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THE WELFARE STATE

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I. Introduction

The most obvious achievement of the welfare state is to have enhanced economic security and evened out the consumption profile over the life-cycle of citizens who, for various reasons, would otherwise not have done so all by themselves. The welfare state has also helped reduce poverty among people with permanently low factor income. In some countries, welfare state policies have contributed to evening out the overall distribution of lifetime income; opinions differ, of course, as to whether this should be regarded as an achievement or not.

The major instruments of these policies have been transfer payments to households, including social security benefits, and subsidies or public sector provision of various "social services". These policies may be motivated not only by social and distributional arguments. They may also be seen as solutions to "market failures"; that is, they may be motivated on grounds of economic efficiency (see, for instance, Snower, 1993). Compulsory social security exploits returns to scale in the insurance field; it also helps solve "free-rider" problems by forcing everyone to pay in advance for their own future benefits,

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rather than relying on the altruism of others in situations of financial distress. Many observers would also credit the welfare state with having increased the supply of services that might not automatically be provided for in a satisfactory way by either the family or the market, such as education, child care, old-age care and health care. For instance, compulsory health insurance helps those who are in poor health to obtain care without diminishing the possibilities of others to be insured; that is, the problem of "adverse selection" is mitigated.

The problems of the welfare state are also easy to identify. The basic problem is that policies which largely disrupt the ties between effort and reward are bound to create economic disincentives on work, saving and entrepreneurship. There are also well-known inefficiencies in the provision of social services when they are produced by public sector monopolies, as in the Nordic countries.

Using Jan Tinbergen's (1956) terminology, we may say that some of the problems are the result of inappropriate instruments of welfare state policies, in the sense that if other instruments had been used instead, the targets of the welfare state could have been reached at lower costs. One purpose of this lecture is, therefore, to reconsider some of the instruments of the welfare state; this is what I mean by "reform" of the welfare state.

It may also be argued, however, that the welfare state in some countries has overexpanded in the sense that a vast majority of the electorate would have preferred less ambitious welfare state programs, if voters had been able to consider all benefits and costs of the entire welfare state program simultaneously. A second purpose of the paper is, therefore, to discuss whether and, if so, how such overexpansion may

come about. This brings us to the question of the possibilities of modifying the aims and ambitions of the welfare state, and also of dealing with various problems of transition in the case of reform or retreat of the welfare state. In discussing these issues I adopt the conventional role of an advisor who proposes certain policies. However, in view of my attempts to explain the emergence of high public sector spending, and hence the behavior of politicians, I end the paper with some suggestions for reforms of political institutions and mechanisms to facilitate reforms and retreat of the welfare state.

Let me start with the question of what should be signified by overexpansion, or "overshooting".

II. What is "overshooting"?

Assertions that the welfare state has overexpanded in some countries must build on the notion that there is some optimum level of welfare state spending. The natural way to define such an optimum is a situation where the marginal benefits are equal to the marginal costs of public funds. "Overshooting" would imply that some deficiencies in the political process have pushed welfare state spending beyond this level.

The marginal costs of public funds are conventionally defined as the sum of direct tax payments and the "excess burden" of taxation due to various disincentive effects on the national economy. If, for instance, these costs are 1.5 dollars per (additional) dollar of public sector spending, it is worthwhile to undertake the last dollar of public sector spending only if it is regarded as worth one and a half times what the individual has to give up when paying one dollar to the government.

It is not obvious, however, according to whose judgement and preferences the benefits and costs, and hence such an optimum, should be defined. Many observers would probably agree that the welfare state has overexpanded if the marginal costs, because of various disincentive effects on the national economy, are so high that the living standard of large groups of low-income earners is actually reduced, on the margin. Observers who assign a sufficiently strong weight to the relative, rather than the absolute, living standard within a nation may, of course, disagree; such observers may prefer that the living standard of the poor is reduced provided the living standard of others falls even more.

Unfortunately, calculations of the costs of public funds are very imprecise, not only because of the difficulties in estimating the relevant elasticities, but also because the calculations made by economists so far cover only very few types of tax distortions. For instance, the consequences for the choice of job, work intensity, the desire for promotion and incentives to invest in human capital are seldom included in such studies.

Moreover, when considering reform or retreat of the welfare state, it is important to interpret both the benefits and the costs broadly. The benefits should include not only individual advantages, but also broad consequences for the functioning of society at large. It may, for instance, be argued that welfare state policies have helped make the western economic system -- based largely on markets, competition, pluralism, and private ownership -- more acceptable to the general public. In this way, the welfare state may have contributed to a degree of social harmony that is an important prerequisite for a reasonably smoothly functioning, and hence efficient, economic system.

In a similar vein, the costs of the welfare state should include not only the economic costs mentioned above, but also various undesired, "qualitative", side effects of the welfare state. For instance, reduced private saving not only slows down the accumulation of national wealth; it also has profound effects on the functioning of society at large, as domestic private entrepreneurship requires domestic private wealth, that is, accumulated private savings. Capitalism cannot exist without capitalists.

Moreover, while high marginal tax rates tend to shift the service of material objects -- such as repairs on homes and on consumer durables - from the market to the household sector, subsidies of public sector service production shift personal services from the family to the public sector. We may say that while traditional socialism opted for socialization of firms, high-tax welfare states with a large volume of public sector service provision (such as in the Nordic countries), imply far-reaching socialization of the traditional functions of the family.

A particularly problematic phenomenon in advanced welfare states is that the incentives to cheat on taxes and benefits are considerable. It becomes expensive to be honest; accordingly, the supply of honesty will gradually fall -- even in countries where honesty has originally been relatively pronounced, as in the Nordic countries. There is, therefore, a risk that high-tax welfare states will gradually depreciate the historically inherited "capital stock" of honesty, and it might be difficult, or at least take a long time, to restore it. This is a serious problem, in the sense that honesty may be regarded as a very important public good, with strong externalities among households and firms. There is also a severe risk of uncomfortable relations between the individual citizen and the state when the latter feels compelled to

build up elaborate control systems in order to stop tax and benefit cheating. Another possible effect of a "cradle to grave" welfare state is that some individuals may be pacified; that is, self-reliance may be reduced -- what psychologists call "learned helplessness" (Magnusson, 1980).

It is also important to consider the effects on social relations of immigration to countries with generous welfare benefits. There are clearly limits to the capacity of nations to absorb immigrants, without the emergence of severe social and ethnic conflicts. As a result, advanced welfare states would, sooner or later, be expected to either sharpen the restrictions on immigration, or limit the availability of such benefits to immigrants.

There is today, in reality, no other way to pass judgement on whether the welfare state has "overexpanded" than to make subjective comparisons between such broadly defined benefits and costs -- with great uncertainty about the relevance of available attempts to quantify many of the effects.

III. Mechanisms behind overshooting

The expansion of public sector spending during the last century can probably be regarded largely as deliberate ambitions of politicians, with support from the majority of the electorate, to achieve the earlier mentioned goals of the welfare state: income security, redistributions both over the life-cycle of the individual and among individuals, better provision of certain types of services, etc. (See e.g. Lindbeck, 1988, chap. 2).

What types of political mechanisms could, then, lead to overexpansion of the welfare state? There are models of the political

process in which it would be meaningless to talk about overexpansion of public sector spending. One example is Meltzer and Richard's (1981) application of the median voter model to redistribution policy. In this model, a political equilibrium of public sector redistributions is derived in which voters are assumed to consider all conceivable disincentive effects of marginal taxes and benefits. Similarly, in Gary Becker's (1983) model of pressure group politics, there is an equilibrium in which redistributions take place up to the point where the marginal utility of various benefits from the government is equal to the marginal costs for various pressure groups. The latter costs then include not only the tax payments themselves, but also lobbying costs and costs associated with to various disincentive effects on the national economy.

A basic weakness of such models of political equilibrium is that they abstract from various imperfections the political process. As is often pointed out in both public choice theory and in the positive theory of trade policy, collective financing of individual benefits tends to enhance public sector spending. (See Mueller, 1989, for a survey.) This tendency is accentuated by the fact that political decisions in the real world are taken sequentially -- so-called "incrementalism" -- rather than simultaneously. When one particular group of citizens in society is offered a benefit, it tends to accept the offer on the assumption that the costs are borne mainly by the rest of society. Next time, some other group is offered a benefit, which it happily accepts according to the same type of assumption about who pays the costs -- and so on, period after period. (Lindbeck, 1985). In the end almost everyone may, in fact, be accountable for the costs of each

other's benefits, and (nearly) all citizens may end up as losers because of the disincentive effects on the national economy.

We may say that a "lax" budget process lies behind this weakness in the political system. In more abstract terms, we may talk about a political coordination failure. Behind this failure lies, in turn, high or even prohibitive transactions costs, as simultaneous decisions on all budget items would be extremely costly for the cabinet, the parliament and the public administration. It is a commonplace that there are huge transaction costs, in a broad sense of the term, for voters as well. It is often worthwhile for an individual beneficiary to find out the value of promised benefits, as these tend to be concentrated, and hence large for each beneficiary. But it is often not worthwhile for the individual voter to put any effort into calculating the costs of the financing of benefits, as these costs are highly dispersed, and hence small for the individual voter in each case. Indeed, it is likely that people are much less informed about such abstract macroeconomic matters as the "excess burden" of taxes, than about their own, much more concrete needs for economic security in the future, even though the latter type of misinformation is often used as an argument for compulsory social security (the "paternalistic" argument).

I suggest that this type of mechanism is an important explanation as to why public sector spending in Western Europe as a whole has increased from 35 to over 50 percent of GDP from 1970 (Fig. 1); the dispersion among nations is wide, although this also reflects somewhat different principles of recording and administering welfare state benefits (which, for instance, are taxed in some countries but not in others). By way of deficit financing it is, of course, also possible to shift the costs to the future -- and hence to future generations, which

Figure 1.

Total government outlays as percentage of GDP, OECD-Europe, 1971-1992

do not have voting rights today. This type of behavior easily arises, as public sector saving is a collective good, and an individual cannot contribute much to it by his own actions. Such shifting to future generations obviously presupposes that households which are altruistic towards the next generation do not fully compensate reduced government saving by increased private saving -- i.e., that so-called Ricardian Equivalence does not hold.

If the discussion so far makes sense, the traditional welfare state, chiefly designed to provide economic security and to wipe out poverty, may after a while turn into a "transfer state" with free-for-all redistributions to various groups of citizens at the expense of the general taxpayer. Politically determined redistribution may, in this context, largely become a complicated system of tax and transfer lotteries, which are often loaded in favor of politically powerful groups. As these redistributions may severely hurt the national economy, "the general interest" of society cannot simply be regarded as the sum of uncoordinated special interests.

A metaphor may illustrate the point. Suppose a number of fishermen live around a lake. If there are no well defined and enforceable property rights to the fish in the lake, each fisherman has incentives to catch as much fish as possible (also with consideration to his enjoyment of leisure). The resulting "overfishing" means that, after some time, the lake may be empty of fish. The sum of special interests of each individual fisherman has harmed the general interest; most, or possibly all, members of the group may then lose in the long run -- an example of "the tragedy of the commons". The same may happen in a nation if various interest groups, in the process of transferring

resources to themselves from the general taxpayer, push up the marginal tax and benefit rates to levels that seriously harm aggregate output.

IV. Reform and retreat of the welfare state

How, then, could the welfare state be reformed, and a retreat of welfare state spending be organized with the lowest possible economic and social disturbances?

IV:i. The financing of the welfare state

Let us start with the possibilities of limiting the costs of financing the welfare state, that is, of mitigating the tax distortions.

Taxes discriminate against trade within the national economy in the same way, in principle, as tariffs discriminate against trade between nations. While tariffs favor production in the national economy, at the expense of regular international trade, taxes favor household production (including leisure) and various types of illegal economic activities at the expense of exchange in the regular market. Like tariffs, taxes give rise to various types of autarkic economic behavior (Lindbeck, 1988). It is surprising that some economists and politicians who worry about the excess burden of tariffs of some 10-30 percent, are much less concerned about the often much higher tax-induced distortions of market transactions within the domestic economy.

If the level of welfare state spending is kept unchanged, two things could be done, in principle, to mitigate the tax distortions. One is so-called "tax reform", that is, attempts to reduce the distortions of the tax system at given tax revenues. In reality, such reforms have opted for uniform rates, according to the slogan "lower rates and broader base", rather than trying to design "optimum tax rates", which require different rates for different tax bases depending on the

elasticities of the various bases with respect to the rates. One reason is probably the difficulties of calculating such elasticities. Another is that, partly because of these difficulties, attempts to determine optimum tax rates in reality would probably make the rates reflect relative political powers, rather than the best available measurements of relevant elasticities.

An alternative, or complementary, way of reforming the financing of the welfare state would be to shift from taxes to fees, that is, to charge prices for public sector benefits -- for compulsory social insurance as well as public sector services. Indeed, if social security benefits are actuarially fair on the margin, and if the fees for public services are based on marginal costs, then marginal tax wedges in these systems would, in principle, be eliminated.

IV:ii. Selective, means-tested benefits.

It is even more difficult to reform public sector spending programs than to reform taxes and fees. Some of the reasons are the multiplicity of the targets of such programs, the institutional and administrative complexities, and the complicated web of special interests in connection with various benefit systems. Let us start with "selective", means-tested programs, that is, benefits that fall along with higher factor income of the beneficiaries.

There are at least two advantages of means-tested programs: their precision and their relatively low costs. The main reason is that the support is given directly to those we want to help. Therefore, for a given amount of public sector spending, the living conditions of the poor may be improved more by using selective methods than by relying on general transfer payments to the population as a whole.

The most obvious disadvantage of means-tested benefits is perhaps that they necessarily involve some intrusion on the private lives of individuals. It is also difficult to avoid "poverty traps", i.e., high implicit marginal tax rates, if the benefits, in order to limit the costs for the state, are abruptly reduced by higher factor income.

Underlying these problems is the fundamental difficulty that low-income groups, in reality, cannot easily be divided into two separate categories: those who would, in principle, be able to support themselves by work and those who would not. "Moral hazard" is the obvious consequence of this identification problem: the availability of assistance to people in need of economic support tends to make the group expand, possibly even drastically. Some individuals, who were not intended as beneficiaries when the programs were designed, will adjust their behavior to become just that. An often quoted example is various types of support to single mothers. It is unavoidable that such support prompts women with low education to join this group -- by way of childbirth among single women or divorce. Fathers are also induced to run away from their economic obligations. Indeed, as James Tobin (1966, p. 34) put it, on the basis of experiences in the US: "Too often a father can provide for his children only by leaving them and their mother".

This difficulty is the same, in principle, as that of implementing lump-sum taxes: the basis of both taxes and benefits in actually existing programs is endogenous, and may respond quite strongly to the rules determined by the government. The problem is not always impossible to solve, however; the elderly, the severely handicapped and the mentally disabled are relatively easy to identify.

Among economists the most popular method of mitigating the poverty-trap problem is probably the "negative income tax". In principle, such a system consists of three components: (i) a fixed income guarantee (income grant) for everyone; (ii) an implicit tax schedule according to which the net grant falls gradually, rather than abruptly, along with higher factor income to limit the implicit marginal tax rate; and (iii) a break-even level of factor income above which no net grant is received.

The basic weakness of such a system is, in my view, that it neglects the "identification problem" discussed earlier. Some able-bodied citizens, perhaps young people in particular, will choose not to work. They will thereby achieve lots of leisure with a rather small economic cost to themselves in terms of income forgone -- at the expense of the general taxpayer. With some additional income from tax-free black market work, on top of grants from the government, they may even achieve a higher income level than by way of regular work, in addition to ample leisure time. As a result, a negative income tax may, in the long run, generate a considerable group of young subsidized drifters, such as "hippies" in the 1960s, with a very casual attachment to the labor market.

A more promising reform for solving both the poverty-trap problem and the identification problem may be to shift from "welfare" to "workfare". The basic idea is to move from income-dependent, i.e., means-tested benefits, to a "reciprocal" obligation, according to which welfare payments are conditioned on accepting offered work or participation in training programs. Even if such programs may in reality succeed in increasing labor force participation of low-productivity

groups, they are usually not successful enough to allow drastic cuts in total government spending on means-tested benefits (Burtless, 1988).

IV:iii. General transfer programs.

General transfer programs avoid intrusion on the private lives of individuals, as the benefit of such a program is a general right. It is sometimes also argued that it is easier to create political support for the poor if the benefits to them are integrated into a general transfer program that covers the entire population (Esping-Andersen, 1990; Korpi, 1980). The idea is to make the poor "free passengers" on the self-interest of the majority, rather than relying on the latter's altruism.

However, as in the case of many good arguments, these ideas seem to stand equally well on their head as on their feet. It may be argued that it is precisely by "intrusion" on the private lives of poor people that they can be helped in a long-run perspective, as they may then be offered appropriate training and rehabilitation programs, such as in the "workfare" approach mentioned above, so that they have a better chance of supporting themselves in the future.

Moreover, the high budget costs of general transfers imply great risks that "classical" functions of the government, such as the provision of public goods and infrastructure, will be crowded out. Various social services may go the same way. General transfer programs may even crowd out support to the poor, as this group is usually only of modest size, and is often politically rather insignificant. The "free passengers" on the general welfare state voyage may be the first to be thrown out when the ship becomes overloaded.

As ambitious general welfare state policies tend to focus the political process on distributional conflicts, the ability of the

political system to deal with other issues may also be hampered; there may be an "overload" of the political system because of conflicts about redistributional policy. It is even possible that such conflicts tend to be particularly pronounced in societies where the distribution of income has been drastically evened out by politically determined redistributions. The reason is that everybody in this case may think it reasonable to compare themselves with everybody else, and even that the government has the duty to make him as affluent as most other people. In the old "class society", by contrast the income differences were so wide that most people could not imagine comparing themselves with much more affluent citizens. This speculation about the consequences of redistribution policies was, in fact, launched already by de Tocqueville (1848); the more income differences are evened out, the more dissatisfied will people be about the remaining ones. If this speculation makes sense, which I believe it does, conflicts about the distribution of income may not fall monotonously with reduced income differentials, at least not when these are caused by politically determined redistributions. If so, the previously mentioned assertion that welfare state redistributions contribute to reducing social conflicts may hold only up to a certain point.

As compared to both means-tested (i.e., income-related) benefits and negative income taxes, social security is associated with smaller risks that able-bodied individuals would choose to live on government transfers. This means that social security deals better with the "identification problem" and related moral hazard. The reason is, of course, that the benefits in social security systems are often tied to, more or less, well-defined "objective" contingencies, such as old age and physical or mental handicaps.

Moral hazard problems cannot, however, be avoided in social security systems. Illness, work injury and unemployment are in reality relative concepts, and the individual has a certain leeway to qualify for benefits in such situations by adjusting his own behavior. In the same way as support for single mothers creates incentives to become one, generous systems of work injury insurance, health insurance, unemployment insurance and benefits for immigrants from poor countries create incentives to qualify for such benefits (Isaksson, 1992). It is unavoidable that more generous benefits create more beneficiaries. Moreover, as people only gradually learn to exploit the benefit system, the expenditures tend to increase over time, often unexpectedly, even for given rules.

Effects like these are not only a matter of conscious exploitation of benefits, "reckless behavior" or cheating. The benefits of welfare state systems may also result in long term changes in values of individuals. For instance, in the case of health insurance, the insured individual, the physician who is asked to certify illness, and the administrator of the insurance system, all tend to define illness in a liberal way when benefits are generous. The obvious reasons are that personal relations between these agents are thereby smoothed, and that they themselves do not have to pay the marginal costs of such behavior.

How should we deal with these various problems? If we are anxious to cut public sector spending, the most obvious cuts should perhaps be made in general transfer payments outside of the social security system such as interest rate subsidies to housing, as some of these expenditures do not contribute to either economic security or to income redistribution in favor of low-income groups. A more complex issue is what should be done with the social security system itself. The process

of finding reasonable criteria for a good social security system is basically a question of what we want to achieve, and which costs we are willing to pay. The theme of this lecture assumes that we want a system that fulfills, at least, the following objectives, some of which are already fulfilled in some countries. Or, the system should:

- prevent economic hardship of citizens, for instance in the case of old age or bad luck;
- be connected with the smallest possible disincentives, i.e., economic distortions, so that the national economy is hurt as little as possible, and moral hazard and cheating are minimized;
- stimulate the individual to take personal responsibility for his own life;
- be robust towards recurrent changes in political fashions and short term stabilization policies; and
- be reasonably robust against changes in macroeconomic and demographic trends in society, in the sense that such changes do not make the system break down or result in nonacceptable redistributions of wealth among various socio-economic groups.

These requirements point to a compulsory social security system with the following six basic properties (see Lindbeck et al. 1993):

(i) The system should include a fixed minimum benefit, the same for everyone, as the "bottom" of the system, that is, a common safety net for well-defined contingencies in life, such as old age, unemployment, illness, disability, etc.

(ii) The greater the emphasis on "paternalistic" arguments for social security, i.e., the idea that the individual is unable to plan for himself, rather than emphasizing the "free-rider" aspect, the stronger the case for a system of income-standard protection above a

common safety net. From the point of view of economic incentives, there is a strong case for constructing such a system, if we choose it, as actuarially fair as possible, since tax wedges can then be minimized.¹ (An actuarially fair system means that the capital value of expected benefits equals the capital value of expected fees.) Such systems are easiest to construct for pensions, but it is also quite possible to include actuarial elements in systems of unemployment insurance and sickness-compensation benefits. However, it is more difficult to include actuarial elements in health care insurance systems. In order to make the actuarially calculated fees as conspicuous as possible to the individual, the individual and not just the firm should, to a considerable extent, pay such fees ("employee contributions"). As an actuarially fair system tends to create "property rights" in insurance benefits, such a system may also be fairly robust against political interventions.

(iii) There should be a ceiling for income-dependent benefits, above which there are neither additional further benefits nor additional fees -- in order to give the individual an incentive to take considerable responsibility for his own economic security, on top of the support provided by the government;

(iv) So as to enhance the political robustness of these systems, they should be moved outside of the yearly budget process (except the fixed benefit at the "bottom"). There is even a case for moving compulsory social security systems outside of the government sector altogether. The individual may, then, be allowed to place his social security policies in competing funds of his own choice.

¹ It should be noted that an actuarial system does not necessarily require any funds.

(v) In order to mitigate tendencies towards moral hazard and cheating, it is important that co-insurance (or deductibles) is included in all social security systems. Obvious ways to achieve this are to keep the replacement levels of benefits considerably below 90-100 percent, and to include periods without benefits ("waiting periods"). It is also important to opt for the same replacement ratios in all systems between which the individual can easily move at his own discretion, such as in cases of illness, work injury, care of sick relatives and unemployment. To prevent "benefit arbitrage" is quite as important as to stop "tax arbitrage".

(vi) The criteria for receiving benefits should be tightened in most social insurance systems, including insurance in the event of unemployment, illness and work injury, to avoid both abuse and excessively liberal administrative implementation.

Figure 2 gives a schematic picture of such a system.

(Figure 2 approximately here)

It may be noted that these suggestions are also consistent with the views of the most influential writer on social security, Lord Beveridge, who stated as early as 1944: "The State in organizing security should not stifle incentive, opportunity, responsibility; in establishing a national minimum, it should leave room and encouragement for voluntary action by each individual to provide more than that minimum for himself and his family".²

² Quotation from International Social Security Association, 1992, p. 7.

Voluntary private insurance -- on a group and/or an individual basis -- on top of compulsory insurance, is not unproblematic, however. It creates an externality on the compulsory system, as the disincentives that emanate from voluntary insurance also incur costs for compulsory insurance systems. One way of dealing with this problem is to put a ceiling on the total replacement ratio, compulsory plus voluntary, so that this sum is not permitted to exceed a certain level, say 80 percent. The technique would be about the same as that used by private insurance companies to avoid "overinsurance": compulsory benefits are deducted on the basis of the amount by which the total replacement ratio would otherwise exceed a certain level, for instance 80 percent. (This problem does not arise in the case of ordinary old age pensions, however: the passage of time cannot be manipulated by the individual.)

A rather different way of dealing with social security, along the lines of Bismark rather than Beveridge, would be to opt for a system that is run by labor market organizations rather than by the state or independent insurance companies. A danger inherent in such a system is that the individual easily winds up in the hands of these organizations, which, for instance, may misuse the system to get more members. (This is the experience of the unemployment insurance system in Sweden.) Moreover, if these systems are funded, the labor market organizations would gain control over a substantial share of equity capital in society, which creates a threat to the idea of a decentralized economic system, and hence a substantial risk for erosion of pluralism in society. There are similar risks, of course, in all highly centralized funded systems, not least government-operated systems.

We may also consider a more radical, occasionally suggested, overhaul of the welfare state, whereby individuals are given generalized

Figure 2. Three elements in a future social insurance system

"drawing rights" on special accounts that they are obliged to accumulate during their working life (Fölster, 1993). Typically, the individual would accumulate a negative amount on his account early in life, by borrowing from the state for his studies (at least education above the compulsory level). Later on, the negative balance would gradually be replaced by a positive one, which may subsequently be drawn upon in the case of unemployment, illness, adult education and, finally, old age. The system would, of course, also have to include an element of insurance for serious (particularly expensive) well-defined contingencies that would otherwise extinguish the account. The great advantages of such a system -- if it can be implemented in a world with internationally mobile labor -- would be to mitigate moral hazard, probably even more efficiently than co-insurance or deductibles do, while allowing the individual considerable freedom to choose his own time-profile of consumption.

IV:iv. Social services

How should we deal with the efficiency problems related to the other major element of the welfare state: subsidies and public sector provision of social services? The conventional solution to these problems, which I sympathize with, is to allow free entry of private and cooperative producers, and to let them compete with public sector producers without discrimination. The idea is to emphasize open competition rather than privatization per se; to the extent that public sector institutions can compete on equal conditions, they may survive, or even expand. Instead of today's subsidies to public sector producers, the subsidies should then be paid directly to households, for instance in the form of service checks ("vouchers"). There is hardly any reason

why competition and free choice would be less important for social services than for goods and services in general. The case for competition and freedom of choice is also much stronger for social services than for social insurance, as there are hardly any important returns to scale in service production, by contrast to insurance systems. Competition, and freedom of choice for certain social services -- at least health -- also requires, of course, well functioning insurance systems.

Often, the idea of freedom of the household to choose a producer of social services is challenged, however. The most common argument seems to be that such freedom results in unacceptable segregation between social groups. But this is a doubtful argument if competition and freedom of choice are combined with service checks, which also create opportunities for low-income groups to choose a producer freely - even to choose producers outside their own highly segregated housing area. In other words, it is possible to separate the financing and the production of services that today are often provided by the public sector; moreover, financing can, in principle, be organized in such a way that distributional consequences and unwanted segregation are avoided. Of course, the middle class might be the first to seize new opportunities created by service checks. It is quite likely, however, that low-income groups would learn over time to use their freedom of choice, as they earlier learned to use their voting rights after the introduction of general franchise.

But why should such services be subsidized in the first place? The most common argument seems to be "paternalism", i.e., an ambition to induce households to consume more of certain services than they would otherwise choose at prices that reflect the opportunity costs. A

related argument is to bring about a more equal distribution of certain types of services than of consumption in general (Tobin, 1970).

There is, however, also an efficiency argument for subsidizing some service production outside the household. The government may want to counteract unintended favoring of household production of services due to marginal tax rates. Along this line of argument, we may defend some subsidies of child care and old-age care outside the household in countries with high marginal tax rates. Neither this, nor the paternalistic argument, of course, can create a case for the monopolization of public sector production of such services.

But some politicians -- at least in my country -- want to go much further. They seem to have a policy goal that both parents should work outside the home. According to this view, the government should consciously influence the division of work within the family, in particular between men and women, according to political preferences, rather than merely try to counteract the distortions that are created by the tax system. Again, paternalistic ambitions appear to be the rationale for such interventions. The idea must be that the family does not understand its own interests when it, for instance, decides that the wife should stay home to take care of the family's own small children.

V. Problems of transition

So far, I have just outlined problems and suggested alternative solutions. There are, however, also serious transition problems associated with attempts to reform either the social security system or public sector service production. The most obvious is that sudden changes in the rules of the social security system tend to disrupt the lifetime planning of the individual. After all, social security is a

long-term contract between the individual and the state, and there is a strong case for changing such contracts quite slowly. This holds in particular for the old-age pension system, regardless of whether the reforms imply lower pensions or a higher pension age. This illustrates the general problem that there may be a conflict between good rules and stable rules.

Transition problems may also arise if the activities of public sector monopolies are cut down abruptly, for instance for financial reasons, before cooperative and private institutions can take their place. Certain services might simply disappear from the market for a while. One reason why it may take time for private and cooperative producers to emerge is that those who have been trained to work in public sector institutions have not developed an ability and taste for entrepreneurship. Moreover, if there is political controversy about de-monopolization, private and cooperative producers may hesitate to enter the market because of the risks that in the future they might not be allowed, or at least would again be heavily discriminated against.

A retreat in welfare state spending may also create temporary problems for macroeconomic stability. If the benefit levels in social security systems are reduced during a severe recession without simultaneous (and sufficiently large) cuts in taxes or fees, it is very likely that the recession would be accentuated.

To some extent, this dilemma may be mitigated by making decisions about reduced welfare state spending as soon as it is politically feasible, even in a recession, but to postpone the actual implementation to the next boom -- a "back-loading" of the path of the cuts. Unfortunately, such a back-loading strategy is not easy to implement successfully in reality. First, expectations about a future fall in

benefits have immediate effects on spending -- though presumably smaller effects than if the budget cut is implemented immediately (both because the present value of the cuts will be smaller, and because some households are liquidity constrained). Second, there is a serious credibility (time-consistency) problem, as it is difficult to tie the hands of future parliaments and cabinets. Short election periods for parliament accentuate the problem. Still, such a back-loading strategy may be the only way of dealing with the dilemma.

VI. Concluding Remarks

This paper has dealt with the need and possibility of reform and retreat of the modern welfare state. Examples of appropriate policies are less distortionary financing of welfare state spending, including a shift from taxes to actuarially fair, although compulsory, insurance premia; wider use of co-insurance or deductibles, such as lower replacement ratios or longer waiting periods before benefits are received in the social security system; and the provision of the same replacement ratios in all systems between which the individual can easily move at his own discretion. It is also important to put a ceiling on the total replacement ratio, compulsory plus voluntary, to avoid a situation where disincentive effects of additional voluntary insurance harm the compulsory system at the bottom. There is also a case for making social security entitlements more robust against political intervention by moving them outside of the government budget, and possibly even outside of the public sector altogether, though still keeping them compulsory.

Other examples of suggested reforms are more reliance on fees for public sector production of various social services; freer competition

in the provision of such services, for instance by distributing service checks (vouchers) to households rather than allowing public sector service monopolies (as in some Nordic countries).

Several of these reforms, such as reduced replacement ratios, non-discriminated private and cooperative alternatives in the field of social service production, as well as greater freedom of choice and increased self-reliance of individuals, may be regarded not only as reforms but also as a retreat of the welfare state.

When making these various policy recommendations, I have placed myself in the conventional position of an economic advisor who recommends that the government "pull one lever or the other". However, like other agents in society, politicians are influenced by the incentives and institutions of the system where they operate. In this sense, politicians, like households and firms, should to some extent be regarded as endogenous variables in the economic system (Lindbeck, 1973).

The obvious implication of this observation is that advice on discretionary economic policy measures should be combined with advice on changes in institutions and mechanisms in the political system. Concrete examples of conceivable political reforms are election reforms that make it easier to form majorities, so that the government can avoid compromises which expand government spending; longer mandate periods for members of parliament to enhance a longer time perspective of politicians; more frequent use of referenda for tax changes, so that it becomes more difficult to hide the costs of government spending from the electorate; new working procedures for both the cabinet and parliament

and its various standing committees, including a stricter budget process and less influence of special interest groups, etc.³

A basic problem with such reforms, however, is that our knowledge about the consequences of alternative institutional arrangements is quite limited. It may also seem paradoxical that we ask politicians to take action in order to prevent themselves from doing what they want in the short run. But there is nothing illogical about this. After all, politicians have agreed to a domestic political constitution that delegates decisions to, for instance, independent judiciaries. Politicians have also made international agreements, such as GATT -- agreements which constrain their own freedom of action in day-to-day politics. It is, therefore, neither paradoxical nor undemocratic to consider institutional reforms that constrain domestic policies in order to enhance responsible expenditure policies by the government. An analysis of the pros and cons of specific types of institutional reforms of the political system are, however, outside the scope of this paper.

The reasons for the political difficulties in reforming and rewinding a welfare state are probably the same as those for overshooting in the first place: each separate spending program, with concentrated benefits, means much more for the individual beneficiary than the dispersed costs for those who finance the benefit. One possibility of breaking this impasse is to construct a broad, comprehensive "package reform" so that most voters will both lose, on the benefit side, and win on the tax side. The idea behind such a reform is the same as the idea behind recent broad tax reforms in some countries. Indeed, by making sufficiently many decisions

³ Such proposals formed an important part of the suggestions set forth by the Economic Commission appointed by the Swedish government in December 1992 (Lindbeck et al. 1993).

simultaneously, it would even be difficult to calculate the distributional consequences of a "package reform"! This uncertainty regarding the distributional consequences means that is difficult to form strong resistance groups against the package; on the other hand, uncertainty about the distributional effect may induce people to ask for higher expected gains than otherwise.

The general purpose of these various suggestions is to prevent the welfare state from undermining its own foundations by destroying economic incentives, pacifying citizens, being politically unstable or socially unacceptable. This means that the basic idea behind the proposals is to save the welfare state rather than to dismantle it. Indeed, I regard the welfare state as a major contribution to western civilization (Lindbeck, 1988) -- although it has recently tended to overshoot reasonable limits in some countries. The welfare state today is more threatened by some of its most ardent friends, who favor rules that tend to undermine the economic foundations of the welfare state, than by its enemies.

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