Hazardous Welfare-State Dynamics

Assar Lindbeck

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James J. Heckman

THE UNIVERSITY OF CHICAGO

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- The achievements and costs of the mod- ern welfare state are both usually analyzed in static terms.

- Some consequences of welfare-state arrangements, however, could rather be characterized as dynamic, in the sense of reflecting the interacting adjustments over time of basic behavior patterns of households, firms, interest-group organizations, politicians and public-sector administrators.

- Many of these dynamic adjustments are no doubt regarded by most observers as positive, or virtuous.

- For instance, it is easy to visualize how welfare-state policies, under favorable circumstances, may generate virtuous circles of reduced poverty, better neighborhoods, less street crime, improved health among low-income groups, the accumulation of widely distributed human capital, increased labor productivity, and higher labor-force participation rates for women and various ethnic minorities; and all this contributes to expand the tax base, which facilitates the financing of the welfare-state programs in the first place

I. Delayed Effects on Private Agents

- A strongly humanitarian case can no doubt be made for generous benefits to people in connection with contingencies such as unemployment, sickness, work injury, permanent disability, single-motherhood, and old age.
- The basic dilemma of the welfare state, however, is that the more generous the benefits, the greater will be not only the tax distortions but also, because of moral hazard and benefit cheating, the number of beneficiaries.
- This is a field where Say's law certainly holds in the long run: the supply of benefits creates its own demand.
- Indeed, moral hazard and cheating are, in my judgment, the weakest spots of the welfare state.

- My basic hypothesis is that such hazardous adjustments tend to be stronger in the long run than in the short and medium term.

- One reason is that individual adjustment in some cases requires collective action. For instance, individual adjustment in work effort may require new collective-bargaining agreements between unions and employers, such as the number of working hours, which is bound to take time.

- However, some delays in disincentive effects also depend more directly on the inertia of individual behavior.

- An obvious explanation here concerns the various types of information and adjustment costs, such as the costs and time required to acquire information about the tax and benefit systems, to find out the advantages and disadvantages of adjusting to or exploiting these systems, to adjust investment in human capital, to change jobs, and so forth.

- A more profound reason why disincentive effects on individual behavior are often delayed is that habits, social norms, attitudes, and ethics restrict the influence of economic incentives on economic behavior.

- More specifically, it is reasonable to assume that the individual experiences disutility when breaking existing habits and violating social norms-because of a loss of reputation (possibly in connection with punishment) and because of a subjectively felt resistance to violating habits and norms that he or she believes should be obeyed.

- It is also likely that a single individual is more inclined to conform to traditional habits and social norms the greater the number of individuals in society who do so-an example of the importance for individual behavior of a "critical mass" of people with similar behavior patterns.

- Obvious illustrations of the role of habits and social norms in the context of welfare- state policies are

    1. that people often ab- stain from applying for benefits to which they are entitled,
    2. that the majority probably do not abuse the system of state bene- fits even when the risk of being caught is small, and
    3. that most people largely comply spontaneously with the tax rules, in particular if they believe that tax revenues are being used in a reasonable way.

- A well- documented example is the hesitation to apply for social assistance ("welfare" in U.S. terminology) because of the stigma attached to such support, combined with an unpleasant sense of a loss of one's personal in- tegrit

- For these reasons, the national economy may be protected for a while from the effects of a deterioration in economic incentives and from a softening in the administrative control of beneficiaries.

- A large increase in the generosity of the welfare-state benefits, a pronounced relaxation of the control system, or a drastic increase in marginal tax rates, however, may make this protection recede with time.

- A likely mechanism is that the adherence to previously dominating habits and norms is first abandoned by some individuals, and that others follow suit, particularly if friends or neighbors have started living on social benefits, and perhaps even cheating with benefit rules or taxes-an illustration of the dynamics generated by the "critical-mass" effect mentioned above. Serious benefit-dependency, or "learned helplessness," may therefore emerge only in a long-run perspective.

- It should be emphasized that a decline in private saving (even if delayed) not only reduces the aggregate stock of national wealth in the future-assuming, realistically, that government saving does not usually increase correspondingly.

- One would also expect that in the long run the growth dynamics of the economic system will be influenced by a substantial reduction in household saving.

- The reason is that private entrepreneurship requires private equity capital, and this presupposes domestic private saving, in particular for small firms. Capitalism cannot exist without capitalists

II. Short-Term Macroeconomic Stability

- Welfare-state arrangements also have consequences for short-term macroeconomic dynamics.
- The most celebrated example is probably the automatic fiscal stabilizer.
- At a first glance it is tempting to argue that this is stronger, and hence more favorable, the greater the sensitivity of the bud- get deficit to variations in macroeconomic activity.
- In this perspective, macroeconomic stability could be expected to be favorably influenced by high marginal tax rates and generous income compensation to those who lose their jobs, regardless of whether they become openly unemployed, engaged in public-sector works or training programs, or take subsidized early retirement.

- Another reason for modifying the traditional theory of the operation of the automatic fiscal stabilizer during deep recessions derives from the effects on the household saving rate of large budget deficits.

- It is a commonplace from a theoretical point of view that a galloping public-sector debt may lead households to expect either future tax increases or future cuts in entitlements promised earlier, thus generating a negative wealth effect on household spending.

- Increased uncertainty about the entitlements or the jobs, or both, could also be expected to reduce household spending, in particular on durables (John Hassler, 1993).

- For all these reasons one may hypothe- size that the effects of a larger budget deficit on aggregate demand is not monotone:
    - While a modest increase may stabilize aggregate demand, along the lines of the traditional theory of the automatic fiscal stabilizer, a huge increase- particularly when starting with an initially large government debt- may very well be a destabilizing factor.
- A macroeconomic vicious circle may then emerge in deep recessions, with a galloping government debt, increased uncertainty, higher interest rates, an increased household saving rate, a further fall in aggregate demand, a still deeper recession, and so on.
- The macroeconomic collapse in Finland and Sweden in the early 1990's can perhaps il- lustrate this.

III. Consequences for Political and Administrative Processes

- Important welfare-state dynamics are also present within the political process itself.

- The most, obvious example is perhaps the common political-economy hypothesis that a combination of specific benefits and general taxes generates strong pressure for continuous expansion of government spending, and that this tendency is accentuated by the recursive (sequential) nature of spending decisions.

- Moreover, it is not clear that the political demand for redistributions will fall by reducing the inequalities in disposable income, as suggested by the median-voter theory of redistribution policy.

- "The political taste" for redistribution may instead rise as a result of previous redistributions.

- Voters could also be expected to support politicians who propose to legislate for shorter working hours and longer vacations, when tax distortions make leisure less ex- pensive for the individual.

- As the enactment of such legislation may take considerable time, here is another reason why the disincentive effects on work of wider tax wedges may be delayed.

- Moreover, when nonnegligible disincentive effects finally emerge and the tax base is eroded, the government may be forced to raise tax rates further to balance the budget, with a new round of disincentive effects as a consequence, and so on.

- Adjustments of individual behavior to various welfare-state arrangements depend, of course, not only on the generosity of the benefit systems, but also on the administrative control of the beneficiaries.

- If a major unemployment-generating macroeconomic shock shifts large groups of people onto various safety nets, there may not be enough administrative resources for efficient control.

- Administrators may also find it un- pleasant to be harsh to beneficiaries, including unemployed workers, when there are very few jobs around.

- Thus, endogenous changes in habits, social norms, attitudes, and ethics may emerge with time, not only among potential beneficiaries, but also among the administrators of the systems.

- With less efficient controls it becomes even more tempting for some individuals to exploit and abuse the systems, which means even more people to control, and so on.

- All this means that benefit systems that function reasonably well during prolonged periods of full employment, may run out of control as a result of a major macroeconomic shock, providing an illustration of the "ketchup effect" mentioned above.

- More specifically, to be sustainable a generous welfare state presupposes a national economy with high productivity, a large share of the population at work in the market sector, general adherence to norms that condemn the exploitation of the benefit and tax systems, and strict administrative controls.

- But in advanced welfare states forces may emerge that undermine all these prerequisites, either endogenously or as a result of exogenous shocks.

- Analytically such developments may be handled either as the existence of multiple equilibria or as "vicious circles."

- This discussion evokes something of a welfare-state paradox.
- It is often asserted that welfare-state arrangements, unlike private insurance schemes, shield the individual from the consequences of noninsurable macroeconomic shocks.
- However, precisely such shocks may contribute to undermine the welfare state itself by pushing large parts of the labor force onto various safety nets for prolonged periods.

IV. Policy Risks

- Because of gradually emerging welfare- state problems, the government may sooner or later be forced to reform or unwind the welfare state, that is, to renege on its previous welfare-state commitments.

- This is bound to create serious problems for the population, as welfare-state entitlements may be regarded as long-term contracts between the government and the citizens.

- Welfare-state arrangements may lead not only to the replacement of market risks by rule instability (i.e., greater uncertainty on the part of the individual about exogenous data); unstable rules may also create new types of market risks, as disturbances from the political system are bound to influence people's behavior in various markets.

- Two examples have already been mentioned: gal- loping government debt may dramatically raise interest rates and also generate instability in the household saving rate.

- Another example is that price controls tend to create uncertainty about the availability of goods and services.

- For instance, rent control and the resulting excess demand for apartments generates uncertainty about the chances of getting an apartment among those who do not already have one.

V. Retreats with Irreversibilities

- If a large group of the population has already abandoned previously prevailing habits and social norms, a drastic strengthening of incentives and controls may be necessary to restore previous behavior.

- Indeed, it may be necessary to be much more harsh toward people-by way of low benefits levels, considerable coinsurance, strong actuarial elements, and strict controls-than if the benefits had not been so generous to begin with.

- However, in the same way that the combi- nation of specific benefits and general financing, strengthened by the recursiveness of the spending process, all help to explain the expansion of the welfare state, the same factors also help to explain why it is politically difficult to reverse the process.

- An unwinding of welfare-state spending could be expected to be particularly difficult in societies where a large share of the electorate is financed by the public sector (i.e., is tax-financed rather than market-financed).

- To take an extreme example: in the early 1990's, a large majority of the adult population in Sweden received practically their entire income from the public sector, either by way of transfer payments or as factor incomes from public-sector employment (apart from state-owned corporations).

- Is this "a point of no return" for public-sector spending?
- Or is it possible to get the sup- port of some tax-financed groups of the population to cut the benefits for other groups?
- Perhaps a severe economic crisis (e.g., with a galloping public-sector debt) is necessary to convince the beneficiaries that it is better to start to reform and unwind the welfare state immediately, rather than to take the risk that benefit levels will have to be cut even more drastically in the future.