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Can we afford the welfare state?[1]

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1 Is a welfare state necessary?

There are powerful arguments for the welfare state: it addresses major market failures; by sharing risks, it facilitates economic growth; it pursues widely-supported equity objectives; and it contributes to social cohesion.

Important implications follow. First, to the extent that the welfare state has a significant efficiency role, opposition by libertarian writers is misplaced because it fails to take account of information problems, behavioural issues, and incomplete markets. Thus the right question is not whether to have a welfare state but what form it should take. That theoretical argument has historical support. Governments, including those of Ronald Reagan and Margaret Thatcher, came to power pledging to roll back the frontiers of the state. In practice, there was little change in welfare-state spending.

Once the welfare state's efficiency role is understood, this finding is not surprising. Social institutions are relevant to the population at large, not just to the poor. The welfare state is justified not only by redistributive aims but because it does things that private markets for technical reasons would either not do at all, or would do inefficiently. We need a welfare state of some sort for efficiency reasons, and would continue to do so even if all poverty problems had been solved.

That said, the welfare state is not a complete solution. It may make unemployment more bearable but does little to reduce the number of unemployed; nor does it improve working conditions; and many people, including women and ethnic minorities, are underprivileged for reasons not directly connected with poverty.

[1] This chapter draws on Barr (2012, Ch. 13).

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2 Is the welfare state desirable?

MISTAKEN OBJECTIVES? Libertarians, espousing freedom and choice, argue that the welfare state threatens individual freedom. The validity of that view depends on the weight given to freedom compared with other objectives, and also how freedom is defined: to a Libertarian, it means absence of coercion, to social democrats freedom includes an element of security.

AN INHERENTLY MISTAKEN ENTERPRISE? Libertarians argue that a large purposeful collective enterprise is not possible, pointing to the coordination problems that beset central planning. However, the welfare state is not a monolith, but comprises smaller components. Secondly, many of these components are publicly *financed* but privately and competitively *produced*—welfare does not have to be state welfare. Thirdly, where market failures are severe, state action, albeit imperfect, may produce the least-bad outcomes.

DAMAGING TO ECONOMIC GROWTH? Several arguments should be distinguished.

Does the welfare state reduce growth? It is not controversial to argue that beyond a certain point higher taxation harms growth. What is controversial is (*a*) where that point is, and (*b*) the mechanism by which welfare-state spending might reduce growth. The issue remains disputed, as Atkinson (1995, Ch. 6) makes clear.

- Welfare-state spending varies widely around the OECD average, with no evidence that growth has been slower in high-spending countries or vice versa.
- If the charge is that the level of welfare-state spending is too high, then, 'the Welfare State is no more than a co-defendant with other elements of the state budget' (p. 123).
- Causation can be problematic. Does higher spending reduce growth, or do countries with lower growth need to spend a larger fraction of GDP alleviating poverty?

Are assessments of the welfare state well specified? The flaws in an argument that considers costs but ignores benefits are obvious.

> 'The emphasis by economists on the negative economic effects of the welfare state can be attributed to the theoretical framework adopted . . . which remains rooted in a model of perfectly competitive and perfectly clearing markets. *[This] theoretical framework incorporates none of the contingencies for which the welfare state exists ….* The whole

> purpose of welfare state provision is missing from the theoretical model' (Atkinson 1999, p. 8, emphasis added).

Atkinson's point is that a model based on the assumptions of perfectly-functioning markets systematically rules out the market failures that it is one of the fundamental tasks of the welfare state to address.

Is reduced growth necessarily a problem? Even if the welfare state reduces growth, that is not the end of the argument. If in state-of-the-world A ('capitalism'), there is rapid growth but little security, electorates may prefer to trade some growth for increased security, analogous to an insurance premium. At its broadest, this is a stylized representation of the development of the welfare state over the twentieth century. In state of-the-world B ('communism'), there is considerable material security but growth rates are low. People are therefore willing (as in the former Communist countries) to adopt market mechanisms, offering the potential for higher living standards at a cost of less security. In short, too little security reduces well-being; so does too much.

DAMAGING INCENTIVE EFFECTS? Some writers argue that social benefits, are not the cure to social ills but part of their cause, in that social assistance creates a 'culture of poverty'. The counter-view is that labour-market behaviour, crime, and single parenthood are far too complex to be explained only—or even mainly—by the incentives offered by social benefits.

3 Is the welfare state feasible?

Even if the welfare state is desirable, does it remain feasible?

IS THE WELFARE STATE COMPATIBLE WITH A GLOBAL ECONOMY? Today much economic activity takes the form of computer-transmitted information. Thus national boundaries become porous, making competition global and reducing the freedom of any country to conduct an independent economic policy. The implications for the welfare state, however, are not necessarily apocalyptic.

The world is not wholly global. Competition is powerful but not all powerful. Not all goods are tradeable. Nor are all factors mobile: labour mobility is reduced by choice (people prefer to stay with their language, culture and family) and because of constraints on migration.

Western countries can adapt. Box 1 summarizes an important but often overlooked distinction between two ways – scale and structure – in which countries can adapt. Global pressures are not an argument for dismantling the welfare state, still less for radical structural change such as privatization. Rather, they are an argument for reducing the scale of some welfare-state activities.

Newly industrialized countries may also adapt. Unless developing countries are very different, rising incomes and the weakening of extended family ties will lead to demands for rising social spending in those countries. Thus a plausible outcome of global competition is some convergence.

Box 1 What type of change: scale v. structure?

It is important to keep two issues logically separate.

- What should be the *scale* of the state's activities—that is, the level of public spending on income transfers, health care, education, and the like?
- What is the appropriate *structure* of activity—that is, the public/private mix?

The first is largely a matter of budgetary balance—an issue of macroeconomics and political economy. The second is microeconomic. It is concerned with which activities are most efficiently privately financed and/or privately produced and which are not. The distinction is important: a budgetary crisis is *not* a reason for privatization.

DEMOGRAPHICALLY SUSTAINABLE? A range of policies address the problem of population ageing. Output can be increased by:

- Increasing the productivity of each individual worker, e.g. through higher investment in physical and human capital;
- Increasing the number of workers, e.g. by raising labour-force participation, raising retirement age, and/or by importing labour directly (immigration) or indirectly (exporting capital to countries with a young labour force).

If those policies are not a complete solution, demand can be reduced by reducing consumption by workers (e.g. through higher taxes or contributions) or by reducing consumption by pensioners (e.g. through lower monthly benefits). Thus the scale of pensions may need some reduction, but that is not an argument for radical change in structure.

COMPATIBLE WITH SOCIAL CHANGE? Labour-market relationships and family structures have both become more diverse and more fluid. As a result, contributions related to employment are a less-good fit than in the past, suggesting that a non-contributory element in the pension system, as in Australia, New Zealand, the Netherlands and Canada, is useful both to address elderly poverty and for reasons of gender balance.

COMPATIBLE WITH ECONOMIC CRISIS? The economic crisis created pressures to reduce welfare-state spending (i.e. scale), but does not call the institution into question (structure). The argument that the crisis weakens the case for a welfare state is 180 degrees mistaken. Rather, the crisis emphasizes the centrality of the welfare state as a device for risk sharing.

A LONGER-TERM CRISIS OF THE WELFARE STATE? Parts of the system certainly require change. And the welfare state is adapting.

- Demographic change means that pensions and health care will continue to face resource constraints, creating further upward pressure on retirement age.
- There will be mounting pressure for new insurance instruments (public, private, or mixed) to cover contingencies such as long-term care.
- New lending instruments will emerge. Income-contingent loans will increasingly pay for part of the costs of post-compulsory education and training.

POLITICALLY SUSTAINABLE? The survival of the welfare state depends on political as well as economic sustainability. Libertarians argue that the state takes on tasks (e.g. the abolition of poverty) that are impossible, that failure undermines the state, and thus the welfare state contains the seeds of its own political demise. The exact opposite can be asserted. It is the welfare state that has made capitalism, with its attendant benefits of economic growth, politically feasible. Failure to address poverty can be destabilizing and politically damaging.

Discussion should not be about whether there should be a welfare state, but about its precise form and its distributional objectives. In reaching a similar conclusion, Glennerster points to two crucial sets of facts. First, the level of taxation and social spending varies widely and is not correlated in any obvious way with economic performance. Secondly, in the UK in 1945, 'in a ravaged economy, when real incomes were less than half what they are today, people voted for what came to be called the welfare state, and paid the price, and voted to continue affording it' (Glennerster 1997: 298).

Thus the future of the welfare state depends not only on economic feasibility, but also very much on what people, through the political process, decide that they want.

4 Conclusion

A defence, however robust, understates the strong positive case for the welfare state.

- It exists not only to provide poverty relief (its 'Robin Hood' function) but also to offer insurance and consumption smoothing[3] (the 'Piggy Bank' function) in areas that private institutions are able to cover incompletely, if at all. It also has an important role in fostering social cohesion.
- There is increasing evidence that the roots of exclusion lie in early childhood, stressing the need for policies to support and enhance families. Such policies—a confluence of economics and social policy—involve cash benefits, health care, and education (including nursery education), alongside broader policies to improve parenting. Again, such activities require state action.
- The insurance element will become increasingly important. Risk and uncertainly are likely to intensify. An OECD report (2003) emphasises natural disasters, technological accidents, infectious diseases, food safety, and terrorism. Actuarial insurance is not able to address problems of this type or on this scale. The 2008 economic crisis reinforces the salience of insurance.
- The previous point emphasises the importance of the welfare state as a device for risk sharing. Too little risk is suboptimal because it gives no incentive for risk-taking (e.g. low growth rates under communism). Too much risk is also suboptimal because it

[3] I.e. redistribution from a person's younger self to his/her older self.

creates incentives against taking risks (in the absence of a safety net, a failed business start-up can leave a family destitute). Thus one of the purposes of the welfare state is to share risks optimally. From that perspective, far from being a regrettable necessity, the welfare state is an essential nurturing element in economic growth.

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