Is The Welfare State in Trouble?*

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There are many different kinds of economists. Some try to solve well-defined problems, which can be expressed in terms of a few "economic" variables, and for which formalized models serve as excellent tools of analysis, or "flashlights." Metaphorically speaking, these are the economists you find standing under the lamp-plies digging where the flashlight happens to be the strongest. Then you have another group of economists who walk around as observers in the dark between the lamp-plies, often without much analytical equipment, trying to get a feeling for the broad contours of the overall landscape. For keen observers of everyday life, with powerful intuition, the latter, more impressionistic strategy may give quite as profound contributions to our knowledge as does analysis by way of formal models. In other words, what cannot be discovered by formal analysis may still exist, and even be important.

A third group of economists try to be in both camps—sometimes digging under the lamp-plies, sometimes searching out there in the dark. A rationale for this "mixed" research strategy is that formal analysis has much to gain, in terms of relevance, on interaction with casual observation and informal reasoning; conversely, the latter activities can minimize the risks of logical conclusion and undisciplined "ad-hocery" by being forced to continuous confrontation with formal model building and rigorous statistical tests. A main risk, though, for economists who try to pursue this mixed strategy is, of course, that they may never develop very strong comparative advantage, and that they may often also rank fairly low in terms of absolute advantage in both fields—if they do not work twice as hard as economists who specialize more.

However, when we try to deal with large and complex issues, such as the troubles and limits of the welfare state, it is necessary to take this risk and hence try to combine both strategies. Anyway, that is what I will do here. This means, of course, that experience, creative thinking, common sense and judgement become quite as important as formal analysis. In fact, conclusions concerning complex issues have to be judgmental, in the sense of relying on the balancing of all evidence that is relevant for a certain issue, rather than, as in some natural sciences; being reached once-and-for-all by way of a logical deduction, a few statistical tests or some laboratory experiments.

Against the background of these methodological considerations, let us turn to the troubles of the modern welfare state. The term "welfare state" I then reserve for the collection of publicly organized social-security systems, transfers and subsidies, and the public provision or subsidization of personal services such as health, education, old-age care and child care.

Achievements of the Welfare State

However, before turning to the question whether the welfare state is in trouble, it is important to record some of its main achievements. Maybe it is useful to classify these into four categories:

1. One important achievement is certainly to have mitigated, or even removed, destitution among people with extremely low lifetime (wealth). It is obvious that the elaborate welfare state systems in the most "advanced" welfare states of Western Europe have been much more successful in this endeavor than has been the less elaborate, but hardly less complex, welfare
state system in the US. We can see this by, for instance, comparing statistics on poverty, infant mortality and child mortality, where the achievements in US, as we know, ranks very low considering the high per capita income of that country. Indeed, you don’t have to look at statistics to discover poverty in the US; it is enough to walk the streets and follow the mass media.

(2) A second, and related achievement of some of the most advanced welfare states is to have evened out (lifetime) wealth among households in general—not only ex post, which occurs automatically in all insurance systems, but also ex ante. Progressive taxation, income-dependent transfers and the wealth-redistribution elements of the social security systems are important components behind these results. Of course, it is a question about subjective values whether this should be regarded as a positive or negative contribution.

(3) A third achievement of the modern welfare state has been to raise productivity in the national economy by inducing investment in human capital, in particular by the subsidization of schooling and health care, for which at least until recently the social return seems to have been higher than the return on alternative investments. Moreover, many governments have certainly also been anxious to achieve a more equal distribution among citizens of investments like those than of purchasing power in general, which indeed have turned such services into what Richard Musgrave (1959) has called “merit goods.”

(4) However, for voters in general the most important achievement of the modern Welfare State has probably been to help individuals to reduce economic uncertainty and to even out the time path of consumption over the lifecycle. As this effect probably has occurred in particular for individuals who would not do that by themselves, by way of private saving or private insurance, there is probably a strong element of “paternalistic altruism” behind these policies. The main tool to achieve this has, of course, been social security systems, though progressive income taxes and income-dependent transfers have similar effects to some extent. However, even a majority of citizens may have gained on the introduction of social security systems, as such systems, to some extent, may be regarded as a method of preventing some people from taking “free rides” on the altruism of others. (Lindbeck 1985; Lindbeck and Weibull, 1987).

The four achievements of the modern welfare state discussed here—(1) the mitigation of destitution, (2) the overall equalization of life-time wealth, (3) investment in human capital and (4) the reduction of economic uncertainty and the smoothing of consumption over the life-cycle—indicate that the social and economic achievements of the modern welfare state are both far-reaching and impressive. Indeed, I would go as far as to regard the modern welfare state as a triumph for modern civilization.

However, these major achievements of the modern welfare state have not been brought about without various types of costs to society. When looking at these costs, it is important to realize that these may include not only economic costs, as conventionally defined, but also various types of “non-economic” costs, such as (i) the consequences for the role of the family in society, (ii) negative effects on individual freedom of choice, as well as (iii) regrettable implications for the relations between the individual and the state. However, it is useful to start with the economic costs, as these are the basis also for some of the most important non-economic consequences.

**Economic Costs**

There are two main types of economic costs associated with welfare state policies—administrative costs and “dead-weight costs.” The types of dead-weight costs that have been studied by economists are mainly those associated with the allocative distortions of the choice of hours of work, saving, and the composition of assets. When discussing such costs, it is important to emphasize the many different channels by which they may occur, and hence the pervasive nature of such economic costs, rather than some single cost. It was a strong tendency in the literature of public finance during the 50s and 60s to minimize these costs. However, recent empirical studies for the most advanced welfare states suggest much stronger effects, and indeed quite high economic costs, in particular on the margin. One reason is, of course, that the marginal tax rates in some welfare states are much higher today than they were some twenty or thirty years ago. Moreover, early studies usually looked only at the effects of isolated tax changes, even though it is just the combined increase in public spending and taxation that is the budgetary implications of the build-up of welfare states. In other words, early studies tended to forget that the positive “income effects” on labor supply of higher taxes are mitigated, or in some cases even cancelled, by the negative income effects of the accompanying increases in public spending (Lindbeck, 1982). It is also well-known today that early studies did not treat the progressiveness of the tax system in an analytically satisfactory way, which resulted in an underestimation of the dead-weight costs of higher income taxes. (See for instance Hausman, 1981).

However, there are even more fundamental reasons why “early” studies underestimated, and many contemporary studies still underestimate, the dead-weight costs of welfare state programs, and associated taxation. In particular, many effects are transmitted via collective decisions and institutional adjustments, and not just via individual adjustments, which means that the effects on working hours may be considerably delayed. For instance, the number of working hours are often regulated in collective bargaining agreements or by government regulations, which create obstacles to individual adjustments. However, after some time (which may be one or several decades) when union members and voters discover that high marginal tax rates have made the income loss of reduced working hours small, union leaders will most likely feel pressured to bargain for shorter working hours instead of for higher wages, and politicians will be tempted to legislate shorter working hours, longer vacation and more possibilities for the individual to stay home from work for various reasons.

There is no time here to summarize the vast literature on the “dead-weight” costs of taxes and public spending programs in various countries. However, the best available studies for the most advanced welfare state of all, Sweden, suggest that the distortions of the allocation of labor between the (taxed) market sector and the (untaxed) household sector creates “marginal costs of public funds” as high as S3–7 per additional tax dollar collected in the form of progressive income taxes to finance money transfers to households. (Hansson, 1984). The economic meaning is that increased tax-transfer programs of this type should be implemented only if the spending they finance is regarded as being worth three to seven times more than the income that is taken away from households in the form of tax payments.

It should then be observed that these studies cover only one of the many channels by which the tax system distorts the labor market, namely the reallocation of hours of work between the market sector and the household sector (including leisure), due to taxation. It is likely that the sum of all types of distortions and disincentives in the labor market are much larger, as there is no good reason to assume that various distortions usually cancel, or even offset, one another. For instance, the substitution effects against intensity of work, and against the acquisition of skills, certainly would be expected to add to the efficiency losses that are related to the reallocation of hours of work between the market sector and the household sector.

By contrast, the marginal tax rates in the US, which are typically 30–40 per cent, certainly
create considerably smaller dead-weight costs. Usual estimates of the marginal costs of public funds in the US, due to distortions in the allocation of labor, are around $1.5 (including administration costs). (Browning, 1976; Shoven, 1983.)

In general, we may say that marginal tax rates operate much like tariffs on market transactions, breeding various types of autarchic economic behavior. It is therefore surprising that some economists and politicians, who worry about the dead-weight cost of tariff, and hence pledge against tariff increases, are much less concerned about the often much higher dead-weight cost of taxes. While tariffs often create a distortion of relative prices by at most 10-30 per cent in developed countries today, marginal tax rates of 2/3rds or 3/4ths create relative price distortion between the taxed sector and the non-taxed sector of the economy by 200 percent and 300 percent, respectively. This comparison, is highly relevant, as the type of distortion is the same in both cases. Both tariffs and taxes discriminate in the same way against trade—in the first case in favor of production in the national economy rather than international trade, in the second case in favor of household production (including leisure) and various types of underground economic activities, rather than exchange in the regular market.

Non-economic Problems

(i) The Changing Role of the Household. The dead-weight costs of welfare state programs, and related taxation, may be the most interesting aspects for an economist of the problems of welfare state spending and related taxes. But other aspects probably attract the interest more among the general public. One such aspect concerns the consequences for the role of the family in society, or more specifically, the division of labor between households, markets and government. In particular, while the substitution effect of higher marginal tax rates shift the production of some services from the market to the household sector, for men as well as women, publicly provided services that are close substitutes to household work (and often also to market production), tend to shift away the production of such services from the public to the private sector.

Household members, in particular married women, will then be induced to increase their labor supply in the market, in particular via higher labor force participation rates. Obvious examples, from an early stage of the welfare state, are education and health care. More recent examples are child care and old age care, which in some countries in North Western Europe, in particular in the Scandinavian countries, have largely been taken over by the public sector due to extremely large subsidies to publicly provided day care centers. Generally speaking, while the services that have been shifted from markets to the household, due to high marginal tax rates, largely consists of the maintenance of durable consumer goods, houses, gardens, etc., i.e., "the care of things," the services that are shifted from households and markets to public authorities consist basically "the care of persons."

This means that many households are induced to act contrary to what has traditionally been regarded as "the comparative advantage" of the family, i.e. the care of other family members, in particular the children and the old parents.

(ii) Freedom of choice. This brings us to the issue of the freedom of choice of the individual. It may then be useful to make a distinction between two aspects of freedom of choice. The first aspect is simply the size of the budget set of the individual: the more resources you have, the greater is your freedom of choice, in the sense of the size of your economic option. It is clear that welfare state policies, by redistributing income and wealth, are redistributing also the freedom of choice in this specific sense as well.

An analytically more challenging aspect is, however, changes in the freedom of choice at existing initial wealth, in the sense of the possibilities of individuals to influence their own lives by their own actions. For instance, everybody would probably agree that an individual that is exposed to a marginal tax rate by 100 percent, by being "trapped" into one level of income, has lost his freedom of choice between income and leisure. However the same argument holds, of course, also when the tax rate is 90, 80, 70, or 60 percent, as it is then very difficult, though not impossible, for individuals to change their own living standards by way of their own actions by honest market activities. Obviously, this type of limitation in the freedom of choice is closely related to the previously mentioned dead-weight costs by way of high marginal tax wedges.

Moreover, if government service programs are very large, the average tax rates, and not just the marginal rates, will be very high. As a consequence, it will be next to impossible for households to let only one family member earn income in the market. Also other family
members will have to work in the market to make it possible for the household to get enough money income to buy the goods and services it needs from the market. In other words, as public services often are nonmarketable, and cannot be transformed into purchases of normal goods and services in the market, all adult household members, or at least husband and wife, may have to work in the open market, even though one family member may have liked to stay home to take care of their small children for a number of years. The earlier discussed welfare state effects of shifting personal services out from the household will then be accentuated.

(iii) Relation—Individual—Government. Another profound consequence of "advanced" welfare state policies, with accompanying high tax rates, is that high marginal tax rates automatically imply high return for various types of cheating the Government—not only by avoiding taxes for normal economic activities, but also by conducting illegal transactions, such as fraud in the context of ordinary business activities, as well as by engaging in illegal business areas (like theft or drug-peddling). The result is not only strong incentives to engage in activities in "the underground economy" but to illegal economic transactions in general.

We may say that honesty becomes expensive in a high-tax society, and as a consequence, the supply of honesty will become more scarce.

As a consequence of induced reductions in honesty, the government may be forced to adopt a more and more elaborate control system— to increase tax compliance, to fight illegal economic activities in general, and to prevent individuals from giving misleading information in order to receive benefits for which they are not eligible. Moreover, as individuals all the time try to avoid the consequences of laws and regulations, there is a continuous race between these and adjustments of the individual. As a result, the laws in society will be expected to change rapidly, possibly at a more and more rapid speed, which implies that planning for the future becomes extraordinarily difficult for the individual, because there is no confidence in the stability of the rules of the game. Another expected reaction of the government to the continuous new adjustment of individual citizens is to make the rules and laws so vague that the authorities can catch an individual that acts against the "intent" of the laws, even though he does not violate any formal law. This means that the borders of what the citizen can do and not do become blurred. Political uncertainty may then replace, or add to, the market-uncertainty, which the welfare state was designed to mitigate.

CONCLUSION

When considering all these various problems of the modern welfare state—in terms of economic costs, the consequences for the role of the family, the freedom of choice of the individual, and the relations between the individual and the state—it is important to emphasize that these problems are not mainly the results of the attempt by the government to remove poverty and to provide basic economic security of the individual. For that could certainly be achieved by public spending of distinctly less than 50 per cent of GNP, i.e., at levels that were typical for North West European countries about two decades ago (including publicly run social insurance systems). Really serious problems emerged, in my judgement, not until the "welfare state" started to be transformed into a free-for-all "transfer state" with policy-induced redistribution, in cash as well as in kind, back and forth between practically all population groups. In other words, it is important to make a distinction between a traditional "welfare state," which existed in several countries in North Western Europe some fifteen or twenty years ago, and a "transfer state" with public spending of some 50-65 per cent of GNP, which has emerged recently in some countries. Personally I believe that one of the basic "welfare state problems" is just to prevent the traditional welfare state from developing into such a generalised "transfer state."

FOOTNOTES

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1. For a fuller discussion of this point, see Lindbeck, 1981.

2. See Lindbeck (1987) for a detailed analysis of this issue.

REFERENCES


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