in the rich OECD countries, it is usually in the interval of 0.20-0.30 in the case of yearly disposable (i.e., post-tax post-transfer) income (Mitchell, 1991, p.127). Suppose that the "poverty line" is drawn at 40 percent of median income, and that the "poverty gap" is defined as the aggregate amount of income that would have to be given to households below the poverty line in order to bring their income up to this line. The relevant amount is typically 3.0-5.0 percent of GNP in most OECD countries in the case of factor income. In the case of disposable income, the corresponding amount is as low as 0.1-1.2 percent of GNP (Mitchell, 1991, pp. 57 and 75).

The figures refer to yearly income. We know less about the difference between the distribution of factor income and disposable income *on a lifetime income basis.*

[3] In the US, the "marginal costs of public funds" are often estimated at about 1.2-1.3 dollars per dollar of additional spending, which 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. By contrast, in Sweden during the 1980s, the marginal costs of public funds have been estimated at two or three dollars. Because of the limited domain of such analyses, in terms of the number of decisions studied, and also because of the methodological difficulties involved, we should probably regard calculations like these as experiments in quantification rather than as reliable estimates.

[4] For illustrations in the case of Sweden, see Lindbeck (1996).

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

[6] For an analysis of issues like these in Sweden, see Freeman, Swedenborg and Topel (1995).

[7] Sweden is a pronounced example. Labor-force participation is 70-80 percent for both men and women between 24 and 65 years of age, but the average number of hours *per year* for those who work was during the 1980s only about 1,400 while typical figures for most other developed countries are between 1,600 and 2,000. (The *statutory* number of working hours per week, however, were not particularly low in Sweden.)

[8] In a system of work-injury benefits, actuarial elements may be introduced by varying the contributions from firms in accordance with revealed 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.

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

[10] This has been suggested by, for instance, Peter Diamond, 1995.