

# Economics and ethics of a Welfare State

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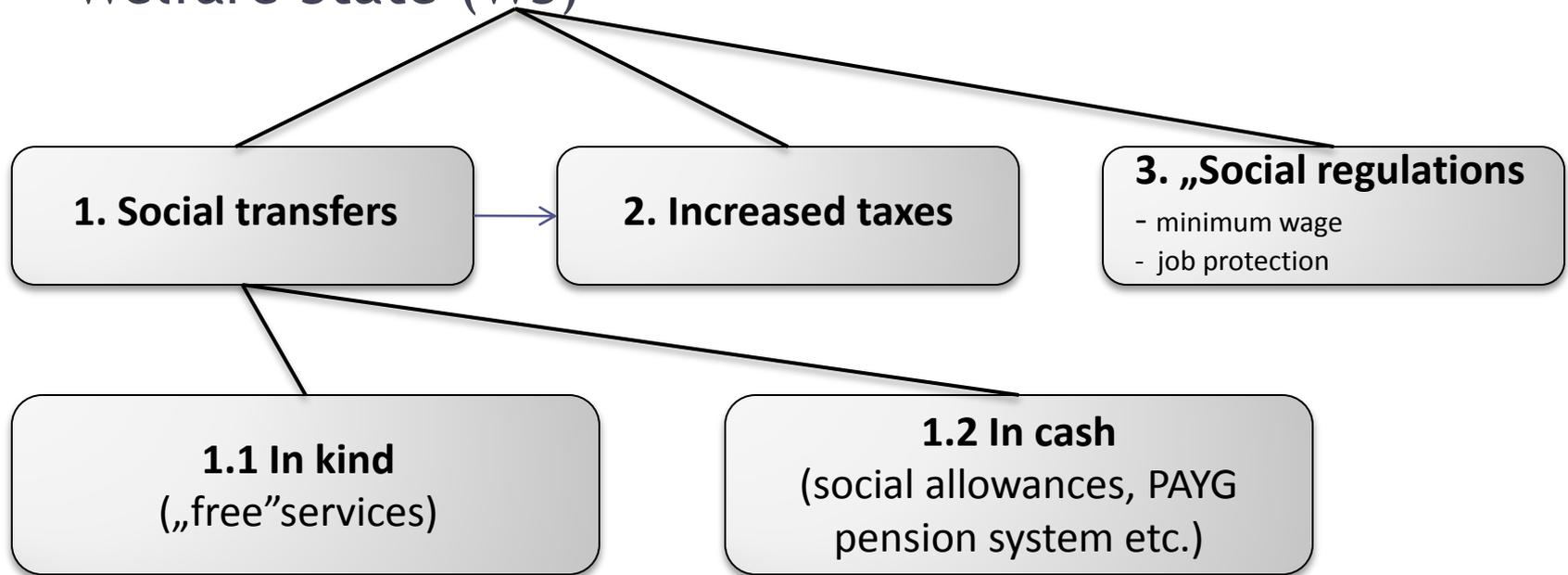
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# I. The Welfare System

- The welfare systems: **transfers and regulations related to the existence of certain risks to the individuals.**
- Five types of welfare systems:
  1. Family (kin)-based
  2. Civil society-based
  3. Welfare state
  4. Company-based
  5. Individual (market)-based
- Some of the above systems can be combined in various proportions, e.g. 1 and 3; 2 and 5. However, the expansion of the welfare state tends to crowd out other welfare systems, especially 1, 2, and 5 (see later).
- Each society has a certain welfare system, being a combination of the above types. The lack of welfare state does not mean a lack of a welfare system.

## II. Components and types of the Welfare State (WS)



Transfers are sometimes replaced by tax preferences.

- The WS should be defined by these mechanisms and not by official goals in order to avoid “magic thinking” and not to confuse declarations and reality

There are many actual or potential combinations of these mechanisms, i.e. many variants of the WS. They differ:

- in size (as measured by transfers / GDP ratio, an index of “social” regulations);
- in structure, e.g. replacement ratios, eligibility criteria (means tested, asset tested, universal) , types and relative size of various transfers.

Some dimensions of structure determine the size of the WS, e.g. high replacement ratios, easy access to social benefits, high share of PAYG pensions and publicly funded health services - produce large WS.

There is no uniform Welfare State.

# Welfare State typologies

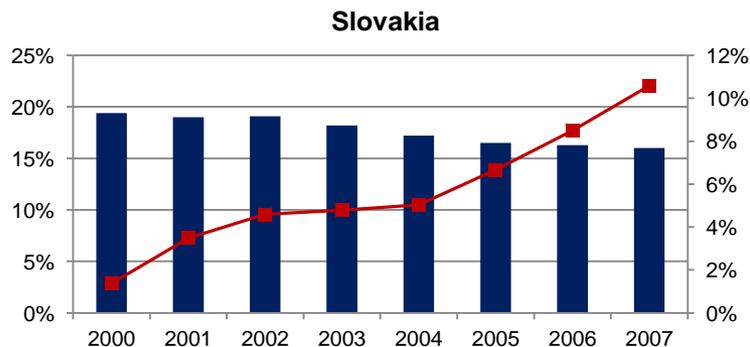
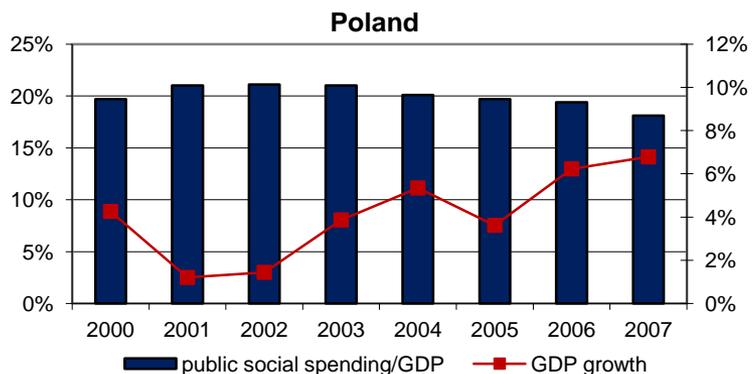
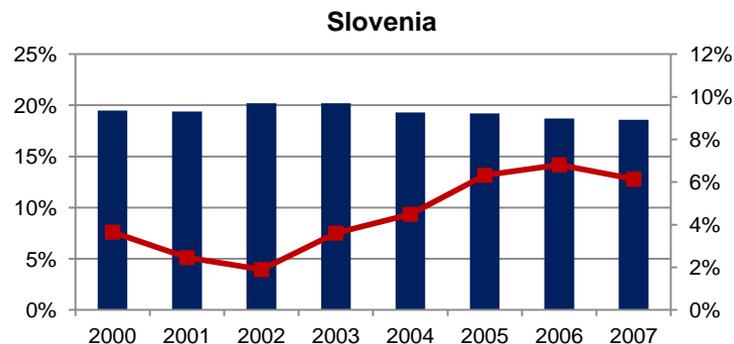
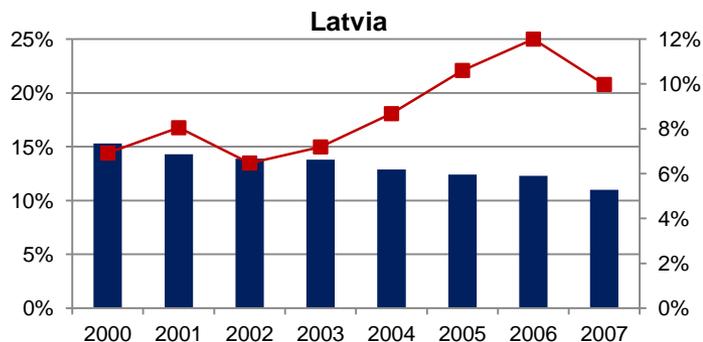
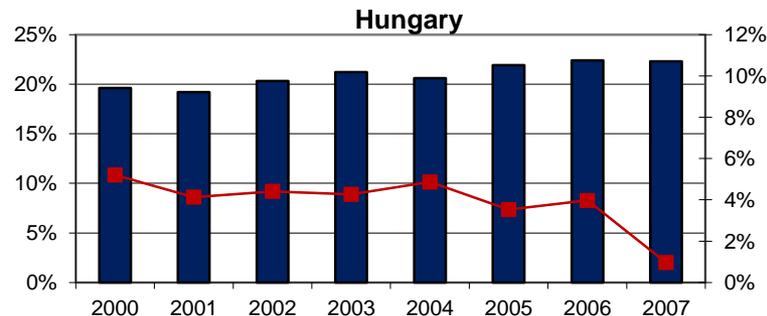
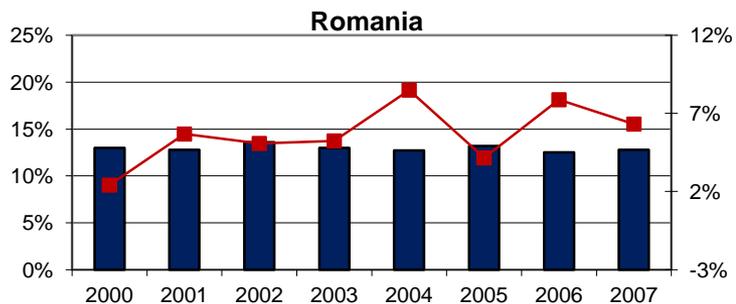
There are many typologies of the WS.

Author	Classification	Criteria
Esping-Andersen	<b>Liberal</b> (e.g. USA, UK, Australia) <b>Conservative</b> (e.g. Germany, France, Japan) <b>Social-democratic</b> (e.g. Norway, Sweden, Belgium)	<b>Level and availability of benefits (<i>decommodification</i>)</b> <b>Level of redistribution (<i>stratification</i>)</b>
Ferrera	<b>Anglo-Saxon</b> (e.g. US, UK, Australia) <b>Bismarck</b> (e.g. Germany, Austria) <b>Scandinavian</b> (e.g. Sweden, Norway) <b>Southern-European</b> (e.g. Spain, Greece, France)	<b>The rules of access to benefits</b> <b>Conditions of granting transfers</b> <b>Regulations to finance social protection</b> <b>Organization and management of social security administration</b>
Castles and Mitchell	<b>Liberal</b> (e.g. USA, Ireland, Japan) <b>Conservative</b> (e.g. West-Germany, Italy) <b>Non-Right Hegemony</b> (e.g. Sweden, Norway) <b>Radical</b> (e.g. Australia, UK)	<b>Level of welfare expenditures</b> <b>Income and profit taxes/GDP</b> <b>Average benefit equality</b>
Korpi and Palme	<b>Basic Security</b> (e.g. USA, UK, Canada) <b>Corporatist</b> (e.g. Germany, France, Italy) <b>Encompassing</b> (e.g. Sweden, Norway) <b>Targeted</b> (Australia)	<b>Basis of entitlements</b> <b>Methods of determining benefits level</b> <b>Governance of social insurance programmes</b>
Bonoli (only European WS)	<b>British</b> (UK, Ireland) <b>Continental</b> (e.g. Germany, France) <b>Nordic</b> (e.g. Sweden, Norway) <b>Southern</b> (e.g. Italy, Spain, Greece)	<b>Extensiveness of WS</b> (social spending/GDP) <b>Financing</b> (% of social expenditures financed by contributions)

Source: Pierson, Ch., et al. (2006.), *The welfare state reader*, Fenger, H. (2007), Welfare regimes in Central and Eastern Europe: Incorporating post-communist countries in a welfare regime typology.

# There are various models of the WS in the postsocialist world

## Public social expenditures (as % of GDP) and GDP growth



■ public social spending/GDP    ■ GDP growth

## The Welfare State in the Third World: huge gap between ideology and practise...

- “... while governments devote about one third of their budgets to health and education, they spend very little of it on poor people (...) Public spending on health and education is typically enjoyed by the non-poor” (World Bank Development Report, 2004, p.3)
- In poor, African countries (Ghana, Malawi, Guinea, Cote d'Ivoire) the richest quantile of the population had far bigger share in public spending on education and health than the poorest one (Casro-Leal, F., et. al., 1999 )
- In some countries public transfers in kind are paid for but not provided. e.g. in Bangladesh the absentee rate among doctors in primary health care was founded to be 74% (ibidem, p. 4-5)
- Transfers tend to be regressive:
  - In Mexico the National Solidarity Program was launched at the cost of 1.2% GDP in 1989. After six years it turned out that the reduction of poverty was only 3% among the poor. If the funds were distributed equally among the poor and the rich, the reduction of the poverty would be 13%.
  - In India huge inequality of education measured by years of schooling (Gini index in rural areas in 2002 was 63 (out of 100) vs. 13 in the US). (P. Bardhan, WSJ, 8th August 2006, p.9)

# The Welfare State in the Third World:

- Welfare State creates disincentives to work:
  - In South African extended families, reaching retirement age by older member of the family causes a sharp drop in the working hours of younger individuals. (Bertrand, M., et.al, 2003)
  - In Chile, the unemployment benefits financed by solidarity fund proved to create a „moral hazard” problem. „... the job finding rate is lower at the beginning of the unemployment spell (reflecting the „waiting” effect moral hazard), the effects in place over the period of potential receipt of benefit...”. (Hartley, G.R., et. al., 2010).
- There are also some good practices:
  - In Brazil, a conditional social programme, Bolsa Familia significantly contributed to the reduction of poverty. Since 2003, „the number of Brazilians with incomes below 800 reais (\$440) a month has fallen more than 8% every year”. Bolsa Familia contributed to 1/6 of this reduction, even though the benefits in the programme are small (its expenditures amounted to 0,5 percent of GDP) (The Economist, July 2010).
  - Some social assistance programmes are designed to create incentives for poor parents to send their children to school. In South Africa, Child Support Grant receipt lead to reduction of the „probability that school-aged child is not attending school by over half” (Vincent, K., Tully, C., 2009).

### III. The growth of the Welfare State:

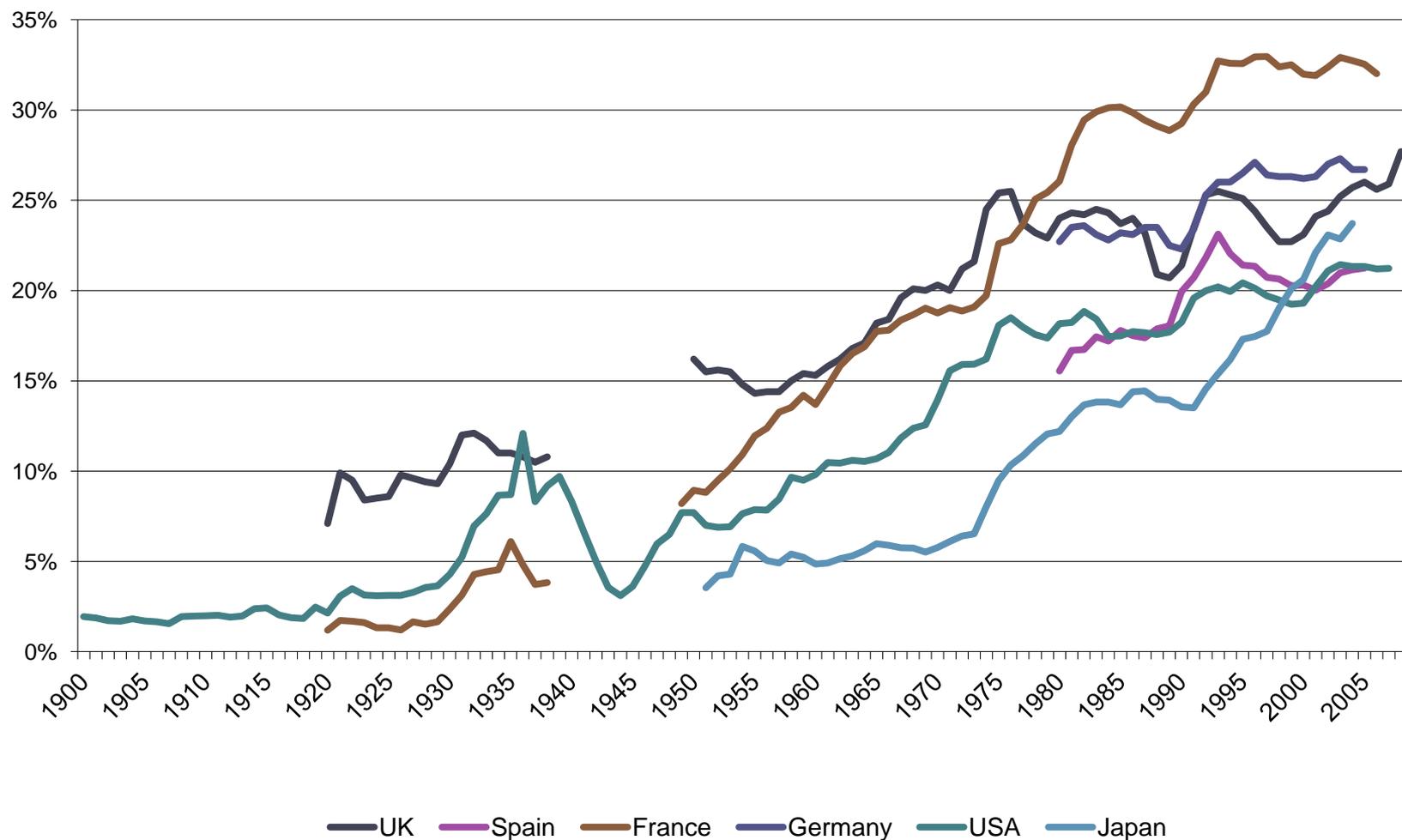
- Before the Welfare State in 19th century: families, communities, churches, voluntary mutual aid associations (e.g. friendly societies in Britain), philanthropy. Expansion of these non-state forms in 19th century. Public spending was at the level below or around 10% of GDP. There were many poor people. Why? Because of the lack of the WS or because capitalism was only in its beginnings?
- The beginnings of the WS are usually linked to the reforms of Bismarck (1889). During his time the life expectancy was so short that the system was not costly. The accumulated contributions during 1889-1899 were sufficient to finance pensions during the next 17 years (Sinn, H.W., 1996)
- The WS expanded after WW II, especially during 1960's and 1970's.

## *Public and mandatory private transfers in kind and in cash(% of GDP)*

<b>Country</b>	<b>1960</b>	<b>Maximum year</b>	<b>2005</b>
<b>Austria</b>	15,9%	28,4% (2003)	28,1%
<b>Australia</b>	7,4%	18,6% (2000)	17,1%
<b>Belgium</b>	13,1%	26,6% (2004)	26,4%
<b>Canada</b>	9,1%	19,6% (1995)	16,5%
<b>Czech Republic</b>	16,4% (1990)	21,0% (2002)	19,7%
<b>Denmark</b>	12,3%	29,4% (1995)	27,3%
<b>Finland</b>	8,8%	30,9% (1995)	26,1%
<b>France</b>	13,4%	29,5% (2005)	29,5%
<b>Germany</b>	18,1%	27,5% (1995)	26,7%
<b>Greece</b>	9,3%	20,5% (2005)	20,5%
<b>Ireland</b>	8,7%	21,3% (1985)	16,7%
<b>Italy</b>	13,1%	26,5% (2005)	26,5%
<b>Japan</b>	4,1%	18,6% (2005)	18,6%
<b>Netherlands</b>	11,7%	29,6% (1975)	20,9%
<b>New Zealand</b>	10,4%	21,9% (1990)	18,5%
<b>Poland</b>	14,9% (1990)	22,6% (1995)	21,0%
<b>Slovakia</b>	18,9% (1990)	18,9% (1990)	16,8%
<b>Sweden</b>	10,8%	33,0% (1995)	29,4%
<b>Switzerland</b>	4,9%	26,4% (2001)	20,3%
<b>UK</b>	10,2%	23,0% (1995)	21,3%
<b>USA</b>	7,3%	16,2% (2003)	15,9%

Source: OECD

# Transfers in-cash and in-kind as % of GDP

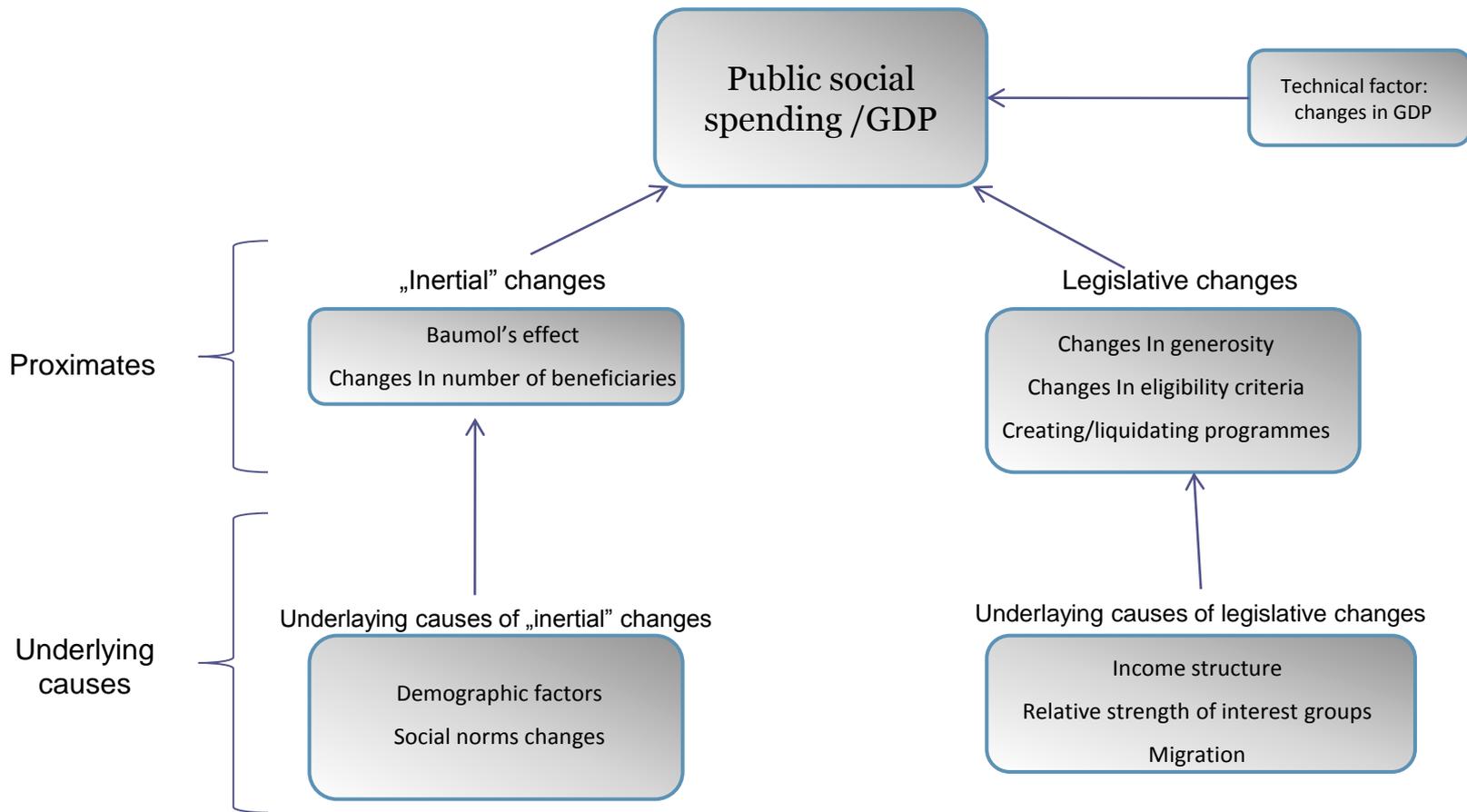


Source: Data collected by Jarosław Kantorowicz, Joanna Lednicka, Magda Ciżkowicz, Marta Gwizdowska, Piotr Pękała, Seweryn Szawrocki, Wiktor Rak.

## The Driving Forces of the WS: some popular hypotheses

- Growth of poverty? No, an acceleration of the growth of the WS occurred during periods of rapid economic growth.
- Rapid economic growth increased social support for increased social spending? (Benjamin Friedman) It appears to be a one-sided explanation.
- Market failures (of insurance market)? No,
  - Why should market failures grow? The opposite should be true.
  - It disregards the non-state mechanisms of individuals' savings, mutual aid and social assistance.

# Determinants of WS dynamics



## The expansion of the Welfare State resulted from the combination of the following main factors:

- political competition for the support of various sections of the population, both in democracies and non-democracies,
- very good situation in the world economy in 1950-75,
- a favorable demographic situation in the DC during this period,
- a strong ideological pressures and the related ideological and interest groups,
- asymmetry: it is easier to increase social spending than to reduce it.

# Differences in the expansionary forces

- **US versus Europe**

- 60% of Americans think that the poor are “lazy” while only 26% of European think that. On the contrary, 60% of Europeans think that the poor are trapped by the system (...) while only 30% of Americans think that way (the World Value Survey)

- Greater income mobility: „71 percent of Americans, but only 40 percent of Europeans, believe that the poor have a chance to escape from poverty” (the World Value Survey)

- Type of electoral system- the more proportional, the bigger transfers (Alesina, A., et. al., 2001)

- Racial fragmentarisation (Alesina, A., et.al., 2001)

- Stronger impact of Marxism in Europe (Alesina, A. )

- **Asian Tigers versus e.g. Brasil**

- In Latin America, Welfare States were created in a response to growing political power of workers and their organisations, whereas in East Asia labor was perceived as contender for power and therefore repressed (Haggard, S., Kaufman, R., 2004)

- **Reasons for the different dynamics of the WS:**

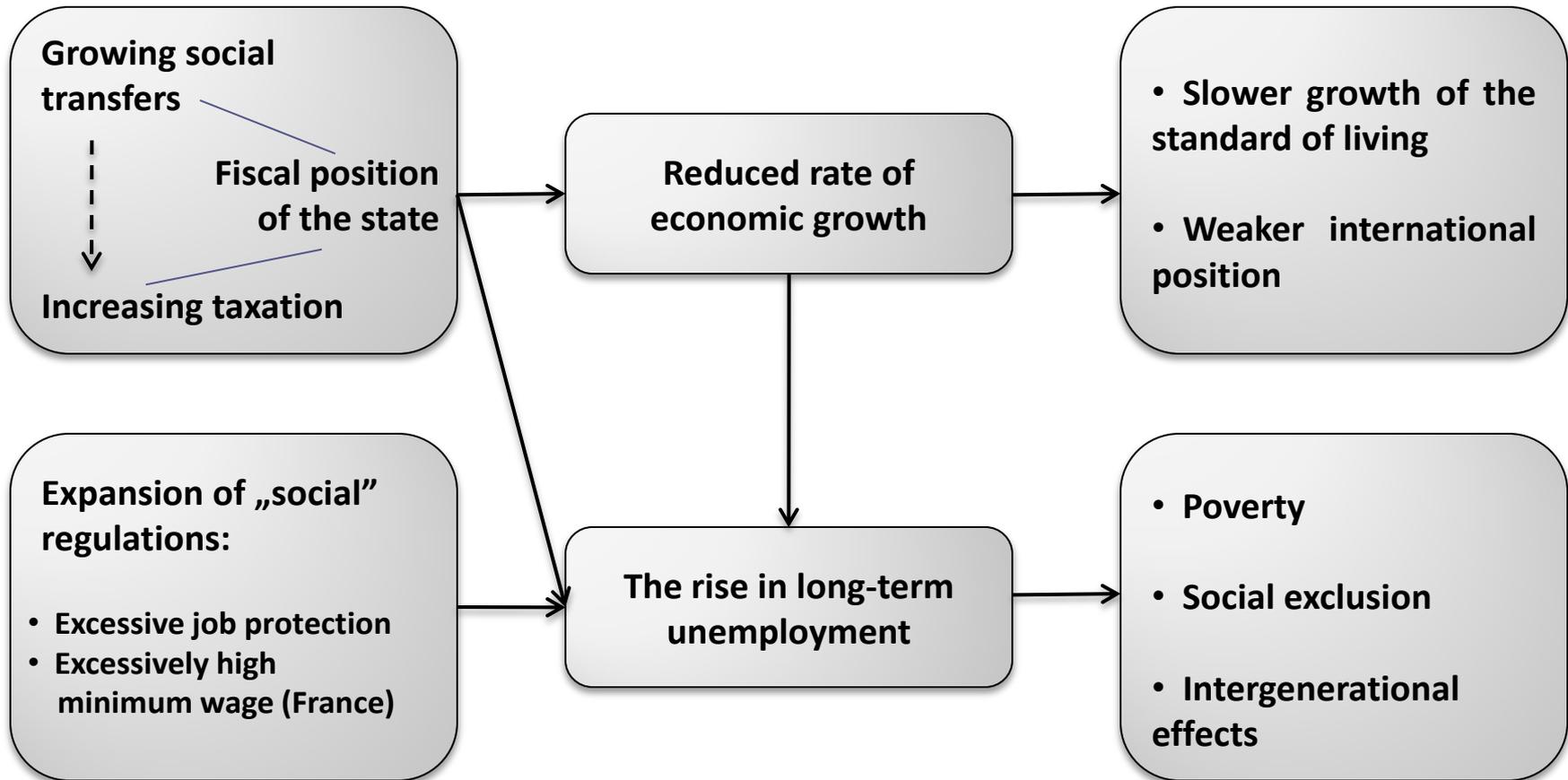
- differences in ideological beliefs, related - to some extent – to differences in social mobility
- differences in structure and strength of interests groups
- differences in economic shocks (dramatic vs. creeping)
- elements of path dependence e.g. large PAYG pension system – large transition costs

## IV. The effects of the Welfare State

$$E_{ws} = E(WS; E)$$

- As the WS is a complex institutional variable, the effects depend on the state of this variable i.e. the size and structure of the WS. Remember the structure influences the size.
- Effects also depend on the environment, in which the WS operates e.g. the Danish model transferred into the US would produce much higher unemployment than in Denmark because of faster growth of labour supply in the US. Models should be compared for the same conditions.
- Four mechanisms related to badly structured WS:
  - 1) distorting the individual's incentives and, as a result, behavior (e.g. propensity to work, to search for a job, to save);
  - 2) the distorted behavior leads to a reduction in the capacity to work (hysteresis);
  - 3) massively distorted behavior - change in the social norms (e.g. the work ethics, the cohesion of the family); (Lindbeck, A., 2003)
  - 4) the expansion of the WS crowds out actual or potential forms of non-state social assistance and of mutual aid (see later).
- As a result of crowding out, larger WS are accompanied by smaller doses of non-state mechanisms (both of market and of non-market type) than smaller WS. Effects of larger WS include these displacement effects.

# The analytical scheme



# Other consequences of some Welfare States

- **Increasing inequalities**

- 1) The victims of the average high structural unemployment are young people and women (OECD).
- 2) Strong job protection produces the division into privileged “insiders” and discriminated “outsiders”; dual labour market.
- 3) Social transfers in many countries, especially of the Third World, are regressive.

- **The misuse of social transfers**

- Sweden: sickness benefits:  
1955: 12 days/person/year  
2001: 32 days/person/year
- Germany - “Sozialbetrug”

- **Strong tax progression**

- Weakening the incentives to work more.
- Stimulating the growth of the second economy and/or weakening the division of work in society (expensive services).

# Expansion of the Welfare State has crowded out the actual or potential forms of non-state social assistance and mutual aid

- **Britain**

- friendly societies (mutual aid associations)
  - 1877: 2.8 million members
  - 1897: 4.8 million members
  - 1910: 6.6 million members
- strong crowding out since 1948 (Green, P., 1988)
- spending on education
  - 1833: 1% national income
  - 1920: 0.7% national income (West, E., 1991)

- **The US**

- the reduction in public social spending at the end of 19th century has been accompanied by the increase in the non-state arrangements.
- 1 percentage increase in per capita federal social spending on education, health care and public assistance in years 1950-1970, led to reduction of private charitable contributions by 0,28 percent (Roberts, R.D. , 1984).
- public assistance transfers, unemployment insurance benefits, workers compensation payments, as well as social insurance benefits crowd out private interhousehold transfers of money and time (Lam, D., Schoeni, R., 1993).

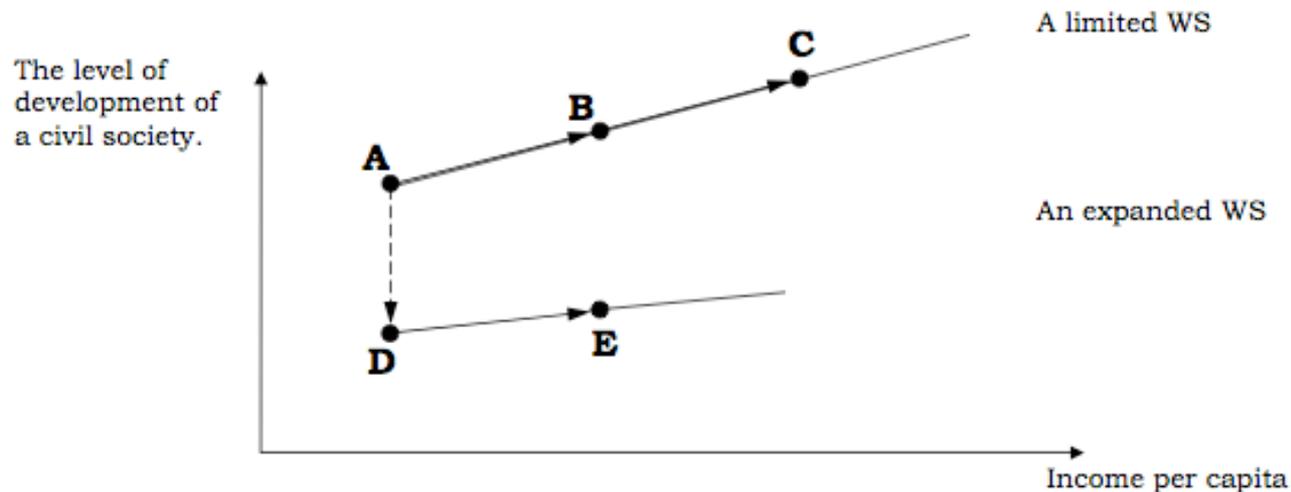
## •Developing countries

- Expansion of state-financed social insurance crowds out traditional and modern non-state mechanisms: “Competition by the government in providing social transfers may drive out private institutional arrangements (...) which can be targeted more effectively to the poor than more arm’s length (public) social assistance” (World Bank, 2001)
- Introduction of new programme of public assistance in Mexico in 1997 resulted in a decline of transfers from private risk sharing arrangements by 3-10 percent (Pavan, M., Colussi, A., 2008)
- In Ethiopian rural areas public food aid programme has crowded out risk sharing mechanisms (Dercon, S., Pramila, K., 2002).
- The simulation of the effect of public social transfers on non-state financial support showed, that liquidating public social insurance system would lead to 20 percent increase in private transfers to elderly.

# The main mechanisms of crowding out

- “Free” (tax financed) services - the decline of demand for the services of actual and potential private schools, hospitals etc.
- Transfers in cash:
  - decline of voluntary precautionary savings (market type solutions)
  - decline of voluntary mutual aid associations (non market type solutions, civil society).

**In an extreme case the expansion of the Welfare State crowds out a large part of a civil society and transfers the society into a clientele of the social state.**



## V. Reforms (constraining) of the Welfare State

- **Main directions:**

1. limiting the social expenditures in order to reduce the budgetary pressures,
2. reforming of the spending schemes so as to reduce the perverse incentive,
3. liberalization of the labour market.

- Reforms are usually undertaken because of:

- growing budgetary problems
- forecasted deficits of PAYG pension systems
- high structural unemployment
- misuse of social transfers.

- Additional reasons:

- immigration and emigration
- decreasing social support for some types of transfers (eg. benefits for single mothers in USA)

# Examples of WS retrenchment

- In the United Kingdom efforts to reduce social expenditures were undertaken already in 1980s. One of the examples was sharp reduction in the income replacement provided by public unemployment insurance, as well as stricter eligibility criteria for this kind of benefits. (Pierson, P, 1996).
- In 1998 Sweden introduced a major pension reform. One of the main goals of the reform was to ensure the financial sustainability of the pension system. In order to achieve it, government introduced number of changes: second, fully-funded pillar of the system was created; it was changed from defined benefit to mainly defined contribution system; flexible retirement age was introduced; if the financial stability of the system was threatened, the indexing of the benefits can be reduced or abandoned. (Sunden, A., 1998).
- Additionally, since 1990, a series of piecemeal changes resulting in reduction of replacement rate of sick pay, parental leave and unemployment insurance from 90 to 80 percent have been implemented. (Clayton, R., Pontusson, J., 1998).
- In 1999 Danish parliament passed the law aimed at limiting spendings on disability pensions. According to this regulation, benefits can only be received until the age of 65 (not 67 as earlier). Furthermore the means-testing procedure includes the income from capital pensions. Finally, to be eligible for the pension, individual has to pay a voluntary (and significant) contribution for a period of 25 years. (Green-Pedersen, Ch., 2001)
- In the USA, the family support programme called Aid to Families with Dependent Child was replaced in 1996 by Temporary Assistance for Needy Families: the benefits in this programme are granted only for the limited time and the eligibility criteria are stricter than in case of its predecessor

## VI. Ethical aspects of a badly structured and overgrown Welfare State

- Ethical judgments should not be based on declared intentions but on actual results, and these are:
  - long term unemployment;
  - crowding out of genuine solidarity;
  - violating the subsidiary principle;
  - eroding the work ethics;
  - turning the individuals into clients of the state.
- A badly structured and overgrown welfare state fails not only from the economic but also moral point of view.

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