Welfare State Disincentives with Endogenous Habits and Norms

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1. The Basic Idea

- The basic idea of this paper is that various disincentive effects of welfare- state arrangements on economic behavior, and related economic distortions, are often delayed because habits and social norms constrain economic behavior.

- It will also be argued that these constraints themselves may subsequently be influenced by the very same disincentives.

- This is assumed to be the case not only for private agents but also for public-sector administrators.

- As a result, generous welfare-state arrangements may generate multiple equilibria and vicious, or "hazardous" dynamics.

- One reason for confining the discussion to disincentive effects, and hence to various costs of welfare state arrangements, rather than covering both benefits and costs, is simply a lack of space.

- Another reason is that understanding of disincentive effects, and related hazardous welfare-state dynamics is essential if we want to avoid that the welfare state, over time, undermines its own economic foundations by way of disincentive effects on the national economy and therefore also on the tax base; for discussions of benefits and costs of the welfare state, and of virtuous as well as hazardous dynamics, see Lindbeck (1 993, 1994, 1995).

- The paper is limited to what may be regarded as the "core" of the welfare state, namely cash transfers to households, including both social-insurance benefits and social assistance, and public-sector subsidies and the provision of various social services.
- I concentrate on the disincentive effects on a few broad economic activities - work, saving, asset choice and entrepreneurship.
- Considering the complexity of the issues to be dis- cussed, my ambition is mainly exploratory.
- This is the reason for the informal, essayistic nature of the paper.
- I leave the task of theoretical formalization and empirical verification, or falsification, to future work; for a theoretical formalization of some aspects of the paper, see, however, Lindbeck, Nyberg and Weibull (1995).

II. Habits and Social Norms

- Habits are usually defined in the sociological and psychological literature as routine behavior without much cognition or evaluation; cf. Verheller and von Raaij (1985, p. 5).'

- Social norms are usually characterized in the same literature as "required", or (by others) expected behavior, without much explicit purpose and calculated concern for the consequences, except for the expected discomfort associated with breaking such norms; see discussions in Parsons (1952), Lewis (1969), Scott (1971), Opp (1979), Elster (1989) and Bicchieri (1990). Individual behavior in conformity with habits and social norms is often contrasted to behavior based on instrumental rationality ("rational choice"), which is distinctively future oriented, purposeful, calculating and hence outcome oriented.

- The usual distinction between habits and social norms is that the latter are shared by others and sustained by their approval of compliance and disapproval of non-compliance, while habits (like "private norms") are regarded as more individualistic phenomena and not enforced by others to the same extent.

- In terms of utility theory (which has traditionally not been used to any large extent by sociologists), an individual who breaks an internalized social norm will experience a utility loss not only through external sanctions and related losses of reputation, but also through internal sanctions in the form of subjectively felt discomfort.
- Borrowing Etzioni's (1989, p. 46) characterization of the "internalization of moral", we may say that the internalization of social norm turns constraints into preferences.
- Thus, social norms that emphasize socially acceptable behavior, or "community values", are assumed to mould preferences and constrain the effects of a deterioration in economic incentives.
- The individual, therefore, feels guilt, i.e., pays a psychological price, for having broken previously obeyed social norms. This guilt may, or may not, dominate over the direct material benefits of breaking the norm.

- In game-theoretic approaches, social norms are treated as equilibria of strategic interaction, reflecting clusters of self-fulfilling expectations of rationally calculating agents; for early attempts along these lines, see Lewis (1969) and Ullmann-Margalit (1977).

- Each individual's strategy is then a best reply to the others' strategies, where the latter are taken as given.

- Or, according to Bicchieri (1990, p. 841): 'A norm is there because everyone expects everyone else to conform, and everyone knows he is expected to conform, too".

- The adherence to a social norm reflects, in this view, a conditional choice based on expectations about other peoples' behavior and beliefs; this means, of course, that conformity to a social norm is not a dominant strategy.

- The most difficult question when analyzing habits and social norms is probably to determine how they emerge and are sustained.

- A standard answer among sociologists is learning ("socialization"), which in evolutionary game theory is expressed by e.g. Sugden (1986) as repetition and imitation of successful behavior, as well as the disappearance of agents who use inappropriate strategies - an idea that harks back, at least, to Adam Smith (1758).

- Other (complementary) explanations for the emergence and sustenance of habits and social norms are the value-creating effects of law, the dominance of some people over others, membership in voluntary organizations that expect certain types of behavior of their members, and "metanorms" that require people to express disapproval of those who violate social norm.

- Norms against living on selective social assistance ("welfare" in US terminology) would be expected to be particularly strong, because of the stigmatization of such support; this stigmatization is accentuated by the inconvenience of losing one's personal integrity vis-d-vis the social- assistance administrators.

- Such stigmatization has, in fact, been amply documented in the sociological literature; see interview studies by Horan and Austin (1974) and Rainwater (1979)."

- An econometric study by Moffitt (1983, pp. 1030 and 1032-4) suggests that the stigma is connected with the act of welfare recipiency per se, but that it does not vary with the amount of the benefit once on welfare.

- Most likely, individuals are less hesitant to live on, and adjust their lives to, general social security benefits, such as sick pay, work-injury pay, unemployment benefits, early retirement (disability) pensions and old-age pensions.

- It is reasonable to assume that the adherence to habits and social norms subsides only gradually if new institutions emerge that make such adherence more expensive than before, for instance because of more generous benefit systems and higher marginal tax rates, or because of softer control of the misuse of benefit and tax systems.

- Invoking a general concept introduced by Loury (1987), we may regard social norms as "social (collective) capital" which, like other kinds of capital, accumulates or decumulates over decades and centuries, partly in response to institutional arrangements including economic incentives and government control systems.

- Honesty is one example of such collective capital.

- Interpersonal dependence may, of course, be analyzed without con- structs such as habits and social norms.

- We may, for instance, simply assume that the behavior of others influences the benefits or costs, or both, of the actions of an individual with given preferences.

- This is the approach in e.g. Schelling's (1971, p. 167) "tipping model", in which an individual with given preferences is no longer willing to reside in a certain neighborhood if the percentage of residents of another ethnic origin exceeds a certain limit, as then the (economic and psychological) costs of living there start to exceed the benefits.

- While such models may be useful for the analysis of housing segregation and rioting, and several other social phenomena, I believe that models with "conditional habits and norms", as applied in this paper, are also useful for analyzing the long-term consequences of welfare-state arrangements.
- It is true that the expected pecuniary costs of moral-hazard behavior and cheating with welfare-state benefits and taxes tend to decline when many others behave in the same way, simply because the risk of being detected tends to fall - as in the case of a growing riot.
- But as will hopefully be clear from the subsequent discussion, it is also useful to assume that the hesitation of an individual to engage in such behavior depends on the psychological costs of deviating from previously established habits and social norms in society - either because of external sanctions and related losses of reputation, or as a result of the individual's own internal sanction system.

III. Work Disincentives and Government Controls

- The fact that tax wedges create disincentives on work (substitution effects against hours as well as intensity and quality of work) does not require elaboration.

- The reason why various welfare-state benefits do the same is, of course, that they reduce the difference in income when people work and when they are out of work.

- This effect arises both because benefit systems are seldom actuarially fair, partly due to ambitions to redistribute income and wealth, and because contingencies that qualify individuals to receive benefits cannot be perfectly monitored by the authorities, which is bound to create moral hazard and cheating.

- A good humanitarian case can, no doubt, be made for generous welfare- state benefits in connection with contingencies such as sickness, disability, unemployment, single motherhood, etc.

- A basic dilemma for the welfare state, however, is that generous benefits tend to create many beneficiaries due to moral hazard and in some cases also benefit cheating.

- Ceteris paribus, the higher the sick-pay benefits, the more people will call in sick; the more favorable the conditions for disability pension, the more people will find it attractive to live on such pensions; the more generous the unemployment benefits, relative to after-tax wages, the more people will in the long run choose to stay unemployed; and the higher the benefits for single mothers, the more single mothers we would expect, as such support is an implicit subsidy to birth "out of wedlock", divorce, runaway fathers, and separate living quarters for formally unmarried couples.

- Moral hazard and cheating look rather similar on the surface. But there is a distinction.
- If, because of generous sick pay, I choose to call in sick on Monday because I feel tired after drinking heavily on Sunday night, this would be classified as moral hazard.
- If I go to Copenhagen for a long weekend, but in fact pretend that I have stayed away from work because of (insured) illness, this is, of course, plain cheating.
- Similarly, while it is an example of moral hazard if I do not search for a job very energetically when I receive generous unemployment benefits, I would certainly be characterized as a cheater if, while receiving such benefits, I work in the underground economy.

- We may schematically differentiate between two types of benefit dependency.
- One type is when individuals become "pacified", in the sense that they lose the energy to look for jobs and to improve their skills.
- Such developments are analytically highlighted by the branch of modern psychology that deals with so-called "learned helplessness", according to which the individual is unable to control his own situation; see Seligman (1975) and Magnusson (1980).
- Casual evidence suggests that such pacification of individuals has occurred on a much broader basis in the former socialist countries than in the welfare states of Western Europe.

- We would, of course, also expect habits and social norms to limit the frequency of tax avoidance, tax evasion and benefit cheating, not to speak of various types of criminal activities (including work in the "black economy") for which income is usually tax free, except for a stochastic "tax" in the form of punishment if caught.

- There is also evidence that peoples' willingness to pay taxes is favorably influenced by positive attitudes to the government's spending programs; see Lewis (1982).

- But there must also be a "price" on honesty, in the sense that habits and social norms that encourage such behavior may be undermined if honesty becomes sufficiently expensive because of high marginal tax rates and generous benefit levels, or because taxpayers become less supportive of government spending programs

- It is a commonplace that adjustments of individual behavior to welfare- state arrangements depend not only on the generosity of the benefits but also on the conditions for receiving benefits and on the administrative controls of beneficiaries.

- From a normative point of view, it is indeed useful for the government to strive for an optimum combination of incentives, on one hand, and conditionality and controls, on the other: the stricter the conditionality and the tighter the controls, the more generous benefits are possible without serious problems of moral hazard and cheating; cf. Lantto (1991).

- An illustration of the importance of government controls is that the strictness of "work requirements" in the unemployment benefit system the requirement that the individual should accept work offers, seems to influence how many employees choose to live on such benefits.

- But it may be difficult for public-sector administrators to cut off unemployment benefits in situations of heavy unemployment - as illustrated by the experience in several countries during the 1980s and early 1990s; see Layard, Nickel and Jackman (1991).

- Another illustration of the difficulties in enforcing strict government controls is that the number of people living on subsidized disability (early retirement) pensions has recently "exploded" in some countries, in particular in periods when layoffs of elderly workers and unemployment have increased. In the Netherlands, 12 per cent of the population of working age had such a pension in 1993; the corresponding figure in Sweden was 8 percent.

- Moreover, if a major macroeconomic shock has shifted large groups of citizens onto various safety nets, there may simply not be enough administrative resources for efficient control.

- And with less efficient controls, it becomes even more tempting for potential beneficiaries to exploit and abuse the systems, etc.

- The punchline of this discussion is that benefit systems which function reasonably well under prolonged periods may subsequently go out of control either because of endogenous behavior adjustments over time, or because of macroeconomic shocks that increase the number of beneficiaries substantially.

- It is tempting to analyze mechanisms like these in terms of models with multiple equilibria (as in the earlier mentioned tipping model) - one equilibrium with widespread adherence to social norms, strict administrative control and few beneficiaries, another with less adherence to social norms, lax administrative control and many beneficiaries.’

- Such developments may also be described in terms of vicious circles, or hazardous dynamics, in order to emphasize the dynamic process by which the number of beneficiaries may increase over time in connection with changes in habits and social norms among beneficiaries, administrators and experts.

- The ensuing fall in the tax base may subsequently force the government to increase tax rates, which tends to reduce the tax base even further because of new disincentive effects, and so on.

- Developments like these imply that the equilibrium position of the economy is path dependent in the sense that the behavior of a certain individual, at a specific point in time, depends on the previous behavior of others.

- This discussion raises somewhat of a welfare-state paradox.
- The welfare state has largely been motivated as a way of shielding the individual from the consequences of macroeconomic shocks and related market risks.
- It is possible, however, that exactly such shocks may undermine the welfare state itself by pushing large fractions of the labor force onto various safety nets for prolonged periods, and by undermining the financial position of the government.

- More generally, while a generous welfare state presupposes a national economy with high productivity and a large fraction of the population at work in the market system, forces may emerge in advanced welfare states that undermine both these prerequisites - either endogenously or as a result of exogenous shocks, or a combination of both.

- Neither politicians nor economists, or other social scientists, seem to have been much aware of such long-term dynamic adjustments

- It may be retorted that similar incentive problems arise in the case of means-tested income support, i.e., social assistance.

- An important difference, though, is that in the case of a negative income tax (in its pure form) it is, in principle, impossible to prevent able-bodied beneficiaries from abstaining from work, while this is possible, at least to some extent, in the case of means-tested systems as the benefits are then tied to specific contingencies such as poor health, unemployment and old age.

IV. Saving, Asset Choice and Entrepreneurship

- We would expect that habits and social norms are also important for saving behavior.
- For instance, households have, at least until recently, "learned that it is proper to save.
- Moreover, people have traditionally saved not only to be able to consume in the future, but also to avoid being dependent on their children or the government, and to enhance their reputation (status) and self-respect in general.
- Among many citizens it has probably been regarded as particularly improper to incur debt, except perhaps in connection with buying real estate.
- Indeed, "reluctance to being in debt" seems to be, or at least to have been, a strongly held habit and norm among households. "

- It may, for these reasons, take considerable time before household saving is very negatively influenced by higher marginal capital-income tax rates and improved social security benefits.

- For instance, it would seem that households in some countries only gradually gave up their earlier acquired saving habits, including their reluctance to being in debt, during the post-World War II period, in spite of the fact that real after-tax interest rates (at least ex post) were often negative, and that the government provided more and more elaborate systems of social security and social assistance.

- It is also likely that the consequences of tax-induced distortions of asset choice - often accentuated by inflation and various asymmetries in the taxation of different types of assets - develop only gradually.

- For instance, it was not until the second half of the 1980s that households finally seemed to have adjusted their behavior to the fact that borrowing for the purchase of various types of assets, including real estate, durable consumer goods and shares - was highly profitable.

- At that time, in a number of countries, households were also finally allowed to borrow freely in the wake of the deregulation of capital markets.

- Ironically, just when households had "learned" to borrow, real after-tax interest rates increased abruptly in the late 1980s and early 1990s because of tax reforms and lower inflation that were not fully reflected in lower nominal interest rates.

- A more speculative point is that welfare-state egalitarianism may also influence policies towards entrepreneurship.
- As entrepreneurs often strive to become affluent, and in some cases also succeed, they may easily come to be regarded as "alien" figures in a highly egalitarian welfare state.
- This is, I believe, what happened in Sweden in the "egalitarian" 1960s and 1970s.
- One illustration is the strongly negative attitudes towards entrepreneurs in the mass media during that period.
- A concrete expression of these attitudes is that policies in some highly egalitarian countries favor plowback of profits at the expense of dividend payments, apparently belief that this limits the income (or at least consumption opportunities) the owners.

- We may, with slight exaggeration, say that there has been a tendency in some countries with highly egalitarian welfare-state policies, Sweden being one example, to opt for "capitalism without capitalists", and "enterprises without entrepreneurs" - probably not a very efficient economic system.

- These experiences illustrate how values that originally stimulated the build-up of a welfare state, after a while, may penetrate other sectors of society.

V. Difficulties of Reform

- The basic dilemma of the welfare state is that it partly disconnects the relationship between effort and reward by creating disincentives to work, saving, asset choice and entrepreneurship.

- It is, therefore, important to avoid pushing welfare-state disincentives into "dangerous territory", where disincentive effects seriously damage the national economy and erode the tax base, and hence undermine the economic foundations of the welfare state itself.

- In particular, it is important not to build up welfare-state arrangements on the assumption that private agents do not, over time, change their economic behavior in order to utilize, and perhaps even cheat with the system.

- It is also important to avoid creating welfare-state systems that get into serious difficulty if the national economy is hit by severe macroeconomic shocks that drastically increase the number of citizens who depend on various benefit systems.

- It has been argued in this paper that some disincentive effects of welfare-state policies, and their financing, are delayed because of the influence of habits and social norms on individual behavior, and that these delays may induce politicians to offer more generous benefits to citizens than if induced changes in habits and norms had been anticipated.
- This problem is particularly serious if, after severe disincentive effects have emerged, it takes considerable time to restore previous habits and social norms by way of reduced benefit levels and tighter controls.
- It may then be necessary to be much more harsh toward citizens - by way of lower benefits and strict control - than if the benefits had been less generous to begin with.

- Ideological beliefs, which are mixtures of values and views of the world, also tend to block, or at least delay, the realization that incentive problems do exist.
- Information that indicates such effects is often neglected among adherents of existing welfare-state systems, while information pointing in the opposite direction is often accepted.
- Welfare-state sceptics tend to screen information in the opposite direction.
- Psychological research on "cognitive dissonance" gives strong support for the existence of this type of screening behavior; see e.g. Aronson (1979), Hirschman (1965) and Akerlof and Dickens (1982).

- Serious problems necessarily arise when attempts are made to reform or rewind a welfare state that is believed either to be poorly designed or to have "overshot" reasonable limits.

- The most obvious example is perhaps that several welfare-state arrangements (such as pension rules) may be regarded as long-term contacts between the government and the citizens.

- As life is irreversible, the individual runs into serious problems if such contracts are broken by the government after several decades.

- Long-term changes in habits and social norms among beneficiaries may also con- tribute to the political difficulties of reforming or rewinding the welfare state.

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- For instance, the subjectively experienced utility loss when a benefit is removed may be much greater than the "utility loss" of never having received it in the first place - a hypothesis that is consistent with Tversky and Kahneman's (1981) "prospect theory", according to which the utility function is steeper to the left of the initial point than to the right of it.

- The least risky way of mitigating various welfare-state distortions and of fighting vicious welfare-state dynamics, without damaging the achievements of the welfare state, is probably to concentrate spending cuts on entitlements and other transfers to the large middle-class.

- It would then be possible to maintain, and possibly even expand, public-sector spending with large elements of investment in human capital, in particular perhaps among potential low-income groups. The problem is the political feasibility of this strategy.