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For a Targeted Criticism of the Welfare State³

This criticism of the welfare state (WS) would be more effective if it were better targeted. This is why we start with certain clarification distinguishing three dimensions of the WS. We use them to show how large are the differences between the welfare states in the real world. Then we identify those countries that appear to face the greatest challenges regarding the sustainability of their welfare states. We conclude with same remarks on how to make the criticism of the overgrown and/or baldy structured welfare state more effective.

Some clarifications.

It is best to define the welfare state not through its noble goals but through its instruments. At the minimum they include transfers in cash (PAYG pensions, unemployment benefits, family allowances, etc.) and transfers in kind (especially publicly financed health and education). One can add to these components the tax subsidies, e.g. subsidies to the employers financed health insurance in the USA. (see: e.g. Feldstein, 2006) and “social” regulations like the minimum wage, rent controls, employment protection, etc. We will focus on the social transfers because they are by far the most important instruments of the WS and also due to the availability of data. However, occasionally we will also refer to the two other policies.

It is useful to regard the WS as a special kind of a welfare system which we define as arrangements to deal with various individuals’ risks: acute poverty, sickness, accidents, etc. A brief look at history reveals the existence of various welfare arrangements: family (kin) based, religion-based, civil-based, corporate-based, the market-based (insurance through jobs, private savings and commercial insurance). Countries have always had some welfare systems being the combinations of all or some of the above “pure type” arrangements. The poor laws in Europe constituted the early welfare states (Tocqueville, 1835) had shown the incentive problems of the early welfare state in Britain which foreshadowed those of a larger WS).

The concept of a welfare system (as distinct from the welfare state) is a useful communication device: First, it highlights, a basic fact that a lack of large WS does not need to mean the absence of the alternative

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welfare arrangements. Second, it draws the attention to the question of what happens to these arrangements when the WS expands and shrinks. There is a large body of empirical literature on the crowding out effects of the growing WS or (e.g Morduch, 1999, Kelly 2009) and, more interestingly, for the present situation of the unsustainable WS, there is some literature on the crowding in effects of the shrinking WS (Heutel, 2009). Third, distinguishing various welfare arrangements should lead to more comparative analysis of the WS. There are many ideologically idealized descriptions of this system and not enough comparative research which would, for example, show how different is the treatment of the welfare beneficiaries by the welfare officials and by the other suppliers of the welfare services (family, churches, other voluntary organizations, the employers of the commercial organizations).

There are many criticisms of the WS. They can be grouped into economic, moral and philosophical and political. The distinctions between these categories are to some extent arbitrary but still useful because different types of criticism lead to partially different proposed remedies. And any proposal for reform should start with a clarification of what is its main goal.

The economic criticism of the WS ultimately focuses on its negative impact on the long-run economic growth. The intermediate variables are the tax burden, reduced private savings, reduced employment, chronic fiscal fragility or outright fiscal crises.

The moral criticism shows how the repeated deviant behaviour (using or misusing various social benefits) erodes the valuable social norms: honesty, work, ethic, the family values (see: Lindbeck, 1999, Niskanen, 1996).⁴

Moral criticism also highlights how some social benefits undermine the family and lead to the increased criminality, especially among young man brought up without fathers. These effects have, of course, negative economic consequences, too.

Philosophical and political criticism refers to the erosion of valuable social norms and of the family issues, which are especially important for the conservative critics of WS. The liberal (libertarian) critics focus on the two other related problems: The increased tax burden reduces the extent of the individual freedom as it increases the share of individuals who are forced to pay “for the activity which does not serve their interests or which they resolutely oppose” (Wicksell, 1898). And the distributive state which offers social programs in response to the pressure of various interest groups transforms the society into the collection of its own clients.

⁴ This impact of largely independent is the national culture, as strong incentives, including the perverse ones, overwhelm the cultural specificities. For example, the Germans speak of “Sozialbetrug” (social cheating).

As we mentioned, these criticisms differ in their focus. But they have also a large common ground which makes it easier to form coalitions for the reform of the WS. For example, the reduction of the tax burden can be justified both on economic and on liberal (libertarian) grounds. The elimination of the perverse incentives makes both economic and moral sense.

However, in mobilizing people for the reform of the WS we have to go beyond a general notion of the welfare state, so that they can see which of its features produce the worse excesses. And elementary step in this direction is to distinguish the size and the structure of the WS.

The size is usually measured by the ratio of social spending to the GDP⁵. This is a very important dimension of the WS as it is strongly linked to a country's tax burden and – to some extent – to fiscal fragility and the frequency of the fiscal crises. Both matter for the long term economic growth (see: e.g. Balcerowicz and Rzońca, 2015)

But the welfare states differ very much not only in their size but also in their structure. To be sure, structure is related to the size: countries with large PAYG pension system and the publicly funded health services tend to have large WS, as these two components of the WS absorb a lot of social spending. But they can be structured or – in other words- “designed” in various ways – which matters very much for their future growth (see: Feldstein, 2006, Börsch-Supan, 2012).

Besides, there are important differences in the design of the less fiscally important components of the WS, which, however, matter very much for the strength of the perverse incentive and the resulting social traps, they produce. These microstructures increase the relative utility of non-working income and include the ease of access to, the duration of and the replacement ratios of the various social benefits.

The structural issues of the WS include the distinction between the WS which consist of many social programs and the “universal” WS which would include, as a border case, the guaranteed income proposal (a negative income tax) originally proposed by Milton Friedman and developed by Charles Murray (2006). The main argument for the latter option is that it would abolish the extended social bureaucracy and the pressures related to the very possibility of lobbying for special social benefits. The conservative critics would object that social benefits should be “deserved” (i.e. means tested), and not evenly distributed. There are also same serious practical problems especially regarding the transition to the system of guaranteed income, especially in the countries with large PAYG pension systems. Finally, even if such a transformation succeeded there would still remain an issue, how to prevent the politicians to reintroduce the special programs and/or to politicize the level of guaranteed income. The above remarks are not meant to disqualify this proposals as

⁵ In comparative research one can also use the ratio of the public spending to GDP as it is almost perfectly correlated to that of social spending to GDP. This correlation reveals that both the cross-country differences in the public spending and in its dynamics have been caused by the social spending.

every reform has to meet two challenges: first, to be launched and second to be sustained. And there is no reform which just because of its design would solve these two problems. There is no good substitute for a well-organized civic pro-reforms effort.

The third clarification refers to the structure of taxes necessary to finance the WS. All taxes hurt economic growth but some (direct) taxes are worse in this respect than the others (indirect ones) (see: Acosta-Ormeacha and Yoo, 2012)

In assessing the impact of the WS on the economic growth we should, therefore, consider the differences in the tax structure . In looking at this issue from the point of view of political economy one would perhaps prefer to have a worse tax structure on the assumption that rising direct taxes generates more taxpayers' resistance than that of indirect ones. However, we are not able to asses this differences empirically. Besides, even if it were politically more difficult to increase the direct taxes than the indirect ones, the pressure for increased spending could overwhelm the taxpayers' resistance. In other words the strategy to "starve the beast" may not be effective (Niskanen, 2006). It appears again that there is no good substitute for the civic efforts aimed at the source of the problem: the pressure to increase social spending.

The Diversity of Welfare States

Let us now use our three dimensions of the WS: size, structure and the mode of financing to show how diverse are the welfare states in the world. True, many if not most of them suffer from serious problems, but the mix of them as well as their intensity differ across countries. Therefore, the combinations of required solutions differ, too.

Let us start with the size of the WS.

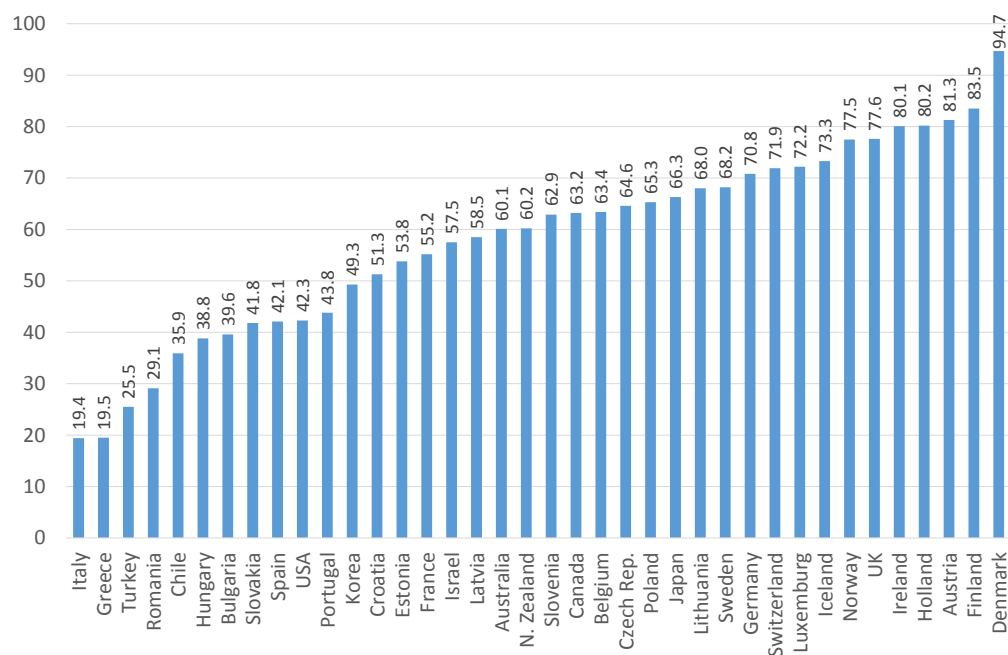
Figure 1. GDP per capita and social spending (years 2013-2014*)

The postsocialist countries in Europe inherited a large welfare state due to a PAYG pension system and a socialized health, and most of them have social spending to GDP ratio of 25% or more. This contrasts with China which accelerated its growth since the late 1970s while letting its social spending to GDP decline from above 30% of GDP to below 15%. It was largely following the strategy of the earlier Asian Tigers of creating welfare through economic growth and the related job creation rather than through the expansion of social spending. The opposite strategy, as practised, in some Latin American countries (e.g. Brazil, Uruguay) does not have a good track record.

The structure is a very important dimension of the WS, because large structural differences bring about large differences in its outcomes. However, it is impossible to rank countries according to the quality of the structure of their welfare states as there is no single synthetic index which would adequately measure it. But there is massive literature on the perverse incentives created by the various combinations of the social benefits, taxes and “social” regulations on which one can draw.

Countries differ, for example in the “participation tax” which shows the fraction of any additional earnings that is “taxed away” by the combined effects of higher taxes and reduced benefits when an individual takes up a job.

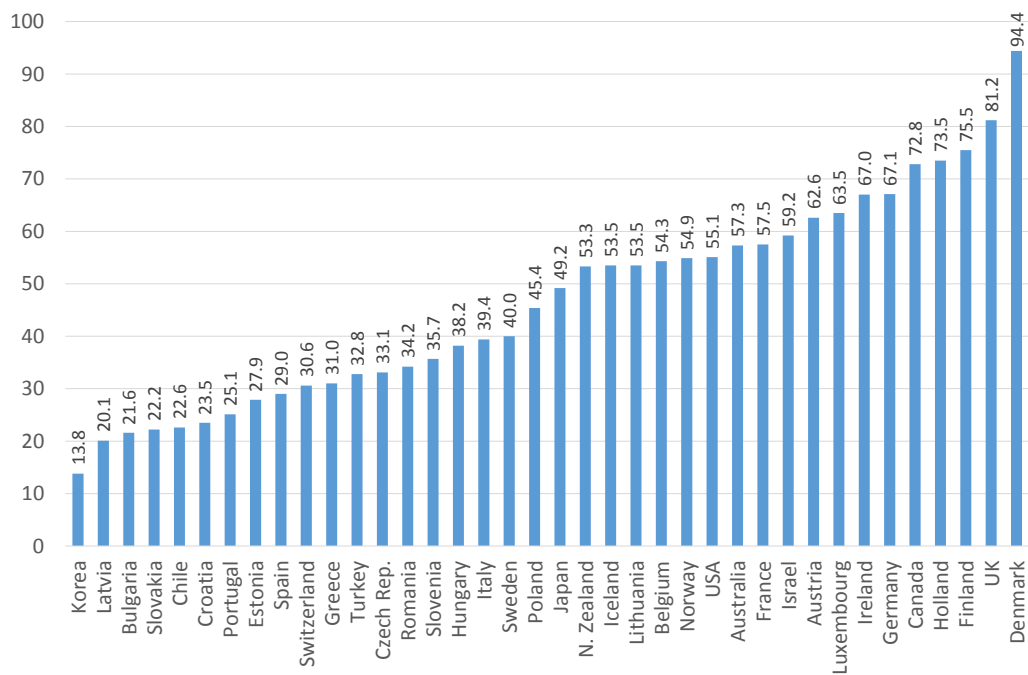
Figure 2. Participation tax rates (into work at 100% of average wage from inactivity, % of gross earnings, one earner couple with two children, 2014)



Source: OECD.Stat.

There are also huge differences in the marginal effective tax rate that shows the fraction of any additional earnings that is “taxed away” by the combined effect of higher taxes and reduced entitlements when an individual increases the number of working hours.

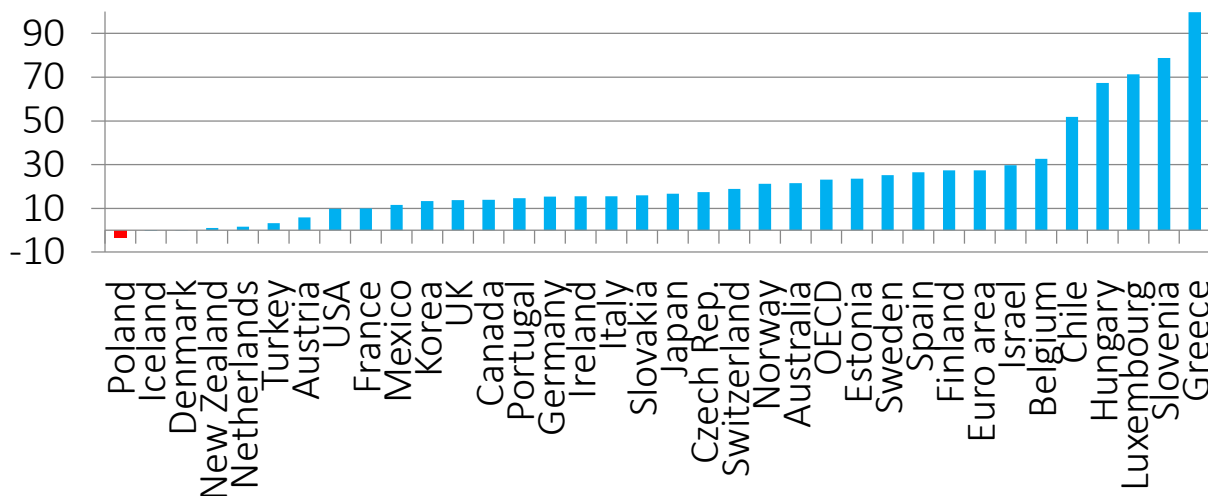
Figure 3. Marginal effective tax rates from part-time to full-time work (from 50% to 100% of average wage, % of gross earnings, one earner couple with two children, 2014)



Source: OECD.Stat.

Finally, the implicit tax on continued work for the pensioners ranges from below zero in Poland to over 90% in Greece.

Figure 4. Implicit tax on continued work: old-age pensioners, 2009



Source: OECD

Average for 55 and 60 year-old workers of implicit tax on continued work for five more years in "early retirement route". Special pension schemes not included.

The leftist anticapitalists tend to deplore what they call "social exclusion" and to blame it on free markets. But the fact is that it is various combinations of the perverse features of the welfare state which condemn some people to inactivity and thus undermine their family life. High marginal taxes on taking on a job or on working more or longer are just one example of this category. Another social trap is created by high reservation wage, resulting from excessive minimum wage or excessive level of social benefits. It is especially destructive when combined with bad public education that prevents certain groups from moving beyond the reach of this welfare inactivity trap. And if these groups happen to be minorities extreme tension are likely to appear.

Finally, let us look at the tax structure. Figure 3. shows that there are big differences in this respect. Some countries rely more on direct than the indirect taxes: especially Denmark, Norway, Finland, Belgium, Switzerland, US and Canada. Sweden, Greece and – above all – the postsocialist countries collect more indirect than direct taxes. Most of the big spenders (except Sweden) and moderate ones among the richer countries. have a worse tax structure than the post-socialist economies.

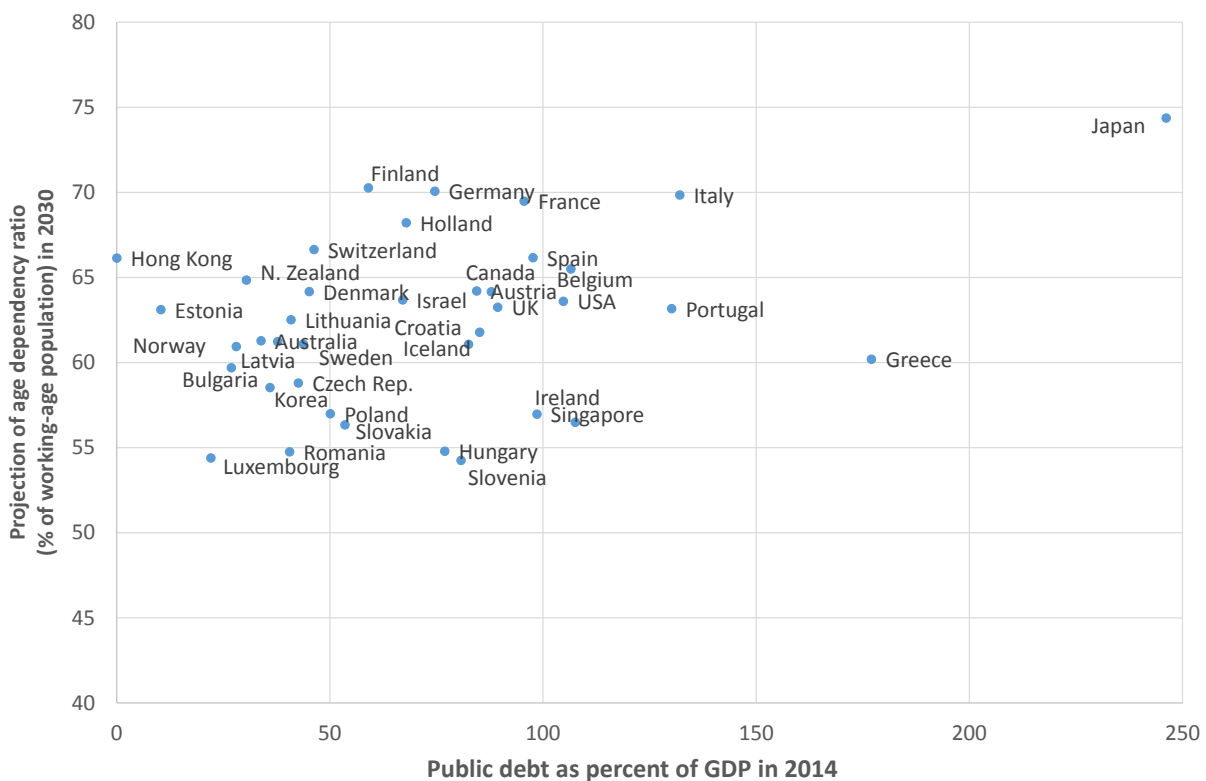
An especially bad situation exist in those countries which have big PAYG pension system financed by high payroll taxes (e.g. Belgium, Austria, Italy, Greece). They combine a big WS with the taxes which are especially detrimental to legal employment.

Different challenges faced by different welfare states.

There is small minority of countries which managed to keep relatively small WS (see: Figure. 1) and the challenge for them is to keep it that way. The growing problems of large (and often badly structured) welfare states should perhaps make it easier. And one would hope that there would be less propaganda of the “European social model”.

However, most countries in the a developed world and many poorer economies face the problem how to contain already large WS and, if possible, to reverse its growth. The situation in this group differs depending on their debt to GDP ratio and on the pace of their populations aging. One would like to know the third factor: the speed of the long-run economic growth but it is very speculative as it depends on policies (including reforms), which depend on politics that is difficult to predict. It is better to focus on trying to influence it than on forecasting it.

Figure 5. Public debt and the projection of age dependency ratio in developed and Central Eastern Europe countries

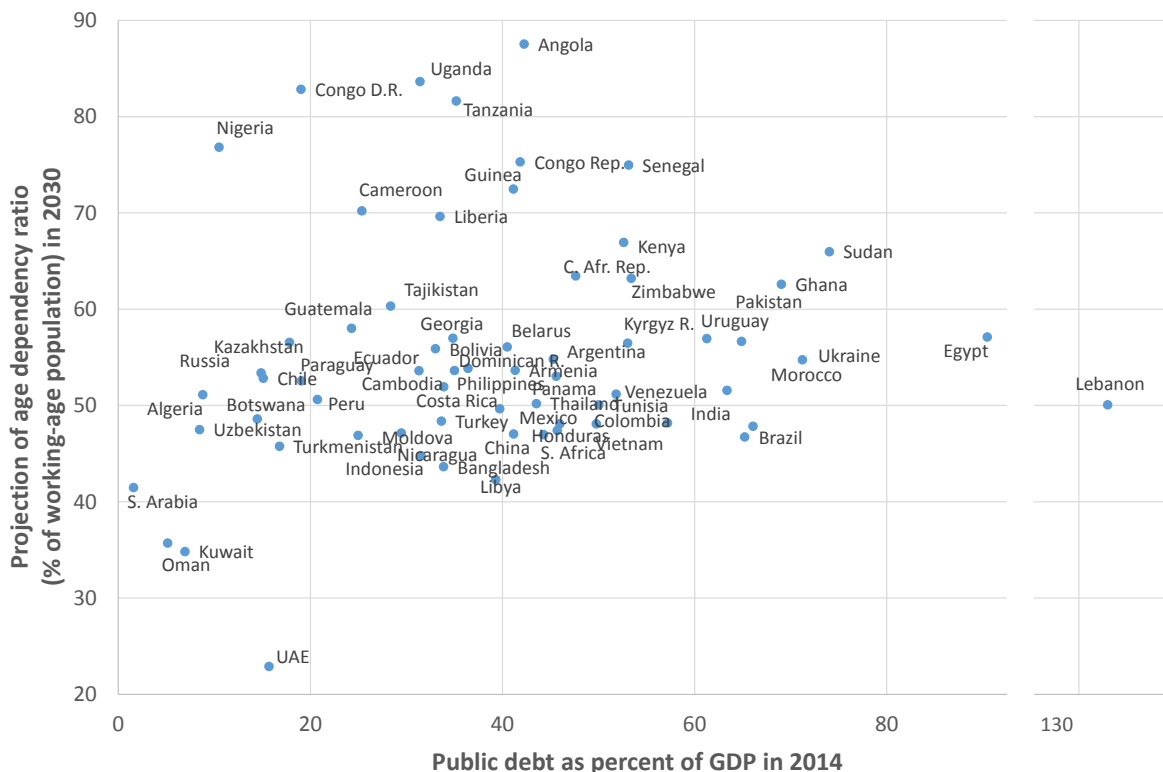


Sources: IMF World Economic Outlook and World Bank World Development Indicators.

As one can see, the worse combinations of public debt and aging characterize Japan and Greece, followed by Italy and Portugal. On the opposite side we have Hong-Kong (no public debt), Israel (good demography, moderate public debt) followed by Australia, Denmark, Switzerland, Korea (moderate aging, moderate public

debt). It is striking that the Scandinavian countries appear to be in a better situation than Italy, Spain, France and Germany. In addition, other large countries (US, Britain) are facing fiscal pressures due to a relatively high public debt.

Figure 6. Public debt and the projection of age dependency ratio in less developed countries



Sources: IMF World Economic Outlook and World Bank World Development Indicators.

There is a large variation among the poorer countries, too. We should remember that a lower public debt to GDP ratio among them constitutes a similar debt burden as much higher level of this ratio among richer economies. We can then see that Egypt, Brazil, Pakistan, Uruguay face a difficult fiscal situation.

Most poorer countries (but not China) will not be burdened in the near future by growing old age dependency ratio. In contrast, especially in Africa, they will have a growing share of working age younger population. And in the absence of job creating reforms this would lead to growing political tensions.

The solutions to the various socio-economic problems, including those of the overgrown welfare states, are located at two levels:

1. The economic level: to identify the best mix of policies, which if introduced and sustained, would solve the given problems.

2. The political economy level: how to ensure that these solutions are introduced and sustained.

There is no shortage of the well-developed and professionally credible proposals at the first level. For example, curbing the excessive pension spending would require the reforms of the inherited large PAYG systems: (moving to a defined contribution, increasing the retirement age) and rising the share of the funded system (see: e.g. Feldstein 2006, Börsch-Supan, 2012). Similarly there are well-thought solutions for the health sector (e.g. introducing the health accounts), for the unemployment benefits etc. (Feldstein, 2006). And a large body of empirical literature shows how to deal with various social traps (e.g. OECD, 2014 and 2016).

Clearly and not surprisingly the key issue is the political economy of welfare state reforms. And it is this problem to which we dedicate our concluding remarks.

Concluding comments: political economy of reforms.

Policies (including institutional reforms) are actions of the politicians, that result from the interplay of various factors. For example, windfall gains in various forms (oil bonanzas, sudden reduction in the interest rates, etc.) reduce the politicians' and broad publics' incentives for fiscal consolidation and encourage the growth of the public spending. In contrast, some crises may force even the non-reformers in power to do what they blocked before. The differences in the personalities of the ruling politicians matter, too, e.g. there would have been much less or no Thatcher's reforms if not for Ms Thatcher. There are complex interactions between the situational variables – the personality factors and the balance of the pressure groups (for more on this see: Balcerowicz, 2015). In the following we will focus on the last factor.

Without an excessive simplification, one can divide these groups into statist and antistatist (libertarian, conservative, modernizers). The former are driven by ideological or pecuniary motivations and aim (not necessarily realizing it) at keeping an expanded state or even increasing the scope of interventionism. The latter aim at reducing it or, if successful, at keeping some newly introduced limits on the state. The members of the antistatist groups are usually motivated by their beliefs in the values of individual freedom, the rule of law, and the limited state – it is hard to obtain pecuniary benefits from reducing the scope of state actions. One of the reasons why statist lobbies often prevail may be the simple fact that – as distinct from the antistatist ones – they include groups that are motivated by the prospects of pecuniary benefits, e.g. budgetary subsidies, tax preferences, anti-competitive regulations. And this creates strong incentives.

However, statism does not need to prevail: much depends on the activity of the antistatist groups and individuals. Let us, therefore, end with some remarks on how these forces can better oppose the welfare statism and press for the reforms. Here are some suggestions:

- Show that the shrinking and the restricting of the welfare state leads to a better welfare system (a greater role of voluntary organizations and markets) Instead of just fighting the WS let us fight for a better welfare system.
- Unmask the logical deficiencies of key concepts used by the welfare statisticians such as the “social rights” or “social justice (see: e.g. de Jasay, 2006)
- Focus on the main deficiencies of the respective WS’s and not on the WS as such. Show how an overgrown and unreformed PAYG pension system penalizes the younger generations. Show how bad public education and/or various social traps create the “socially excluded” groups. Show that a huge gap exists between the rhetoric of the welfare states and the results of their policies.⁶ Take away a high moral ground that the welfare statisticians try to occupy.
- Expose the mainstream fallacy that the present welfare state results from various “market failures”. No market failure can explain the growth of the WS to the size existing in the most developed countries. And there are non-state alternatives to a growing WS, that – together with the market arrangements – that are being crowded out by that growth.
- Focus on the doctrines and the resulting policies which tend - in various ways – to obstruct – the reforms of the WS. One is the inequality debate which confuses inequality of opportunity with that of income and fighting poverty with fighting inequality. Another is the revival of crude Keynesianism in the guise of anti-austerity doctrine. Still another is the unconventional monetary policy which – by fuelling the asset bubble - has contributed to the wealth inequalities thus strengthening the political pressures for increased redistribution.
- Present and unmask policies which favour the rich while hurting the economy. They include restrictive zoning (e.g. in Britain) which fuels the rise in the real estate wealth, crony capitalism, insufficient competition. Demand their elimination in the name of libertarian egalitarianism.

Obviously there are just examples of how to make the antistatist case for a better welfare system more effective.

⁶ See: e.g. S. Goulard, 2014 on the French welfare state: “The government’s priority is to defend those who are already best protected”.

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