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WELFARE STATE DISINCENTIVES WITH ENDOGENOUS HABITS AND NORMS

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Abstract:

It is assumed in this paper that habits and social norms, in particular when adhered to by many, constrain the influence of changes in economic incentives on aggregate economic behavior, but that these constraints themselves may subsequently be influenced by the very same incentives. The paper is confined to disincentive effects of welfare state policies on work, saving, asset choice and entrepreneurship. Though the existence of various constraints on economic behavior usually means that changes in economic incentives influence aggregate behavior only gradually, it is argued that major shocks may drastically speed up the process.

I. The problem

The achievements of the modern welfare state are well known: improved economic security, income-smoothing over the life cycle of the individual, redistributions of wealth in favor of low-income groups, and increased provision, and in some cases also a more equal distribution, of various types of "social services". Some welfare-state achievements may, however, emerge only gradually over time. For instance, it is well established that policies that enhance pre-natal care and mitigate child poverty subsequently have positive effects on the health, productivity and income of the labor force -- effects that

* I am grateful for very useful comments on an earlier draft by Kenneth Arrow, Anders Björklund, Peter Hedström, Dennis J. Snower, Martin Paldam and Robert Zeckhauser, without implying any shared responsibility for the somewhat unconventional analysis.
are, in fact, transmitted over generations; see Haveman and Wolfe (1993).

It is also likely that the full positive effects of subsidies to investment in human capital accumulate only gradually, partly because of various intertemporal externalities over time of such investments. It is also reasonable to argue that welfare-state policies that fight urban poverty in a long-term perspective may mitigate the development of cultures of criminal behavior, such as street crimes, burglary, drug crimes and violence, cf. Freeman (1993).

It is also often hypothesized that an equalization of the distribution of factor income mitigates social conflicts. They may also reduce the tendencies to highly distortionary political interventions to redistribute income by way of taxes, transfers and regulations, cf. Meltzer and Scott (19..), Alesina and Rodrik (1994), Persson and Tabellini (1994). We may also hypothesize that people's tolerance of concurrent reallocations of resources is enhanced both by a comprehensive social safety net that mitigates income losses, and by government support to labor market training programs that reduce the risks of long unemployment spells for individuals. It is also tempting to speculate that a fairly equal distribution of disposable income contributes to making citizens sympathetic to the principles of a market system, and that this may reduce the risk that the market economy is replaced with a more command-oriented economic system.

The costs of the welfare state are traditionally defined by economists as the sum of the tax payments and the excess burden of both the implicit tax rates embedded in various benefit systems ("benefit wedges") and the explicit taxes that finance the benefits ("tax wedges"). The basic idea in this paper is that some of these costs are delayed because habits and social norms constrain the influence of changes in economic incentives. It will also be argued, however, that these constraints themselves may be subsequently influenced by the very same incentives. This is assumed to be the case not only for households but also for various private organizations and public-sector administrators. This paper
deals just with this role of habits and social norms as constraints for the disincentive effects of welfare-state policy.

The discussion is confined to what may be regarded as the "core" of the welfare state, namely cash transfers to households, including both social insurance benefits and social assistance ("welfare" in US terminology), and public-sector subsidies and provision of various social services. To limit the scope of the paper, I will concentrate on the consequences for a few broad economic activities -- work, saving, asset choice and entrepreneurship.

Considering the complexity of the issues, and the limitations of both existing theories and empirical research, my ambition is mainly exploratory. This explains the informal, essayistic nature of the paper. I leave the task of theoretical formalization and empirical verification, or falsification, to future work.

II. The basic idea

What do we mean by habits and social norms of individual behavior? Habits are usually defined in the sociological and psychological literature as routine behavior without cognition or evaluation, cf. Verheller and von Raaij (1985, p. 5). The distinction between habits and social norms is usually that the latter are shared by other people, and partly sustained by their approval and disapproval, while habits are more individualistic phenomena in the sense that they are not enforced by others to the same extent. This distinction is somewhat blurred, however, by the observation that norms are sometimes "internalized" in the sense that an individual develops an "internal sanction system", cf. Coleman

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1 Compare the following characterization of habitual behavior by Katona (1973, pp. 218-19): "People act as they have acted before under similar circumstances without deliberating and choosing. Routine procedures and an application of rules of thumb by consumers as well as business exclude the weighing of alternatives".

2 Coleman (1990, p. 243) argues: "I will say that a norm concerning a specific action exists when the socially defined right to control the action is held not by the actor but by others." For a similar view, see also Elster (1989).
(1990, p. 293). Once such an internalization has occurred, individuals conform to social norms even when there are no external sanctions, cf. Hoffman (1983).  
"In short, moral internalization turns constraints into preferences", to quote Etzioni (1989, p. 46). We may in this case say that the individual feels guilt, i.e., pays a psychological price, for having broken previously obeyed habits and social norms.  
Thus, an individual who breaks generally accepted habits and social norms may experience a utility loss not only by losing reputation in society, but also by subjectively felt discomfort from violating habits and norms that he(she) believes should be obeyed.

General illustrations of the influence of habits and social norms, in the context of welfare-state arrangements, are that citizens often abstain from applying for benefits to which they are entitled; that most citizens probably do not misuse or cheat with government-provided benefits even when the risk of being caught is negligible; that most citizens spontaneously comply with the tax codes, etc.

We may, invoking a concept introduced by Loury (1987), regard social norms and ethics as "social (collective) capital"; honesty is one example, cf. Lindbeck (1988, pp.32-33). My hypothesis is that social capital, in the form of habits and norms, accumulates over decades and centuries, but that it tends to depreciate gradually when a new incentive system makes existing norms and ethics more expensive to follow than before. Thus, when conflicts emerge in the mind of the individual between habits and social norms, on one hand, and economic incentives, on the other hand, it is assumed that after a while the habits

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3 Such an internalization has been described as a socialization process in which a person learns to "conform to rules in situations that arose impulses to transgress and that lack surveillance and sanctions", cf. Kohlberg (1968, p. 483)

4 This idea is, I believe, close to a hypothesis launched by Akerlof (1980): "...social customs may act as a constraint on economic activity, preventing trades that would occur in the absence of such a code" (p. 756), and "A custom that is too costly to follow, in terms of lost utility, will not be followed and therefore will disappear" (p. 772). Moffitt (1883) also assumes that the individual suffers a utility loss if breaking a social norm.
and norms may adapt.

More specifically, I assume (i) that today's habits and social norms are influenced by the economic incentives and control systems of the past; (ii) that an individual is more likely to conform to certain habits and social norms, the more individuals in society do so (a "critical mass" effect); (iii) that earlier acquired habits and social norms tend to survive for a considerable time also after the incentive or control systems have changed; and (iv) that emerging conflicts between habits and social norms on the one hand, and incentives, on the other, to begin with, induce a few individuals to stop obeying the norms, but that this behavior gradually spreads to others; but (v) that major shocks to the economic system may drastically speed up this process.

The first four assumptions imply that the national economy is protected for a while from the effects of a deterioration in economic incentives -- perhaps for as much as one or several decades in some cases. As a result, welfare-state policies easily "overshoot", in the sense that politicians would often initially have chosen to offer citizens less generous welfare-state arrangements if it had been possible to anticipate the long-term consequences for the national economy and the financial position of the public sector.

The fifth assumption means that a major macroeconomic shock may result in a sudden "ketchup effect", for instance, by generating a drastic rise in the number of citizens who depend on various types of government support, such as unemployment benefits, social assistance and subsidized early retirement. Due to the earlier postulated interpersonal dependence of behavior, the hesitation among individuals to live on benefits may in this case fall abruptly.

Interpersonal dependence may, of course, be analyzed without constructs such as habits and norms, and without assertions of changes in individual preferences. We may, for instance, simply assume that the behavior of others influences the benefits or costs, or both, of the actions of an individual with given preferences. This is the approach in Schelling's "tipping model", in which
an individual with given preferences is no longer willing to reside in a certain neighborhood if the percentage of residents of another color exceeds a certain limit, as then the (economic and psychological) costs of living there start to exceed the benefits; cf. Schelling (1971, p. 167).

In a similar vein, Granovetter assumes that when the number (or proportion) of people who behave in a certain way exceeds a "threshold level", an individual with given preferences changes his own behavior accordingly because the benefits of that behavior start to exceed the costs -- with different "threshold levels" for each individual, cf. Granovetter (1978) and Granovetter and Soong (1988). For instance, as the size of a rioting crowd increases, the costs for an individual (with given preferences) of joining the riot fall, because of a reduced risk of being detected and arrested; moreover, the benefits of rioting may rise because of a greater likelihood that the rioters' targets will be achieved.

While models like these may be useful for the analysis of housing segregation and rioting, and several other social phenomena, I believe that models with "conditional habits and norms", as applied in this paper, are more relevant for the analysis of the long-term consequences of welfare-state arrangements. It is true that the expected pecuniary costs of moral-hazard behavior and cheating tend to decline when many others behave in the same way, as the risk of being detected tends to fall -- as in the case of a growing riot. But as should be clear from the subsequent discussion, it is also reasonable to assume that the hesitation of the individual to engage in such behavior depends on the psychological costs of deviating from previously obeyed habits and norms.

III. Consequences for work

The fact that tax wedges create disincentives to efficient work does not require elaboration. The reason why various welfare-state benefits do the same is, of course, that these are designed to reduce the difference in income when people work and when they are out of work. As benefit systems are seldom
actuarially fair, partly because of ambitions to redistribute wealth, it is unavoidable that welfare-state benefits subsidize non-work.

A good humanitarian case can, no doubt, be made for generous benefits in connection with contingencies such as unemployment, sickness, disability, single-motherhood, etc. A basic dilemma for the welfare state is, however, that generous benefits tend to create many beneficiaries due to moral hazard and in some cases also benefit cheating.\(^5\) \textit{Ceteris paribus}, the more generous the unemployment benefits are, relative to after-tax wages, the more people will in the long run choose to stay unemployed; the higher the sick-pay benefits, the more people will call in sick; the more favorable the conditions for disability pension, the more people will find it attractive to live on such pensions; the higher the benefits for single mothers, the more single mothers we would expect, etc.

Such problems of moral hazard and cheating are unavoidable costs of welfare-state arrangements, in the same way as the disincentive effects of tax wedges are. Moral hazard and cheating look rather similar on the surface. But there is a distinction. If, because of generous sick pay, I choose to call in sick on Monday because I feel tired after drinking heavily on Sunday night, we would classify this as moral hazard. If I go to Copenhagen for a long weekend, but in fact pretend that I have stayed away from work because of illness, it is plain cheating. Similarly, while it is an example of moral hazard if I do not search for a job very energetically when I receive generous unemployment benefits, I should certainly be characterized as a cheater if, when receiving such benefits, I work in the underground economy.

In some countries, however, there are also elements of the welfare state that favor labor force participation, at least part-time and during some years.

\(^5\) For impressionistic examples of moral hazard and benefit cheating in Sweden, see the lively and personal account by Swedish journalist Anders Isaksson (1994).
The most obvious example is that eligibility for certain benefits in many
countries is tied to previous work, and that some connection often exists between
the size of the benefit and fees paid earlier (such as payroll taxes), even though
the systems are usually very far from being actuarially fair.6

Disincentive effects on work would, however, often be expected to be
stronger in the long run than in the short and medium run. One reason is that
work is partly habitual and that it is also influenced by social norms. This would
be expected to be the case for many types of decisions that are, in principle,
affected by tax wedges and benefit wedges, including the choice between leisure
and income, household service production vs. purchases of services in the
market, the allocation of labor among family members, decisions about the
intensity of work, etc. We should perhaps expect a particularly strong role for
habits and social norms in the case of activities to which strong ethical concerns
are tied, such as tax avoidance and tax evasion, not to speak of various criminal
activities (including work in the "black economy") for which income is usually
tax-free except for a stochastic "tax" in the form of punishment if caught. There
is also evidence that people's willingness to pay taxes is favorably influenced by
positive attitudes to the government's spending programs (Lewis (1982). We
may speculate that this willingness deteriorates if the frequency of moral hazard
and tax- and benefit-cheating increases among others. These incentives
(substitution effects) in favor of dishonest economic behavior tend to counteract
the earlier hypothesized tendency of welfare-state arrangements to mitigate
criminal cultures in poor neighborhoods -- though the types of crimes that are
stimulated and mitigated, respectively, would be expected to differ substantially.

Another important example of the importance of habits and social norms is
the stigmatization of being on "welfare", which is strengthened by the discomfort

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6 In the case of decisions about labor-force participation, it is average rather than marginal
benefits that matter, as the choice set is not convex -- the decisions being taken at the extensive rather
than the intensive margin.
of damage to personal integrity. This seems to be an important explanation as to why many individuals' hesitate to apply for social assistance. Such stigmatization has, in fact, been amply documented in the sociological literature; see interview studies by Horan and Austin (1974) and Rainwater (1979). An econometric study by Moffitt suggests that the stigma is connected with the act of welfare recipiency per se, but does not vary with the amount of the benefit once on welfare (Moffitt, 1983, pp. 1030 and 1032-34).

This stigmatization may however recede over time if the incentives to live on social assistance increase sufficiently, that is if the costs of obeying prevailing norms goes up. The asserted mechanism is, again, that previously obeyed habits and norms are first abandoned by some individuals, and that others may follow suit, in particular if friends and neighbors live on social assistance, and perhaps even cheat with the benefit system.

Most likely, individuals are less hesitant to live on, and adjust their lives to, general social security benefits, such as unemployment benefits and early retirement (disability) pensions than on social assistance. After all, the former are today often described as "entitlements", based on contributions paid previously. Moral hazard and cheating would be expected to emerge only gradually also in the context of these systems, in particular after noticing that others behave in such ways.

Both social assistance and general social security may, for these reasons, only gradually generate benefit dependency. We may, schematically, differentiate between two types of "dependency". One type refers to individuals who become "pacified". This is the case when people lose the energy to look for jobs and to improve their skills. The branch of modern psychology that deals with so-called "learned helplessness", when the individual is unable to control

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7 In the US, as much as 30-60 percent of citizens that are eligible for welfare do not apply; cf. Moffitt (1983)
his own situation, highlights this issue; see Seligman (1975) and Magnusson (1980). Casual evidence suggests that such pacification of individuals has occurred on a much broader basis in the former socialist countries than in the welfare states of Western Europe.

The other type of benefit dependency implies that some citizens actively and rationally adjust, in a calculated way, to living at the expense of taxpayers' money. We may say that they acquire subjectively felt property rights to other citizens' incomes and tax payments. This type of behavior has been observed, in particular, in some countries with a combination of high long-term unemployment and generous social assistance and social security benefits, such as Denmark and the Netherlands. The issue has recently been analyzed empirically by four Dutch sociologists through interviews with people living on social assistance, disability pensions and unemployment benefits in three Dutch cities. They found that about 55 percent of the long-term unemployed in their sample had, effectively, stopped looking for work, and that more than half of these had stopped because they had found "other activities to give meaning to their lives: hobbies, voluntary work, studying, or working in the informal economy". These observations are in line with the assertions by the American sociologist Murray (1984), to the effect that some citizens tend, after a while, to choose quite rationally and actively to live on social benefits.

Changes in habits, norms, attitudes and ethics are perhaps particularly likely to occur when a new generation that forms its values on the basis of a new incentive system, enters working life. Immigrants who have entered a country partly because of the generous benefits may also be relatively quick to utilize the existing benefit system.

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9 Moffitt (1983, p. 1032) reaches, in a regression analysis, the conclusion that the distaste for living on social assistance ("welfare") rises with age.
It is a commonplace that adjustments of individual behavior to welfare-state policies depend not only on the generosity of the benefit levels but also on the conditions for receiving benefits and the administrative controls of the beneficiaries. It is therefore useful for the government, from a normative point of view, to strive for an optimum combination of incentives and controls: the tighter the controls, the more generous the levels of benefits that are possible without serious problems of moral hazard and cheating, cf. Lantto (1991). Similarly, if moral commitments slacken among beneficiaries and potential beneficiaries, an optimum policy response is a combination of stronger economic incentives and stricter controls (sanctions) if the same level of compliant behavior is to be sustained.

An example is unemployment benefits, where not only the duration but also the strictness of work requirements seem to be important for how the behavior of the unemployed (Layard, Nickel and Jackman, 1991). Another example is subsidized disability (early retirement) pensions, which have "exploded" in some countries, such as in the Netherlands (12 percent of the population of working age in 1993) and Sweden (8 percent in 1993), in connection with improved benefits and less strict control. A further example is support to single mothers. It is unavoidable that such support is an implicit subsidy to births "out of wedlock", divorce, runaway fathers, and separate living quarters for unmarried couples. A combination of work or training requirements for the beneficiaries, the provision of child care, controls of the single status and strict enforcement of the economic obligations of the biological fathers are often believed to reduce the risk of generating long-term benefit dependency and a related pacification of the women concerned. A comparison between the Nordic

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10 In some suburbs of Stockholm, more than 50 percent of the immigrants from certain countries lived on social transfers of different types in 1994.
countries, where such requirements and complementary services are common, and the US, where unconditioned cash support dominates, is suggestive from this point of view; it would seem that such dependency among single mothers is less prevalent in the former countries than in the United States. But the basic dilemma that generous support to single mothers tends to expand their numbers cannot be avoided, even with the "Nordic model".

Controls are, however, often difficult to administrate strictly over long periods of time. For instance, public-sector administrators may, after some time, find that it is unpleasant to be harsh toward single mothers; similarly, physicians may hesitate to be strict with people who ask for a disability pension (early retirement) because of asserted physical or psychological health problems. After all, the costs to public-sector administrators and physicians themselves of being "humane", i.e., generous with taxpayers' money, are very small. Indeed, some physicians may even make a living out of writing "humane" testimonies to the effect that individuals are disabled.

Similar types of humane instincts may make it difficult for public-sector administrators to cut off unemployment benefits if unemployed workers refuse to take offered jobs. It is particularly tempting for individual administrators to become more lenient if they find out that other administrators have become more lenient -- again an example of the importance of a "critical mass". Thus, endogenous changes in habits, social norms, attitudes and ethics may develop over time in response to welfare-state policies not only among potential beneficiaries but also among the administrators of the systems.

Moreover, after a major macroeconomic shock that has shifted large groups of citizens onto various safety nets, there may simply not be enough administrative resources for efficient control. Administrators may find it particularly unpleasant to be harsh when there are very few jobs around. And with less efficient controls, it becomes even more tempting to exploit and abuse the systems, etc. This is another example of potentially important interaction
between the behavior of beneficiaries and administrators. Benefit systems that function reasonably well under prolonged periods of full employment may go out of control if a macroeconomic shock reduces labor demand substantially.

It is tempting to analyze mechanisms like these in terms of models with multiple equilibria -- one equilibrium with tight social norms, strict administrative control and few beneficiaries, another with weak social norms, lax administrative control and many beneficiaries. Indeed, a formal analysis of the unemployment benefit system along these lines -- though without concern for social norms -- has been pursued by Ljungquist and Sargent (1994). Moreover, Akerlof (1980, p. 756) has studied a model, which he applies to the unemployment issue, with two equilibria, one where almost everybody adheres to social customs about wage setting, another where almost nobody does.

An alternative representation is to describe the problem as one of *vicious circles*. Such a description would emphasize that the number of beneficiaries tends to increase not only because of exogenous shocks, but also *endogenously* by way of gradual changes in habits, norms and controls when people find out that others have changed their behavior. The ensuing fall in the tax bases also forces the government to increase tax rates which tends to reduce the tax base even further, and so on. Indeed, there may be no limit to such development (i.e., no stable equilibrium) until a crisis situation forces the government to stiffen the welfare-state rules.

A model where, because of habits and norms, disincentive effects only gradually influence the national economy, until a sudden shock abruptly "activates" the disincentives, is very similar to models in modern ecology about "natural disasters": pollution only very gradually damages the ecological system, until a sudden major disturbance (such as a meteorological shock), abruptly shifts the system into a new and strongly inferior state.

This discussion raises somewhat of a welfare-state paradox. The welfare state has partly been motivated as a way of shielding the individual from the
consequences of macroeconomic shocks, while it is asserted that private insurance systems cannot do this. It is, however, possible that exactly such shocks may undermine the welfare state itself by pushing large fractions of the labor force onto various safety nets for prolonged periods and by undermining the financial position of the government.

It may, later on, take considerable time to restore previous habits and social norms by way of a combination of considerably reduced benefit levels and tightened controls. Thus, because of irreversibilities of habits and norms, it may be necessary to be much more hash toward citizens -- by way of much lower benefits and stricter control -- than if the benefits had been less generous to begin with.

More generally, while a generous welfare state presupposes a national economy with high productivity and a large fraction of the population at work in the market system, forces may emerge in advanced welfare states that undermine both these prerequisites -- either endogenously or as a result of exogenous shocks, or a combination of both. Neither politicians nor economists, or other social scientists, seem to have been much aware of such long-term dynamic adjustments.

This neglect is also apparent in many contemporary suggestions for welfare-state reform. An example is the popularity among economists of the idea to replace means-tested benefits with a "negative income tax", i.e., a combination of a fixed (unconditional) cash grant to everybody and an income tax rate. In spite of the elegance of such a system, as well as of its administrative simplicity, it has serious flaws just because it neglects the possibility of long-term adjustments in habits, norms, attitudes and ethics. In particular, people with high preferences for leisure would be systematically subsidized by a negative income-tax system, as there would be no discretionary examination of individuals. Citizens who originally do not belong to this category may also acquire such tastes and habits after a while; the social norms against such
behavior may also be eroded. This is perhaps particularly likely for new
generations entering adult life. There is, therefore, a risk that a negative income
tax will, over time, create a large group of "drifters," who abstain from work in
the official labor market -- living instead permanently on grants from the
government, possibly combined with occasional incomes from underground work
and, in some cases, also criminal activities.

It may be retorted that similar incentive problems arise in the case of
means-tested income support, i.e., social assistance. An important difference,
though, is that in the case of a negative income tax it is, in principle, impossible
to prevent able-bodied beneficiaries from abstaining from work, while this is
possible, at least to some extent, in the case of means-tested systems by way of
work requirements, so-called "workfare".

There may also arise more subtle, though rather speculative, long-term
consequences of welfare-state policies. The egalitarian views that lie behind
much of welfare-state policies may feed back on, and strengthen, egalitarianism
itself. Important social norms about acceptable income differences may, then,
change. One reason is that the political discussion in highly egalitarian welfare
states tends to center on distributional issues: "who gains, who loses?" This may
generate such a concentration on distributional issues in the public debate, not
least in the mass media, that the tolerance for income differences gradually falls,
and that social and political conflicts, as a result, will rise in parallel with an
equalization of disposable income. We may also speculate that the "respect" for
the existing distributions of income falls when it becomes clear that this
distribution is, to a considerable extent, determined by "arbitrary" political
decisions rather than by "anonymous" market forces. It may also be
hypothesized that the more equal the distribution of income, and the more
individuals will as a result have incomes in the neighborhood of that of a given
individual, the more natural it will be for the individual to compare his income
with those of other citizens. All this would mean that the earlier hypothesized
tendency for distributional conflicts to diminish by greater equality of disposable income may not be a monotone relation. If the equalization of the distribution of income has reached a certain state, the demand for further redistribution may rise rather than fall.

IV. Saving, asset choice and entrepreneurship

We would expect that habits, social norms, attitudes and ethics are important also for saving behavior. For instance, households have, at least until recently, "learnt" that it is proper to save. For instance, people probably save not only to be able to consume in the future, but also to avoid being dependent on their children or the government. Private wealth also contributes to the individual's reputation (status) in society. Among many citizens it has probably also been regarded as improper to incur debt, except perhaps in connection with holding real estate; indeed, "reluctance to being in debt" seems to be, or at least has been, a strongly held attitude among households, probably strengthened by social norms.11

It may, for these reasons, take considerable time before household saving reacts fully to higher marginal capital-income tax rates and improved social security benefits. For instance, it seems that households only gradually gave up their reluctance to being in debt during the post-World War II period, in spite of the fact that real after-tax interest rates (at least ex post) were often negative, and that the government provided more and more elaborate systems of social security and social assistance.

It is also likely that the consequences of tax-induced distortions of asset choice -- often accentuated by inflation and various asymmetries in the taxation of different types of assets -- develop only gradually. For instance, it was not

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11 An attempt to integrate such reluctance towards indebtedness with standard microeconomic theory of households is found in Lindbeck (1963, chap. 2).
until the second half of the 1980s that households finally seemed to have adjusted their behavior to the fact that borrowing for the purchases of various types of assets -- including real estate, durable consumer goods and shares -- was highly profitable. At that time, in a number of countries, households were also finally allowed to borrow freely in the wake of the deregulation of capital markets. Ironically, just when households had "learnt" to borrow, real after-tax interest rates increased abruptly in the late 1980s and early 1990s because of tax reforms and lower inflation that were not fully reflected in lower nominal interest rates. It would seem that households adjusted their saving behavior much more rapidly this time to the new economic incentive -- higher real after-tax interest rates -- possibly because of the extraordinary size and abruptness of the real interest shock, and perhaps partly also because of the simultaneous increase in economic uncertainty.12

A more speculative, but potentially important point is that welfare-state egalitarianism may also influence policies towards entrepreneurship, in spite of the fact that the welfare state is concerned with households rather than firms. As entrepreneurs often strive to become affluent, and in some cases also succeed, they may easily come to be regarded as "alien" figures in a highly egalitarian welfare state. This is, I believe, what happened in Sweden in the 1970s -- as reflected, for instance, in the mass media. A more concrete expression of such attitudes is that policies in some highly egalitarian countries tend to favor the plowback of profits at the expense of dividend payments. In some countries with highly egalitarian welfare policies, such as Sweden, the tax burden on small entrepreneurs also became amazingly heavy during the 1970s and 1980s, when all types of tax are considered -- profit tax, payroll tax and sales tax for firms, plus the personal income tax, the wealth tax and the inheritance tax for the owner. Attitudes in society toward entrepreneurs may also have more direct effects on

12 See Lindbeck (1994).
the vitality of entrepreneurship. Entrepreneurship is likely to suffer if entrepreneurs do not feel that they are respected in society. Social norms -- as reflected in the attitudes toward entrepreneurs of politicians, the mass media and the general public -- are perhaps no less important for small entrepreneurs than are the pecuniary rewards on their activities.

We may, with a slight exaggeration, say that there has been a tendency in some countries with highly egalitarian welfare-state policies, Sweden being one example, to opt not only for "capitalism without capitalists", but also for "enterprises without entrepreneurs" -- probably not a very efficient economic system.

V. Difficulties of reform

It is a commonplace that it is important to avoid pushing welfare-state disincentives into "dangerous territory", where disincentive effects seriously damage the national economy and erode the tax base, and hence undermine the economic foundations of the welfare state. In particular, it is important not to build up a welfare-state system on the assumption that private agents do not, over time, change their basic behavior in order to utilize and cheat with the system. It is also important to avoid creating welfare-state systems that get into serious difficulty if the national economy is hit by severe macroeconomic shocks that drastically increase the number of citizens that depend on various benefit systems.

It has also been argued in the paper that habits and social norms that emphasize socially responsible behavior, or "community values", mould preferences and constrain the effects of a deterioration in economic incentives. But, "hazardous dynamics" in the private sector may emerge over time if a deterioration in the incentive structure subsequently induces changes in the habits and social norms. Conversely habits and social norms emphasizing individual gain at the expense of community values may generate hazardous
effects on the political system. Corruption in government is perhaps the most obvious example.

It is analytically useful to make a sharp distinction between rational responses with given preferences and induced changes in these preferences due to changes in habits and (internalized) social norms. An important task for future research is to explain better just how such changes in habits and norms occur, including the disappearance of the social sanctions (partly internal to the individual) that uphold the norms.

A specific difficulty for welfare-state analysis is that it may take a long time for researchers to discover the existence of serious welfare-state problems, partly because of the earlier discussed delay in the adjustment of basic behavior patterns of private agents. Empirical estimates of the effects of welfare-state policies suffer from a problem similar to that expressed by the Lucas critique of estimated econometric functions. Lucas pointed out that such estimates are contingent on the expectations among private agents of the behavior of politicians. The discussion above suggests that estimates of disincentive effects of contemplated welfare-state reforms are contingent on existing habits, social norms, attitudes and ethics, which may change either gradually or dramatically, subsequently generating "regime shifts" for individual behavior patterns. Indeed, this econometric problem may be much more serious than the one emphasized by the Lucas critique which can, in principle, be met either by explicitly introducing government behavior functions or by estimating so-called "deep structures" such as preferences and production functions. It is difficult to design analytical procedures that solve the estimation problems in connection with welfare-state policies due to changes in habits on social norms.

Ideological beliefs, which are mixtures of values and views of the world, also tend to block, or at least delay, the realization among people that incentive problems do exist. Information that indicates such effects is often neglected among adherents of existing welfare-state systems, while information pointing in
the opposite direction is often accepted. Welfare-state sceptics tend to screen information in the opposite direction. Psychological research on "cognitive dissonance" gives strong support for the existence of this type of screening behavior; see e.g. Aronson (1979), Hirschman (1965) and Akerlof and Dickens (1982).

Long-term changes in habits, norms, attitudes and ethics among beneficiaries presumably contribute also to the difficulties in reforming or rewinding a welfare state that is believed to have "overshot" reasonable limits. For instance, the subjectively experienced utility loss when a benefit is removed may be much greater than the "utility loss" of never having received it in the first place -- a hypothesis that is consistent with Tversky and Kahneman's "prospect theory" (1981), according to which the utility function is steeper to the left of the initial point than to the right of it. Alternatively, we may hypothesize that preferences are endogenous in the sense that the aspiration level of individuals increases by previous achievements -- an application of the psychological theory of "the rising aspiration level" (Lewin, 1944)\textsuperscript{13}. Applying this theory to welfare-state benefits may explain why individuals seem to develop social norms in the form of subjectively felt "property rights" in existing benefits, i.e., in other peoples' incomes and tax payments, which means that it is regarded as "natural" to be financed by the government.

\textsuperscript{13} Katona (1951) has applied this theory to different types of economic behavior, though without any attempt to integrate the analysis with traditional microeconomic theory of households. Such an attempt is, however, made in Lindbeck (1963, chap. 2) for the case of wealth accumulation.
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