Introduction: The Welfare Economics of the Welfare State

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I. Introduction

Outsiders to economics might be forgiven for thinking that welfare economics provides the theoretical underpinnings for the welfare state. But although the language is suggestive, the link between theoretical welfare economics and policy recommendations concerning the role of the public sector, the optimal degree of redistribution and social insurance, etc. is not obviously a very strong one. Economists who use a welfare theoretic framework for thinking about economic and social problems might be led to advocate a "night watchman state" which would mainly be concerned with the provision of public goods or, alternatively, to argue for a crucial role of the public sector as a redistributive system, as in the welfare state.

What is the welfare state? It is always tempting to avoid issues of definition, but in this case it seems appropriate to point out that the concept is in fact used in at least two different ways. Some use it to denote a subsection of the public sector, concerned with redistribution (via social security and social assistance) and the provision of those social goods which have a strong redistributive element, like health care and education. Others use the term in a much wider sense to characterize the economic and social policies of a country that gives high priorities to equality and individual protection against social hazards. To illustrate the difference in usage, according to both definitions unemployment insurance would definitely come under the heading of welfare state policies, whereas macroeconomic policies that are designed to prevent or reduce unemployment would be included in the second definition of welfare state policies, but not in the first. I am inclined to take the wider view of the welfare state, primarily because I feel that the more narrow definition introduces a number of rather awkward borderlines between the various areas of economic policy.

In the following I first consider what bearing the neoclassical version of welfare economics has on the design of welfare policy. I then discuss
various modern developments that have led economists to revise some of their views about the costs and benefits of the welfare state.

II. Welfare Economics: Changing Perspectives

Developments in welfare economics during the 1930s and 1940s were admirably integrated and summarized in Samuelson (1947) and further developed and restated by Arrow (1951). The most important insight of the theory was the two equivalence theorems about Pareto optima and competitive equilibria. A competitive equilibrium in which all consumer prices are equal to marginal costs is a Pareto optimum, but the allocation of resources (income, for short) among individuals will not in general correspond to the maximum of a social welfare function. To combine the efficiency property of the competitive equilibrium with an equitable and fair allocation of resources requires a system of lump sum transfers. Lump sum taxes are taxes that do not affect individual decisions except through pure income effects; thus, they lead to no substitution effects as between leisure and work, between different kinds of consumption goods, between consumption at different points in time, etc. Lump sum subsidies must have the same properties. The revenue from lump sum taxes will have to exceed the expenditure on subsidies because of the revenue requirement associated with the supply of public goods.

This theoretical insight could easily lead to a rather optimistic view of the possibility of establishing a redistributive public sector on a large scale. With lump sum transfers there does not exist any efficiency-equity trade-off. Redistributive policy can be carried out without creating price distortions and efficiency losses. True, the requirements for taxes and subsidies to be truly lump sum are very stringent, but in much of the older literature one finds statements which seem to imply that in practice the income tax is a good approximation; see e.g. Hotelling (1938). Thus, redistribution can occur within a system that satisfies, at least as an approximation, the conditions for social efficiency or Pareto optimality.

The standard version of welfare economics used to be silent on the time and uncertainty dimensions of the model, although an old insight was that the concept of a commodity could be thought of as being time-dated. Later on, Arrow (1953) and Debreu (1959) showed how this idea could be extended to include state-contingent commodities, so that commodities would be characterized by both the time period and “state of the world” in which they would be available. This led naturally to the study of redistributive transfers that are both time and state dependent; see Sandmo (1970).

The formulations of neoclassical welfare economics were in most cases so general that they did not carry any visible implications for the question.
of who the beneficiaries of and contributors to the redistributive system should be. References were sometimes made to the idea that someone with egalitarian beliefs would like to redistribute income from the rich to the poor. But how do you know who is rich and who is poor? This may seem like a frivolous question, but it is in fact a serious one when it comes to the design of a redistributive system. Such a system has to be based on a set of rules about the duty to pay taxes and the right to receive benefits, and these rules have to refer to observable characteristics of the individuals concerned. Let us first consider the problems that this raises for the tax system.

The ideal basis for a rational redistribution policy would be information about individuals’ needs and resources. But in general this is private information for the individuals concerned and not directly observable by the government agencies in charge of the redistribution scheme. The most obvious observable criterion for deciding who is rich and who is poor is income, or perhaps consumption, which is income minus saving. But if the lump sum tax is related to income, it is simply an income tax in disguise, and a rather thin disguise at that. Theory tells us that an income tax will have substitution effects in both labour and capital markets, so that the benefits to the needy in this case will be financed through a tax system that imposes efficiency losses on the economy. Taxes on wealth and indirect taxes on consumer goods suffer from the same shortcomings. In brief, apart from Pigovian taxes on externality-generating goods, all feasible tax systems lead to a less efficient allocation of resources. In a realistic setting for the problem of tax system design, where proper account is taken of the asymmetric information between private individuals and the government, there is indeed a tradeoff between efficiency and equality.

Once one accepts this view of the second best setting of redistribution policy, it immediately follows that policy instruments which would be ruled out under first best conditions could indeed be employed to increase welfare. For instance, while a classical result is that transfers in cash are always better than transfers in kind, this is not necessarily the case when there are constraints on the use of other instruments of redistribution. This is demonstrated in the paper by Blomquist and Christiansen in this issue, which analyses transfers in kind as a means of inducing individuals to reveal their true needs. Another implication of this view is that when the productivity of workers is only partly observable by the government, as in the paper by Maderner and Rochet, it could be optimal to subsidize workers of low qualifications.

Let us now look at the receiving end of the redistributive system. A typical feature of the redistributive systems of the welfare state is that they combine principles of insurance with time and state dependent redistribution. The most important parts of the social security system are old-age...
pensions and disability and employment insurance. Now these benefits would be truly lump sum if the probabilities of occurrence of the various states were exogenous, but in reality they can frequently be influenced by the individual’s own actions. For example, the probability of unemployment is partly determined by the worker’s choice of education and training, by his work effort and by the intensity of his search for a new job if he should become unemployed. Generous unemployment benefits could be attractive from an egalitarian point of view, but they could also lead to less efficient educational decisions, lower effort and less search for a new job. Similarly, sickness and disability insurance could lead to less care being taken in work and leisure activities and to more absenteeism on the grounds of minor health complaints. The general problem is, of course, that of moral hazard, which induces efficiency problems also at the receiving end of the redistributive system. Here too there is a tradeoff between equality and efficiency.

However, at this point we should pause to consider whether, even from the point of view of pure theory, there is always a tradeoff between efficiency and equality. Might it be the case that the institutions and redistributive arrangements of the welfare state make a positive contribution to the efficiency of the economy? The discussion above focused on the properties of a redistributive system with reference to a perfectly functioning market economy. But to be realistic we should look at models of market economies that have a stronger resemblance to real economies. Much of the redistribution in the welfare state can be seen as socialized insurance. In order to pass judgement on the strengths and weaknesses of the redistributive system of the welfare state, we ought to take a closer look at the performance of private insurance markets.

Since the path-breaking paper by Akerlof (1970), it is by now a well-established insight that many insurance markets suffer from problems associated with adverse selection. If the insurance company only has statistical information about the risk properties of individuals, it will offer insurance at a premium that reflects the average risk in the population. But this will lead only the high-risk individuals in the population to buy insurance. It is easy to see that this could give rise to a situation where some insurance markets would vanish altogether — or, more realistically, never emerge. This implies that the economy would be undersupplied with coverage against a number of risks, and this is a problem that social insurance could overcome because of its compulsory nature. To some extent, therefore, social insurance and redistribution — the two concepts are sometimes hard to distinguish — could be seen as attempts at improving market performance; this aspect of the welfare state has been stressed by Barr (1987) and is also prominent in Sinn’s contribution to this issue. From this point of view, then, types of redistribution that by many
would be regarded as ethically desirable would also improve the allocative efficiency of the economy; there is then no tradeoff between efficiency and equality. It has also be pointed out by Varian (1980) that progressive income taxation has aspects of social insurance if people's abilities and wages have elements of luck in them; risk averse individuals who did not know their ability \textit{ex ante} would then favour progressive \textit{ex post} taxation as an insurance against low wages.

It is worth emphasizing that while the problem of adverse selection provides an argument for compulsory and possibly social insurance, the same does not apply to the other reason for failure of insurance markets, viz. moral hazard. Adverse effects on behaviour from insurance against risks that are partly under the individual's control are common to both private and social insurance. They do not in general provide any strong argument for socializing private insurance — or for privatizing social insurance.

One problem of welfare state policies that has risen to prominence in recent years concerns the effect of increasing international economic integration on the scope for redistributive policies within the single nation state. This was e.g. pointed out in a much cited article by Sinn (1990), who argued that increased international mobility of labour might lead to the “death of the insurance state”. This type of problem is taken up in the paper by Wildasin, who points out that economic integration may also reduce some of the need for national redistribution.

One general message from the more recent welfare analyses of the welfare state is obviously that although redistributive taxes and transfers do lead to price distortions and efficiency losses, not all effects of welfare state activities point in the same direction. Someone who wants to estimate the social cost of the welfare state in efficiency terms needs to be clear as to what the alternative is, against which that cost is being measured. The Arrow–Debreu economy with a complete set of markets is not a very meaningful comparison, nor is the unregulated \textit{laissez-faire} market economy. The fact that it is difficult to identify an obvious standard of comparison should be a reason for some caution in making too sweeping statements about the welfare state.

Another message is that a meaningful welfare economics of the welfare state must be empirical. This is because in a second best world we are constantly trading off efficiency gains against distributional benefits or considering the benefits of alternative distributional policies, and we have to know how large they are, not only whether they are positive or negative; see Atkinson (1987) and Moffitt (1992) for extensive surveys of empirical studies in this area. This is in contrast to the older variety of welfare economics, in which the magnitude and behavioural effects of the lump sum transfers required to achieve a just distribution of income were not of
much intrinsic interest. But this also means that welfare theory must be closely tied to theories of individual behaviour in the welfare state.

III. Individual Behaviour in the Welfare State

Studies of individual behaviour in the welfare state have traditionally focused on the effects of taxes and social security on labour supply and savings behaviour, as in the paper by Aaberge, Dagsvik and Strøm on taxation and labour supply. The emphasis in such studies is on the distortions of individual behaviour that the welfare state carries with it. This is, of course, right and proper, and we will no doubt be able to look forward to many more studies of this kind. But there are also reasons why this type of research has its clear limitations. For instance, in the area of labour supply, empirical work has concentrated on a fairly narrow range of questions, like the effects of changes in tax rates on overtime work and labour force participation. These are important issues which can be studied by means of cross-section or time-series data covering fairly short periods. But such studies do not quite capture the more systemic effects of the welfare state on work incentives, which may be harder to measure and have more long-run effects. This is discussed more fully in Lindbeck’s paper, which takes up the intriguing and neglected issue of the possible feedbacks from policies to preferences and behaviour patterns.

Individual behaviour in the welfare state must in principle be seen as influenced not only by taxes and social security charges, but also by items on the expenditure side of the public budget. Among such items the main focus in the literature has been on price subsidies and cash transfers, whereas effects of the provision of social goods — both private and public — have not received the attention that they probably deserve, at least not in the mainstream literature on public finance. The provision of health care is discussed in the paper by Currie; a look through her list of references seems to indicate that this is a topic which has not exactly filled up the economics journals. An important theoretical point is that although a high level of average and marginal tax rates may discourage labour supply in quantitative terms, tax financing of public expenditure on health and education will presumably increase the quality of the labour force, so that an assessment of the effects of welfare state policy on labour supply in efficiency terms ought to consider these effects jointly.

Although an ideal egalitarian redistribution policy should aim at equalization of the standard of living, attention has typically been focused on the somewhat more narrow indicator of the distribution of income. Has public policy in the welfare state actually managed to reduce inequality? This is not an easy question, for published statistics tell us only part of the story; e.g. they do not tell us anything about the incidence effects of the

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redistributive instruments on gross incomes. Another shortcoming of published statistics in relation to the distribution of welfare is that they do not take account of the general equilibrium effects on resource allocation within the family, which might change the role and importance of income as an indicator of welfare. Konrad and Lommerud, in their paper, discuss some interesting aspects of this problem.

IV. The Political Economy of the Welfare State

What are the driving forces behind the emergence and continued growth of the welfare state? To some extent the answer to this question may be sought in the propositions of welfare economics. Income redistribution and spending on social goods like health and education are at high levels because there is a social concern with equality and justice; in addition, an extensive social security system is required to overcome the failures of private insurance markets. This answer is not entirely convincing, however; it implicitly interprets welfare economics as a positive theory of the political process. Perhaps the most popular explanation as to why welfare state policies may tend to overshoot their targets lies in the asymmetry between costs and benefits of redistributive policies. Much of redistribution goes from majorities to minorities of the population; from the employed to the unemployed, from the healthy to the disabled, from the urban to the rural population, etc. This implies that for each redistributive measure, the average burden on those who pay is significantly less than the average benefit for those at the receiving end, and this fact may bias political decision-making towards carrying redistribution — in cash or in kind — too far.

Other explanations of the overshooting phenomenon are also possible. One interesting observation is e.g. that in the Scandinavian welfare state, there is not only a high degree of equality of disposable income; gross incomes are also more equally distributed than in other countries. Given this achievement, one would perhaps think that the importance of continued equalization would diminish, but this appears not be the case. One explanation for this is offered in Lindbeck’s paper in terms of a feedback from egalitarian policies to tastes and political attitudes. At a more formal level, Persson analyzes this issue by means of positive models of income taxation in which a crucial role is assigned to the notion of relative income.

Attempts to explain the growth of the welfare state would be incomplete without a consideration of the role of paternalistic attitudes in designing economic institutions. While economists have a fondness for the concept of consumer sovereignty, this feeling has not been shared by all proponents of the welfare state. Much of the motivation for the emergence of
state pensions was certainly the feeling among many politicians as well as among many academic writers that people were not rational enough to understand what would be in their own best interests in the long run. Both in the area of pensions and in that of family policy, it was often maintained that welfare gains could actually be made by restricting people’s range of choices. This was not because of any side effects from behaviour on social efficiency in the ordinary sense of the word, but because people would benefit from constraints imposed by those who knew better; see e.g. the references to the work of the Myrdals in Sandmo (1991).

The economics of the welfare state offers a fascinating field of study for both the theorist and the empirical researcher, inviting contributions from many fields of economics and encouraging collaboration with our colleagues in the other social sciences. This will certainly not be the last conference to offer a range of interesting papers on this set of issues.

References


