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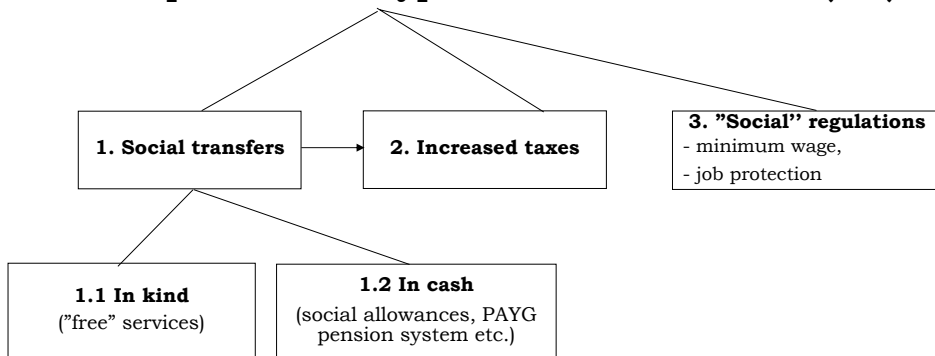
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Layout & Distribution: Valéria Kozakova

# Economics and Ethics of a Welfare State

Leszek Balcerowicz

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



Transfers are sometimes replaced by tax preferences.

- 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 mechanism, i.e. many variants of the WS.

They differ:

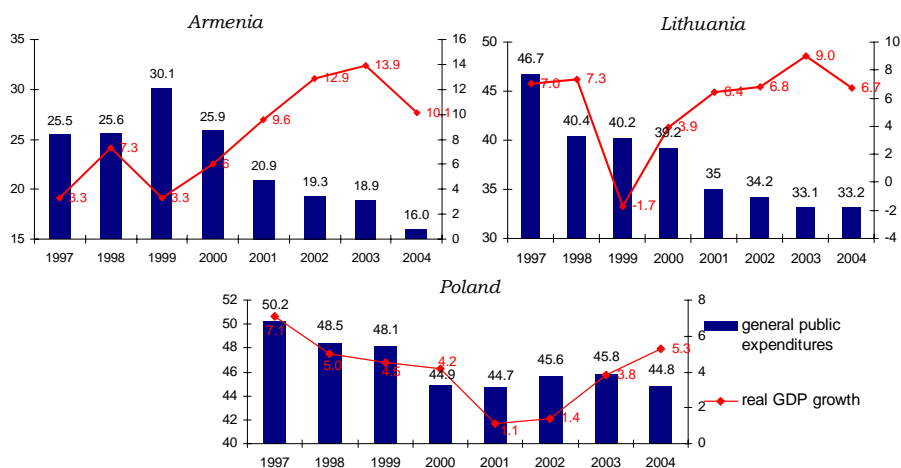
- in **size** (as measured by transfers / GDP ratio, an index of "social" regulations);
- in **structure**, e.g. replacement ratios, eligibility criteria, types and relative size of various transfers.

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 publicity tuned health services – produce large WS.

- There is no uniform European Welfare State.
  - There are many typologies of the WS. One of them:
    - scandinavian model;
    - anglosaxon model;
    - continental model;
    - mediterranean model (Italy, Spain, Greece)
- } developed economies

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

General public expenditures (as % of GDP) and growth of GDP (in %)



Sources: EBRD Transition Report 2005, Eurostat.

**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 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 found 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)

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**II. The growth of Welfare State:**

• Before the Welfare State in 19th century: 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 short so the system was not costly, the accumulated contributions during 1889-1899 were sufficient to finance pensions during the next 17 years (H.W. Sinn)

• WS expanded after II WW, especially during 1960's and 1970's.

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*Social public transfers (% of GDP)*

Country	1960	Maximum year	2003
Australia	7,4%	18,6% (2000)	17,9%
Canada	9,1%	19,6% (1995)	17,3%
Germany	18,1%	27,5% (1995)	27,3%
Japan	4,1%	17,7% (2003)	17,7%
The Nederland's	11,7%	29,6% (1975)	20,7%
New Zealand	10,4%	21,9% (1990)	18,0%
Sweden	10,8%	33,0% (1995)	31,3%
Switzerland	4,9%	26,4% (2001)	20,5%
UK	10,2%	23,0% (1995)	20,6%
USA	7,3%	16,2% (2003)	16,2%
Poland	15,5% (1990)	23,8% (1995)	22,9%

Source: OECD.

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### **What is responsible for the growth of the WS: some popular hypothesis**

- Growth of poverty? No, an acceleration of the growth of 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 market failures should grow? The opposite should be true.
  - It disregards the non-state mechanisms of individuals savings, mutual aid and social assistance.

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- The expansion of the Welfare State resulted from the combination of the following main factors:
  - political competition, both in democracies and non-democracies,
  - very good situation in the world economy in 1950-75,
  - a favourable demographic situation 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.

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

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

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

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

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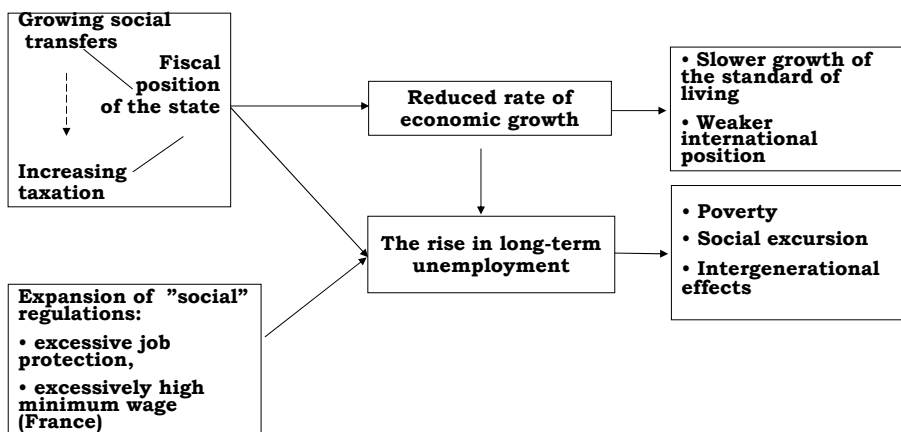
### III. The effects of the Welfare State

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

- As 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,  
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:
  - 1) distorting the individual's incentives and, as a result, behaviour  
(e.g. propensity to work, to search for a job, to save);
  - 2) the distorted behaviour leads to a reduction in the capacity to work (hysteresis);
  - 3) massively distorted behaviour - change in the social norms (e.g. the work ethics, the cohesion of the family); (A. Lindbeck, 2004)
  - 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.

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### The analytical scheme



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### **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).

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

- Britain

- friendly societies

1877: 2.8 million members

1897: 4.8 million members

1910: 6.6 million members

strong crowding out since 1948 (P. Green, 1988)

- spending on education

1833: 1% national income

1920: 0.7% national income

(E. West, 1991)

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- 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.

- Expansion of state-financed social insurance in the today's LDC's crowds out traditional and modern non-state mechanisms:

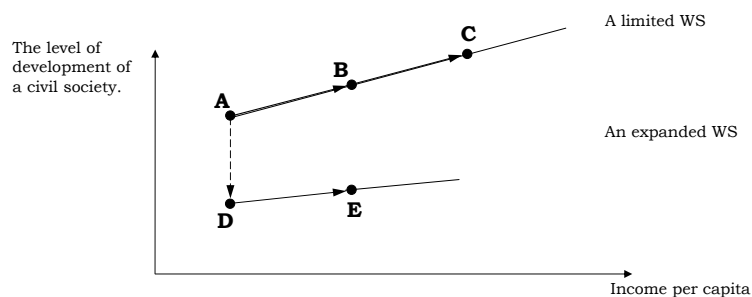
"Competition by the government in providing social transfers may drive out private institutional arrangements (...) which can be targeted more effectively to the poor than more arm's length (public) social assistance"  
(World Bank, 2001)

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### The main mechanisms of crowding out

- "Free" (tax financed) services - the decline 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.**



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#### **IV. Reforms (constraining) of the Welfare State**

- **Main directions:**
  - 1) limited the social expenditures in order to reduce the budgetary pressures,
  - 2) reforms of the spending schemes so as to reduce the perverse incentive ,
  - 3) liberalization of the labour market.
- Reforms are usually undertaken because of the growing budgetary problems, high structural unemployment and the misuse of social transfers.
- Additional reasons:
  - immigration and emigration,
  - aging

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#### **V. Ethical aspects of 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 subsidiarity 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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