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## DISCUSSION PAPER SERIES

No. 1018

### WHAT IS THE DOMAIN OF THE WELFARE STATE?

Dennis J Snower

*HUMAN RESOURCES*



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**Centre for Economic Policy Research**

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**Dennis J Snower**

Discussion Paper No. 1018

November 1994

Centre for Economic Policy Research

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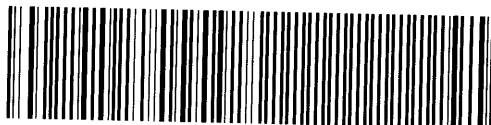
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## **ABSTRACT**

### **What is the Domain of the Welfare State?**

The paper examines the appropriate domain of the Welfare State by exploring the areas in which free enterprise fails to provide adequate welfare state services. The paper outlines a simple coherent strategy for formulating government welfare state policy by identifying the relevant market failures, government failures, and implementation costs. Two proposals for reform of the Welfare State are outlined.

JEL Classification: H1, H2, H4, I1, I2, I3, P5

Keywords: welfare state, free enterprise, unemployment, education, health, poverty, inequality

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## NON-TECHNICAL SUMMARY

The paper explores the appropriate domain of the Welfare State by examining the degree to which we can rely on free enterprise to deliver the requisite amount of Welfare State services. If market forces would lead to adequate provision of health services, education, pension provision, and insurance against unemployment, sickness, and disability, then clearly much of the Welfare State could be placed into the hands of households and firms, each pursuing their own self-interest. The major role of the government in supporting the Welfare State would then centre on redistributive measures, designed to cushion people's exposure to poverty.

In this context the paper argues that it is important to examine the need for government support of welfare state services in terms of uncompensated costs and benefits that prevent free enterprise from operating efficiently. A number of salient areas of Welfare State activities are investigated in this light.

For example, I argue that when the unemployment rate is high, employed workers tend to be substantially better off than their unemployed counterparts. Thus, when a firm hires unemployed workers, they usually experience a significant rise in their incomes. These workers will spend little, if any, of this extra income on the products of their own firm, but will buy a whole range of goods from other firms. These other firms consequently experience a rise in their sales and their profits. If the improvement is sufficiently large, they may find it worthwhile to hire workers themselves who, in turn, will spend their incomes on the products of other firms, thereby creating a chain reaction of increases in profits and wage incomes.

When the initiating firm hired some unemployed workers, it conferred benefits on other firms and other workers, but the beneficiaries did not have to compensate the firm for them. There is no feasible economic or legal mechanism for withholding the gains from the beneficiaries unless they compensate the initiating firm. As a result, something important doesn't get paid for.

Since the original firm is not compensated, it makes its hiring decision only with reference to the profits that it alone can achieve; it has no incentive to take the benefits to others into account. All the other firms are in the same position. Whenever the private gain from employing people is less than the overall social gain, then enterprise leads firms – as if by an invisible hand – to employ fewer workers than would be socially desirable. Seeing this particular

unemployment problem in this light suggests some appropriate policy responses, such as, for example, compensating the firms for the missing compensation by a reduction in the relevant payroll tax or by a marginal employment subsidy.

The same general approach can also be applied to the Welfare State problems of education and health provision. The reason why these are problems under free enterprise is that they both involve substantial uncompensated benefits.

The paper also applies the approach of uncompensated costs and benefits to the problems of poverty, discrimination, and inequality. It argues that reliable information about the loyalty, initiative, and concentration of employees are very hard to come by, and then often only at prohibitive cost. Consequently, employers simply make the best use of whatever information they can easily get hold of. One such piece of information is the length of time a job applicant has been unemployed. As a very, very rough generalization, the longer is an applicant's unemployment duration, the less likely it is that this person would turn out to be competent and productive once employed. Now, any genuinely productive worker who has had the misfortune of not finding a job promptly will automatically be counted with the unproductive people. Consequently, these workers may find themselves unemployed, or locked into disagreeable, low-paying jobs, even though their ability would entitle them to a high-paying job. There is nothing about free enterprise that stops this sort of thing from happening.

Other pieces of information to which employers generally have easy access are the sex, race, and age of potential applicants. Employers know that women and some minorities are more likely, on average, to quit their jobs than non-minority men, and that old workers tend to be less adaptable and more prone to illness, on average, than young workers. Thus, employers are led to discriminate against women, minorities, and senior citizens, making it more likely for them to remain unemployed or poor. This is not sexism, racism, or geriatrophobia; it is simply shrewd business practice under unfettered free enterprise.

Such business practice is generally inefficient. Beyond that, free enterprise may give rise to serious inequities. If the distribution of income generated by free enterprise is socially unacceptable, then the government needs to intervene. Altruism, of course, may help ease the burden of the very poor, but there is clearly no mechanism whereby individuals, each following their own altruistic instincts, are led to establish an equitable distribution of income.

Government intervention in this domain is quite different from the intervention to correct for market failures. It has nothing to do with compensating people for the costs and benefits they confer on others. In fact, it is just the opposite: it gives to the poor for things they haven't done and takes from the rich for things they have done. There are, of course, more and less efficient ways of redistributing income. Prevalent systems of transfers are often unduly wasteful.

The paper then explores why economic policy tends not to be designed according to these principles in practice. It explains why little or no attempt is made to deal with unemployment, education, and health by making people pay fully for the help and hurt they render to one another, and why politicians spend a lot of time interfering with free enterprise where it could be working well. To overcome these difficulties of political economy, the paper suggests three general proposals to mitigate government failure and thereby perhaps create a greater willingness to assess the government's Welfare State role in terms of uncompensated costs and benefits:

1. In formulating efficiency-promoting policies, compensate the victims wherever possible.
2. Put as many efficiency-promoting proposals as possible into one political package.
3. Formulating all new economic policies in terms of *both* the proposals for any necessary government expenditures *and* proposals for financing these expenditures.

Moving from the general political desiderata to the specific problems of the Welfare State, the paper makes two simple proposals to address some of the most significant inefficiencies and inequities in the provision of Welfare State services:

1. Put the decision concerning the split between government and market provision of Welfare State services into the hands of the consumers. This could be done in the following way. Classify everyone in the economy by income, age, sex, marital status, and other major determinants of individuals' demand for Welfare State services. Then compute the per capita cost of these services within each reference group. The first proposal is then (i) for the state to provide these Welfare State services free of charge and to finance them out of general tax revenues; and (ii) to give people the option of relinquishing their entitlements to these services in specific areas in return for a rebate amounting to  $x\%$  (say 70%) of the

cost of these services within their particular reference group. If the entitlements accrue at present (as in the case of public education for people with children of school age), the rebate is to take the form of a tax reduction. If the entitlements accrue in the future (as in the case of pensions for those currently of working age), the rebate would take the form of a bond, with maturity commensurate with when the entitlements accrue.

2. Give jobless people the option of using the funds that finance their unemployment benefits to provide vouchers to the firms who hire them. The vouchers would amount to wage subsidies for unemployed people. The vouchers would be worth more, the longer the individuals had been unemployed and the greater the fraction of the vouchers that firms use on training their new recruits. In this way the proposal could help correct for the uncompensated benefits from employment activity and training under free enterprise.

These two proposals would have to be supplemented by a safety net for those who are either unable to work (e.g. the elderly, the sick, or the disabled) or working more productively in the household sector (e.g. some single mothers with infants). Here income tax credits, medical care cover at reduced premiums, and housing benefits are called for. Inevitably such provision would generate some inefficient government bureaucracy and wasteful attempts by individuals to exploit legal loopholes, but these costs are unlikely to be significant relative to the inequities the safety net addresses. On the contrary, having avoided some of the sources of cost explosion in the Welfare State, the government could then afford to provide a generous safety net for the nation's poor.



## WHAT IS THE DOMAIN OF THE WELFARE STATE?

*Dennis J. Snower\**

### **1. The Problem**

The Welfare State is at a cross roads. In Western Europe, unemployment has trended upwards over the past two decades and many people are becoming increasingly unable to provide for themselves. Governments are finding it increasingly difficult to honor their commitments to the elderly through continued payment of retirement pensions. As the costs of health and education rapidly outpace tax receipts, European governments are reassessing their commitment to support a Welfare State. Meanwhile homelessness, crime, and drug abuse are on the rise. In the United States, the term "Welfare State" may be absent from the policy debate, but the issues aren't. Improving the quality of schooling, making health care affordable and broadly available, and providing a social safety net - these have become matters of pressing US policy concern. And for the people of Eastern Europe and the former Soviet Union, the problem of how to provide a cushion against economic uncertainties and inequities in the transition to free enterprise has taken on a crying urgency.

Over the postwar period, there have been two divergent government responses to these problems. In the 1950s and 60s, many European governments dramatically expanded their provision of Welfare State services, allowing the associated budgetary claims to rise steadily faster than inflation. These services often came to be seen not merely as a safe haven from destitution, but as an inalienable right of all citizens. Then in the 1980s, under the banner of the Conservative Revolution, this process was reversed. The

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vision of the social safety net receded, as the governments strove to make the poor more self-reliant and intent on acquiring initiative and skills.

The verdict on both experiments is now in. It is widely agreed that, although the growth of the Welfare State in the 1950s and 60s did reduce economic insecurity and achieve a more equitable distribution of income, it also reduced people's incentives to engage in productive activities. It also eroded personal freedoms, raised private-sector incentives to engage in black-market activities, and imposed large costs on the tax payer for the sake of small benefits to many special interest groups. As time wore on, the Welfare State gradually turned into the Transfer State,<sup>1</sup> making large and distortionary transfers of income, often not from the rich to the poor, but among politically important groups of middle class voters.

In those countries hit by the Conservative Revolution of the 1980s - notably in the UK and the US - incentives to work and produce were indeed promoted. The distribution of income widened dramatically, but the poor generally did not become hard-working and self-supporting as result. And while many governments focused less attention on alleviating poverty and unemployment, the Welfare State services to the middle classes remained virtually untouched. While the Welfare State withered, the Transfer State bloomed.

No real progress has been made. In a number of countries, the growth of government expenditures on the Welfare State has been arrested, but the unsatisfied needs for Welfare State services have risen. Governments have no coherent guidelines for the division of labor between the private and public sector in satisfying what are indisputable needs for security against economic uncertainty, mitigation of poverty, and limitation of waste in the provision of health, education, employment, and retirement

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<sup>1</sup>The term was coined by Assar Lindbeck (1988).

pensions.

No number of swings between the traditional right- and left-wing policies can get us out of this box. And, what is more, the underlying problem will inevitably get worse and worse with the passage of time, since the costs of Welfare State services are doomed to grow much faster than the average rate of inflation.

The reason is that the output of many Welfare State services is simply the unmediated labor input: doctors cannot significantly reduce the time spent with each patient without reducing the level of care; nor can teachers raise class size without reducing the quality of education. The productivity of these Welfare State services inevitably grows much more slowly than productivity in most other sectors of the economy. And since wages in the Welfare State services will not fall significantly behind the average wage level, the cost of the Welfare State must rise relative to average costs elsewhere. But as economic growth proceeds, the demand for health services, education, insurance against poverty and unemployment, etc., will naturally expand. And since the costs of Welfare State services rise relative to the costs of other commodities, society should consequently allocate an ever-increasing share of GNP to Welfare State services.

If governments are to finance these services, the size of the public sector will have to grow steadily. If they are to be provided by the private sector, they will have to exhaust an ever-growing proportion of consumers' budgets. And if the provision of these services is not divided efficiently between the government and the market, the social cost of this mistake is bound to rise and rise. In short, the question 'What is the domain of the Welfare State?' will inevitably become more pressing as time goes on.

The answer to this question depends crucially on the degree to which we can rely on free enterprise to deliver the requisite amount of Welfare State services. If market forces

would lead to adequate provision of health services, education, pension provision, and insurance against unemployment, sickness, and disability, then clearly much of the Welfare State could be placed into the hands of households and firms, each pursuing their own self-interest. The major role of the government in supporting the Welfare State would then center on redistributive measures, designed to cushion people's exposure to poverty.

Thus, to investigate the appropriate domain of the Welfare State, it is useful to begin by inquiring precisely why free enterprise may provide less Welfare State services than is socially desirable. What are the strengths and weaknesses of free enterprise in this area? Many politicians, civil servants, and journalists would have a lot to learn from returning to first principles and examining carefully what the basic economic case for and against free enterprise is.

Many people believe that this case is an ideological, not an economic, issue. I disagree. Economics has something vital to offer here: it can help us identify when free enterprise works in the public interest, and it can suggest corrective government policy measures when it doesn't. In so doing, it can provide useful guidelines on which Welfare State services can be left to the private sector and which need state support.

## **2. The Basic Case for Free Enterprise**

The most straightforward case for free enterprise was made by Adam Smith back in 1776 in a famous passage from *The Wealth of Nations*, in which he asserts that an individual who "intends only his own gain" is

*"led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for society that it was no part of*

*it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it."*

The underlying idea is simple. What free enterprise is all about is the opportunity for people to exchange goods with one another, on a voluntary basis, on terms which they themselves choose. Clearly, a voluntary exchange does not take place unless both the buyer and the seller can benefit from it.

The grocer who sells me my daily supply of kiwis and kumquats would not do so if this were not in her private interest. And I would not buy them if it were not in mine.

This point is so important that it is worth belaboring. Each person may be concerned only with his own interests, but by engaging in voluntary exchange he automatically furthers the interests of his trading partners as well. Why? Because if he wouldn't, there would be no one for him to trade with.

The terms on which goods are traded for one another are the relative prices of these goods. If people are free to set these prices as they wish under competitive conditions, they will automatically create maximum opportunity for voluntary exchange.

My grocer clearly has no incentive to charge £1 per kiwi, because if she did so, no one would buy her kiwis and she would make a loss on them. Nor does she have an incentive to charge a penny, because under those terms it would not be worth putting them up for sale.

Adam Smith's great insight was that the many millions of voluntary transactions that take place daily in a free-enterprise economy make all the people involved better off. This explains how people can promote each other's welfare, without having to rely on

altruism, and without making any explicit attempt to coordinate what they do.

The result, nevertheless, is a dazzling variety of complex activities that are aimed at satisfying our needs at the lowest possible cost. It is important to recognize that even our most basic material needs - for food, clothing, housing - require an enormous amount of coordinated effort, often from people unknown to one another, working in different parts of the globe.

When I, sitting at my desk in London, decide to talk to my sister, sitting at her desk in New York, I dial her number and a second later telephone rings and she answers it. How do I pull that off? The technicians who constructed the telecommunications satellite are not my friends. Nor are the miners who extracted the raw materials from which the satellite is made. The simple reason why I have this opportunity is that I pay my telephone bills. And the reason that the technicians constructed the satellite is that they were paid for doing so. And so on.

No central planners are needed to coordinate all these activities. People simply do them on their own, in the process of exercising their freedom of choice through voluntary exchange. It is not just that central planners are not needed to produce most of our ordinary goods and services, they are positively undesirable in these areas. This has nothing to do with lack of ability in some central planners, or bureaucratic red tape, or political corruption. Even the most able and benevolent of planners clearly cannot coordinate all the activities of many millions of people to use our ever-changing resources to produce countless goods and services to satisfy our ever-changing needs. Even partial attempts to do so require massive, costly administrations, whereas free enterprise performs the coordination for nothing.

Then there is the problem of motivation. Under free enterprise, people tend to work hard

and be responsive to their customers' needs, because in doing so they make themselves better off. People tend not to be as keyed up when the name of the game is to fulfill a five-year plan.

The case for free enterprise has a simple, persuasive ring. And just because it is so persuasive, it is important to take some care in exploring its failures in providing Welfare State services and the need for government intervention.

### **3. Government Intervention to Support Free Enterprise**

To begin with, we must keep in mind that the smooth functioning of free enterprise is not an argument against all forms of government intervention. In fact, it is only *through* government intervention that free enterprise can be made to function.

It is pointless to give consumers the opportunity to buy cars, houses, clothing, if these goods can be stolen with impunity once their backs are turned. It is equally pointless to give workers the opportunity to take the jobs of their choice if the employers cannot be prevented from withholding the pay checks on pay day.

Free enterprise can proceed only once the government has succeeded in formulating and enforcing laws of crime, property, and contract. This task requires a legal system that defines property rights on the basis of voluntary exchange, imposes restrictions on the types of contracts that are legally enforceable, arbitrates disputes - and does all of this in a sufficiently predictable, understandable way to ensure smooth and secure trading relationships. Furthermore, it requires a comprehensive, systematic, objective system for the collection and dissemination of economic data, since it is impossible to enforce laws of property and contract without it. It also calls for a penal system in which offenders receive predictable punishments. And it calls for years and years of

experience, in which the public has a chance to become familiar with the laws and how they are enforced, and the law-makers and law-enforcers learn what is feasible and expedient. This is clearly a tall order.

These considerations are particularly important with regard to the Welfare State. The degree to which the private sector responds to the public interest in delivering Welfare State services depends on the framework of laws, institutions, and norms that define property rights, determine the nature of contracts, and specify which activities are crimes. These frameworks differ dramatically from country to country. The Austria, Italy, Sweden, Switzerland, the UK, and the US have radically different institutions, determining the scope of free enterprise and providing channels through which interactions among private-sector agents manifest themselves. "Free enterprise", consequently, has a different meaning in each of these countries. Thus it is scarcely surprising that they have witnessed vastly different private-sector responses to the public's demands for Welfare State services and consequently different needs for government intervention.

#### **4. Uncompensated Costs and Benefits**

But that is just the tip of the iceberg. It is certainly not true that, within the framework erected by the laws, institutions, and norms of a country, free enterprise always leads self-interested people to act in the public interest. Despite voluntary exchange, free enterprise is capable of sending the wrong signals to individuals, thereby inducing people to hurt - rather than help - each other.

Market economies periodically go through prolonged periods of high unemployment and excess capacity, even in the absence of substantial minimum wage provisions, price controls, or other impediments to voluntary exchange. In such periods, free enterprise



activity leads us to waste our labor and capital services on a colossal scale. Beyond that, free enterprise may not provide sufficient health care, education, and social insurance.

Why? The answer is deceptively simple: free enterprise works efficiently only when people get paid for all the advantages they confer on others and pay for all the damages they impose on others. More precisely, when all the costs and benefits are compensated, free enterprise ensures that people will continue to trade with one another until it is impossible to make anyone better off without making someone else worse off.

It is clear why this must be so. When people have to pay for all the costs they impose on others and when they get paid for all the benefits, then their own selfish objectives will necessarily coincide with those of society at large. After all, if you harm someone else, you yourself will then have to pay the damage; and if you benefit someone else, you yourself will be compensated. Under these circumstances, people behave in a socially responsible way simply by pursuing their own private ends. Free enterprise will then not only permit the people who buy and sell from one another to make each other better off, but it would also ensure that there are no socially undesirable effects on third parties as result.

But, the layman may ask, isn't that precisely what always happens under free enterprise? Under voluntary exchange, everything is always paid for, right? Wrong.

## **5. Unemployment**

Let us begin by considering a particularly important Welfare State problem: unemployment. When the unemployment rate is high, employed workers tend to be substantially better off than their unemployed counterparts. There are many solid free-

market reasons why this should be so: Employers may offer high wages to motivate their employees to work hard, to discourage them from quitting, and to attract the best candidates in the job market. Or the high wages may be the result of union activities or all sorts of pressures that the incumbent workers are able put on their employers.

Whatever the reason, when a firm hires unemployed workers, they usually experience a significant rise in their incomes. These workers will spend little, if any, of this extra income on the products of their own firm, but will buy a whole range of goods from other firms. These other firms consequently experience a rise in their sales and their profits. If the improvement is sufficiently large, they may find it worthwhile to hire workers themselves who, in turn, will spend their incomes on the products of other firms, thereby creating a chain reaction of increases in profits and wage incomes.

There is an important moral to this story. When the initiating firm hired some unemployed workers, it conferred benefits on other firms and other workers, but the beneficiaries did not have to compensate the firm for them. There is no feasible economic or legal mechanism for withholding the gains from the beneficiaries unless they compensate the initiating firm. As result, something important doesn't get paid for.

Since the original firm is not compensated, it makes its hiring decision only with reference to the profits that it alone can achieve; it has no incentive to take the benefits to others into account. All the other firms are in the same position. Whenever the private gain from employing people is less than the overall social gain, then free enterprise leads firms - as if by an Invisible Hand - to employ fewer workers than would be socially desirable. There is, in short, a "market failure", a failure of individualistic activity in unfettered markets to make people as well off as they can be.

So what is to be done? How should the government react to the emergence of an unemployment problem of the sort I have just described?

First it must decide whether to tackle the market failure by eliminating the market, or to keep working within the system of voluntary exchange. Given the information, coordination, and motivation problems that I have already mentioned, the large-scale central planning that would be required to eliminate unemployment does not seem terribly attractive. The chances are that it would simply replace the market failure by an even bigger planning failure.

The alternative is to retain the advantages of voluntary exchange, but to redirect the incentives that buyers and sellers face. There are many options:

- Should unemployment benefits be raised, so as to compensate the victims of this malfunction of free enterprise?
- Or should unemployment benefits be reduced, so as to give the unemployed workers a greater incentive to seek jobs and thereby reduce the unemployment rate?
- Or should the government increase its spending on the firms' products, so as to induce the firms to hire more workers?
- Or should firms be compensated for the benefits that their hiring activity confers on others, say, by a reduction in the relevant payroll tax or by a marginal employment subsidy?

Each of these policies, and many more, have indeed been proposed at one time or another. What is particularly interesting about looking at unemployment from the vantage point of uncompensated benefits is that it suggests which policy is potentially appropriate. For the particular unemployment problem above, there is only one, namely, the last.

The reason is straightforward. In the above account, the unemployed workers aren't helping or hurting anyone else; so there is no case for either increasing or decreasing unemployment benefits. There is only one missing compensation in this unemployment problem, and that is that firms do not get compensated for the profit and wage income they generate in other firms. Both an increase in government spending and an employment subsidy could rectify this failure, one by raising the firms' revenues, the other by reducing their labor costs.

But the proposal to increase government spending (the standard Keynesian prescription) has major weaknesses: What is the government spending for? If this spending is needed to provide the optimal mix of public- versus private-sector goods and services, then it should have been undertaken regardless of the unemployment rate; and if it is not needed, then resources are being wasted. Moreover, it may be possible for firms to respond to the increased government spending by simply using their labor and capital more fully, rather than by hiring more workers. In that event, the policy compensates firms for something they haven't done.

And so we are left with the last policy proposal: to reimburse firms for uncompensated benefits by making it cheaper for them to hire new workers.

I have called this policy "potentially appropriate", and not just simply "desirable", because the case for government intervention does not just depend on the existence of market failures. It also depends on whether political and bureaucratic processes would permit the government to intervene in the appropriate way and, if so, what the costs of such government intervention would be. If the intervention is likely to be particularly inappropriate or costly, the best thing to do is to do nothing at all.<sup>2</sup>

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<sup>2</sup>This argument is spelled out in greater detail in Snower (1993).

In practice there is, needless to say, much more to unemployment and its policy treatment than this tale brings to light. Unemployment may have many causes: it may be generated by many different market failures. In principle, different market failures may call for different policy responses. But many of the unemployment problems that economists have been able to analyze do involve uncompensated benefits of the sort I have described, calling for policies that reduce firms' labor costs.

Finally, we must keep in mind that the existence of unemployment is not invariably a sign of market failure. Some people would remain unemployed even if all costs and benefits were compensated. For example, employees who quit one job in order to find another, mothers who reenter the labor force after their children have entered school, school leavers who are unsure of which jobs they want - these may all go through periods of unemployment even when free enterprise is working properly. In fact, such unemployment is a sign that free enterprise is doing its job, because in a world of imperfect information, some people need to go through transitional phases of unemployment when making their job choices, while others simply prefer leisure to work.

There are some insensitive individuals who would have us believe that *all* unemployment is of this variety, but we need not be deceived. Whenever people are unable to find work over prolonged periods of time even though they would be willing to work for less than the prevailing wages at jobs for which they are just as well qualified as the current job holders, it is clear that unemployment is not merely a voluntary transitional phase or a leisure spree. Between 1980 and 1982 the aggregate unemployment rate increased by 77% in the UK, by 36% in the US, and by 103% percent in Germany. Does it make sense to suggest that this massive group of people, living in different parts of the world, all decided at the same time to take a long vacation or spend a long time in transit between jobs?

The general lesson to be learnt from this analysis is that by looking at economic problems in terms of market failures, government failures, and implementation costs, we are able to develop a coherent strategy for formulating government policy: First, identify which important costs and benefits remain uncompensated under free enterprise; next, devise policies that make up for the missing compensation, and finally, consider implementing only those policies for which the costs of implementation and of government failure are likely to be substantially lower than the costs of the market failure.

This approach is no news to economists, but it is rarely - if ever - to be found in the corridors of political power.

## **6. Education and Health**

The same general approach can also be applied to the Welfare State problems of education and health provision. The reason why these are problems under free enterprise is that they both involve substantial uncompensated benefits.

The external benefits from education, falling not on the individuals being educated, but on society as a whole, are well-known.

- Education turns people into more informed voters, who are thereby able to raise the quality of service that democracy provides.
- Education makes it easier for people to communicate and work with one another, not only by enabling them to read and write, but also by making them more reliable, punctual, and adaptable. Production and sales processes often call for a large degree of cooperation among workers, and education helps workers enhance each others productivities in these settings.
- Education tends to reduce the overall need for many forms of crime protection.

The list could go on and on. Given these huge uncompensated benefits, free enterprise

may be expected to supply far too little education. Thus it is potentially appropriate for the government to subsidize education provision.

A similar case can be made for the provision of health care. This also generates substantial external benefits, associated with medical research, control of contagious diseases, and so on. A careful analysis of where these uncompensated costs and benefits lie can yield useful guidelines for the areas in which free enterprise is most likely to fail and thus government support of health provision is potentially crucial.

Not only the supplies, but also the demands for education and health are likely to be too low under free enterprise. The reason is to be found in the credit and insurance markets.

Since banks have little information about the potential ability of students, they are unwilling to provide sufficient loans. Adjusting their risk premia on such loans may not help, because the higher the interest rate they charge, the greater the risk of default will be. Default is an uncompensated cost borne by the banks. Thus it is potentially appropriate for the government to subsidize financing of education.

Similarly, insurance companies have limited information about the health risks and health maintenance activities of their applicants. And thus they have no incentive to provide sufficient insurance. There is a potentially appropriate role for the government to play here as well.

As we know, there are many ways in which the provision and finance of education and health can be supported.

One is the "central planning approach", in which the state takes over the provision of

education and health and offers it at a fixed (generally very low) price to the public.

Another possibility that has received much attention in the field of education is the school voucher system which is meant to support education without robbing it of the advantages of free enterprise:

- students (or their parents) are given freedom of choice, and
- schools are given an incentive to compete with one another.

For better or worse, no attempt has yet been made to propose the voucher system for health care, although the arguments for it in this area are similar to those in education.

By some strange quirk of history, the provision and financing of education and health are usually tied to one another in practice: In order for students to receive state support, they must attend state-run schools; and in order for patients to receive state support, they must be treated at state-run hospitals. A quick look at the uncompensated benefits from education and health provision and financing indicates that there is no reason to believe that this linkage is necessarily desirable. If there is a case for subsidizing the provision of state-run schools and state-run hospitals, then that case can often also be made for private schools and private hospitals. Discriminatory treatment in education and health provision is a terrible way to redistribute income.

## **7. Poverty, Discrimination, and Inequality**

Finally, let me apply the approach of uncompensated costs and benefits to poverty, discrimination, and inequality - areas that usually lie on the fringes of any discussion of free enterprise, but that are central to the Welfare State.



Perhaps a good way to begin is to return to my discussion of unemployment. There I mentioned that some unemployment may remain even if all costs and benefits were compensated, specifically, the unemployment of those who are in transit between jobs and those who prefer not to work.

But there is another, more sinister sort of unemployment that may also occur when free enterprise is functioning perfectly: this is the unemployment of educationally, physically, and psychologically disadvantaged people. How does free enterprise generate such unemployment? The answer is through voluntary exchange.

And that is not all. It is a fact of business life that reliable information about the loyalty, initiative, and concentration of employees are very hard to come by, and then often only at prohibitive cost. What employers do, understandably, is to make the best use of whatever information they can easily get hold of. One such piece of information is the length of time a job applicant has been unemployed. As a very, very rough generalization, the longer is an applicant's unemployment duration, the less likely it is that this person would turn out to be competent and product once employed. Now, any genuinely productive worker who has had the misfortune of not finding a job promptly will automatically be counted with the unproductive people. Consequently, these workers may find themselves unemployed, or locked into disagreeable, low-paying jobs, even though their ability would entitle them to a high-paying job. There is nothing about free enterprise that stops this sort of thing from happening.

Other pieces of information to which employers generally have easy access are the sex, race, and age of potential applicants. Employers know that women and some minorities are more likely, on average, to quit their jobs than non-minority men, and that old workers tend to be less adaptable and more prone to illness, on average, than young workers. Thus, the employers are led to discriminate against women, minorities, and senior

citizens, making it more likely for them to remain unemployed or poor. This is not sexism, racism, or geriatrophobia; it is simply shrewd business practice under unfettered free enterprise.

Such business practice is generally inefficient. Beyond that, free enterprise may give rise to serious inequities. Recall that voluntary exchange in the labor market can take place whenever an employer and a worker can agree on a wage that makes it worthwhile *both* for the employer to hire the worker *and* for the worker to accept the job. Now, the productivity of some workers may be so low, that it is not worth the employers' while to hire them at *any* wage would permit them to sustain life. There is presumably a much larger group of workers who are unemployable at any wage above their unemployment benefits. All these workers will be driven into unemployment under free enterprise. And there is an even larger group that can find employment at wages in excess of their unemployment benefits, but who will nevertheless remain terribly poor. There is nothing in the nature of free enterprise that prevents such inequities.

If the distribution of income generated by free enterprise is socially unacceptable, then the government needs to intervene. Altruism, of course, may help ease the burden of the very poor, but there is clearly no mechanism whereby individuals, each following their own altruistic instincts, are led to establish an equitable distribution of income. Government intervention in this domain is quite different from the intervention I have considered thus far. It has nothing to do with compensating people for the costs and benefits they confer on others. In fact, it is just the opposite: it gives to the poor for things they haven't done and takes from the rich for things they have done.

There is an impractical, but very famous, theorem in economics - known as the Second Fundamental Theorem of Welfare Economics - which states that if redistributive transfers among people are in "lump-sum" terms - that is, in fixed amounts that are not related to

their economic activities - then they will not interfere with the efficiency of the free-enterprise system. However, such transfers exist only in the realm of economic mythology, because if people's economic activities are *responsible* for inequalities of income, then it is impossible to equalize the income distribution without relating the transfers to people's activities.

Thus the government cannot reduce poverty and equalize the distribution of income without undoing some of the efficiency of free enterprise. In the process of equalizing income, the government creates uncompensated costs and benefits. When income is moved from the haves to the have-nots, the haves begin to lose their incentive to work - since they are no longer fully compensated for what they do - while the have-nots do not gain such an incentive. Quite on the contrary, the have-nots become less inclined to work, since they are being compensated for what they do not do. So, when the government tries to equalize the slices each of us get out of the national economic pie, the size of the pie shrinks. This is the well-known "equity-efficiency tradeoff".

There are, of course, more and less efficient ways of redistributing income. Prevalent systems of transfers are often unduly wasteful. For example, when an unemployed person finds a job, he usually loses his unemployment benefits as well as subsidies for housing, medical care, and so on, and he acquires tax liabilities on his newly earned income. Thus the net gain from becoming employed is often very small, in some cases even negative. This method of redistributing income does not merely reduce people's incentive to work, but it provides the low-income groups with an overpowering incentive not to work at all. Thereby this system of redistribution magnifies existing market failures that generate unemployment.

## **8. Special-Interest Groups, Bureaucracies, and Government Failures**

There is one major, obvious difficulty with approaching economic policy through market failures, government failures, implementation costs, and the equity-efficiency tradeoff - the practical difficulty that this is not the way economic policy, in practice, is made. Politicians do not, as a point of fact, spend their days agonizing over whether a particular cost or benefit is uncompensated before drafting laws and casting votes. Little or no attempt is made to deal with unemployment, education, and health by making people pay fully for the help and hurt they render to one another.

Furthermore, politicians spend a lot of time interfering with free enterprise where it could be working well.

Agricultural subsidies are a particularly transparent example. The main argument in their favor is that farmers face giant weather risks, which translate into risks of price fluctuations. Although some insurance against these risks can be obtained in futures markets, the overall amount of insurance provided under free enterprise is inadequate. This is one of the important official rationalizations for agricultural price supports. But if governments were genuinely interested in reducing farmers' risks, there would be much more efficient ways of doing so. They could, for instance, provide the insurance to the farmers themselves, at premia which reflect the cost of insurance provision. But if they actually did so, the farm lobby would be furious, for the actual point of current agricultural price supports is actually to raise farmers' incomes; stabilization is of secondary importance.

What has gone wrong here? My guess is that much of the answer lies in the difference between the ways in which economists and politicians evaluate the gains from public policy.

For economists it is natural to measure the attractiveness of a policy by adding up all

the resulting gains and losses to everyone in the economy and finding whether the gainers can compensate the losers. Then, if it can be shown that some people can be made better off without anyone else becoming worse off, the policy is deemed to be desirable.

Politicians generally have a different way of adding up. For them, a policy becomes desirable if it can make a small, identifiable group of voters substantially better off, even if it leaves a large, diffuse group of people slightly worse off. This is particularly true if the adverse effects of the policy are indirect and complex, or - even better - completely hidden from view. In that case, politicians are able to attract the votes of the beneficiaries without necessarily losing the votes of the victims. The trick is to make each of the small number of beneficiaries substantially better off, while each of the large number of victims is only marginally and indirectly worse off. Never mind that the losses to *all* the victims, taken together, may be far greater than the gains to *all* the beneficiaries. The politician's main concern, naturally, is to get votes, not keep tabs on all the gains and losses.

Special-interest groups are, of course, well acquainted with the politicians' way of adding up. Indeed, a major incentive to form special-interest groups is precisely to create small, identifiable groups of voters whose allegiance can be bought with the appropriate policies. This, I believe, goes a long way to explain many of the most blatantly inefficient Welfare State policies.

The main business of special interest groups, as often as not, is the distortion of information. For example, when voters tend get queasy about subsidizing the incomes of wealthy farmers, the farm lobby supports broad-based policies - such as agricultural price supports - that can be supported with reference to the poor farmers. Never mind that the wealthy farmers derive some, perhaps most, of the benefit.

In many cases, the inefficiencies created by special interest groups are magnified through the operation of government bureaucracies. Whereas special interest groups provide some bad ideas, bureaucracies sometimes ensure that these ideas turn out to be much more costly than even the special interest groups could have guessed. The productivity of bureaucrats is often extremely difficult to measure. For this reason, it is virtually impossible to draw up standards to improve their performance. It is in bureaucracies that Parkinson's Law really comes into its own: "Work expands so as to fill the time available for its completion." Like special interest groups, bureaucrats can influence the flow of information, and they are sometimes led - as if by an Invisible Hand - to use this influence so as to increase the size of their staffs.

Common sense tells us that people have the greatest incentive to avoid waste when they are using their own money to satisfy their own needs. Bureaucrats use other people's money to satisfy yet other people's needs - and (although this is not part of their job description) their own as well. The role of special-interest groups is to convince the politicians to tell the government bureaucrats to redistribute money from the public to the special-interest constituency. It is really no wonder that the result does not satisfy the economists' efficiency criteria.

### **9. Three General Proposals**

If there is any way out of this mess, it must lie in the realm of politics rather than economics. Thus let me suggest three general proposals that are meant to mitigate government failure and thereby perhaps create a greater willingness to assess the government's Welfare State role in terms of uncompensated costs and benefits:

*(1) In formulating efficiency-promoting policies, compensate the victims wherever possible.*

Since special-interest groups manage to promote the adoption of inefficient policies by conferring great benefit on each of a small, identifiable group of people while imposing small costs on each of a much larger group, it is scarcely surprising that getting rid of these policies requires hurting a few badly for the sake of a more diffuse public interest. And for that reason, as we have seen, economically efficient policies are often considered political nonsense.

But recall that what makes a policy efficient is that, through it, some people could be made better off without making anyone else worse off. Usually this result can be brought about only if the implementation of the policy is followed by transfers from the winners to the losers. What my first political proposal dictates is that the transfers should be made part of the same political package as the efficiency-promoting policy. For example, a policy that reduces trade barriers could be linked to a proposal for very generous retraining and relocation support for workers who thereby lose their jobs. In that event, economic efficiency would become less of a vote-loser, and perhaps even a vote-gainer to politicians.

*(2) Put as many efficiency-promoting proposals as possible into one political package.*

If a large number of efficiency-promoting proposals are included in a single piece of legislation, it becomes less likely that small, identifiable groups of people will still be badly hurt.<sup>3</sup> The US tax reform of 1986 is a case in point. Groups that were clearly hurt by some of the reform provisions (e.g. the automobile industry, the real-estate sector) were helped by other provisions.

*(3) Formulating all new economic policies in terms of both the proposals for any*

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<sup>3</sup>This case is argued persuasively in Blinder (1986, ch. 7).

*necessary government expenditures and proposals for financing of these expenditures.*

The standard political processes give special-interest groups too easy a time. To gain political support, it is often sufficient for them identify the additional government expenditures required to obtain the votes of a particular constituency. They need not be concerned with where the money is to come from. If every proposal were required to contain its own financing provisions, then different special-interest groups would be brought into conflict with one another and would possibly gain an incentive to become more socially responsible.

## **10. Two Proposals for Reform of the Welfare State**

Moving from the general political desiderata to the specific problems of the Welfare State, let me make two simple proposals that attempt to address some of the most significant inefficiencies and inequities in the provision of Welfare State services.

### *10a. Opting-Out of the Government's Welfare State Services*

The first proposal is meant to put the decision concerning the split between government and market provision of Welfare State services into the hands of the consumers.

The salient problem of Welfare State provision is that market failures as well as government failures abound and that it is practically impossible to assess the relative social costs of these two types of failure with respect to each Welfare State activity. Government officials cannot be expected to make reliable judgments on this issue, even if they were not an interested party. The issue is analogous to that of deciding what should be done by government directive and what by private initiative in a centrally



planned economy; here, too, government bureaucrats are not well situated to discern the public interest. The failure of central planning to bring living standards in Eastern Europe and the former Soviet Union into line with those in advanced market economies indicates how important it is to get this decision right. The strength of the advanced market economies has been to put the decision into the hands of the consumer. My proposal is to put the division of responsibility over Welfare State services into the consumer's hands as well.

This could be done in the following way. Classify everyone in the economy by income, age, sex, marital status, and other major determinants of individuals' demand for Welfare State services. Then compute the per capita cost of these services within each reference group. These costs are to be interpreted widely, to include not only sickness and disability benefits, and health, education and housing costs, but also retirement pensions. Only unemployment benefits - the subject of my next proposal - are to be excluded. The first proposal is then (i) for the state to provide these Welfare State services free of charge and to finance them out of general tax revenues and (ii) to give people the option of relinquishing their entitlements to these services in specific areas return for a rebate amounting to  $x\%$  (say, 70%) of the cost of these services within their particular reference group. If the entitlements accrue at present (as in the case of public education for people with children of school age), the rebate is to take the form of a tax reduction. If the entitlements accrue in the future (as in the case of pensions for those currently of working age), the rebate would take the form of a bond, with maturity commensurate with when the entitlements accrue.

That would leave  $(1-x)\%$  (say, 30%) of the funds to cover the deadweight loss arising when people who consume a disproportionately small fraction of each type of service take disproportionately large advantage of the opt-out option. Needless to say, this option would have to be supplemented by compulsory insurance against sickness, disability, and

old age.

This proposal is equivalent to giving everyone a voucher for specific Welfare State services, with the size of the voucher depending on certain personal characteristics and, other things being equal, with larger vouchers going to those who do not opt out of the state system. There is good reason to believe that free public provision of health, education, and other benefits may enable the state to reap substantial economies of scale by avoiding monitoring, billing, and other transactions costs, but that this saving may be partially or wholly undone by government failures such as the proliferation of bureaucracy. On the other hand, private provision would presumably be more effective in making the consumers of these services internalize the relevant costs, although some market failures would remain. It is simply impossible to tell a priori whether the balance of advantage would lie with public or private provision. What is clear, however, is that making these systems to exist side by side and compete with one another will give each an incentive to become more efficient than it would otherwise be.

Policy makers often argue that to permit people to opt out of publicly provided Welfare State services would turn these services into benefits-in-kind for the poor, and that services to the poor eventually become poor services. The underlying reasoning is that the middle classes would opt out and would then, as voters, withdraw their support for a high-quality Welfare State whose beneficiaries are primarily poor. However, this argument simply does not apply to the proposal above. First, it is not true that the middle classes invariably demand fewer Welfare State services than the poor; this is particularly evident with regard to education and retirement pensions. Second, even if this were true, then - under the proposal - the affluent people would receive smaller tax reductions than the poor for opting out. And third, the proposal ties the tax reductions (for those who have opted out) to the cost of the state-provided services (for those who have not opted out); thus the affluent would have no incentive to vote

for a run-down of the state sector.

Here is a straightforward way for governments to reduce their spending on social security, health, education, and housing without putting significant segments of the voting population at a disadvantage. The reduction in distortionary tax-and-transfer arrangements should gradually generate enough saving to the government - through taxation of the new private sector Welfare State provision - to permit improved Welfare State provision to the poor.

#### *10b. Using Unemployment Benefits to Create Wage Subsidies*

Most people overwhelmingly prefer to work for pay rather than receive government hand-outs for remaining idle. This is not just because unemployment benefits generally fall short of wages, but primarily because people have a deep-seated need to be productive and to support themselves. Nevertheless, as noted in Section 7, governments in most advanced industrial countries discourage people from work by paying them when they are unemployed, and removing these benefits and imposing taxes when they become employed. In this way, governments reduce firms' incentives to hire new entrants and, recalling the argument of Section 5, these firms in times of recession may already be hiring too few people since they are not compensated for the full social benefits of this activity. Furthermore, the unemployed - particularly the long-term unemployed - are generally unlikely to be fully rewarded for training themselves, regardless of how the costs of training are split between the worker and the training firm. The reason is that when a long-term unemployed person is given training, part of the benefits from training falls not on the trainer or the trainee, but on third parties, namely, on firms that can poach the workers after they have been trained. Thus the social benefit from training will exceed the private benefit and consequently free enterprise will not provide sufficient incentives for the long-term unemployed to become skilled.

My second proposal<sup>4</sup> is to replace this policy that encourages unemployment by one that encourages employment. Specifically, the proposal is to give jobless people the option of using the funds that finance their unemployment benefits to provide vouchers to the firms who hire them. The vouchers would amount to wage subsidies for unemployed people. The vouchers would be worth more, the longer the individuals had been unemployed and the greater the fraction of the vouchers that firms use on training their new recruits. In this way the proposal could help correct for the uncompensated benefits from employment activity and training under free enterprise.

The underlying vision is simple. To the unemployed, the amount governments generally spend on unemployment benefits may not appear very substantial; but if these funds, along with the foregone tax revenues, are offered to employers as wage subsidies, they may have a very substantial effect on employment. Since the program is voluntary, the unemployed would join only if it is to their advantage. Many may well become much better off, since the wages they would be offered would generally be much higher than their unemployment benefits. At the same time, employers would join only if they found this profitable. Once again, many may well do so, since the subsidies reduce their labor costs.

In short, employees would wind up receiving substantially more than their unemployment benefits, and many employers would wind up paying substantially less than the prevailing wages. The difference would be the unemployment support that has been transferred to wage subsidies. When people draw unemployment benefits, the government bears the cost of supporting them single-handedly. But when they transfer these benefits to wage subsidies, the government shares this cost with the firms that hire them.

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<sup>4</sup>See Snower (1994) for a brief theoretical and empirical analysis of this proposal.

Since the government would not be spending more on the wage subsidies than it would have spend anyway on unemployment support, the reduction in unemployment could be achieved at no extra budgetary cost. All that would happen is that the funds that previously encourage unemployment would now be encouraging employment.

The program would give the government an instrument for tackling head-on the problem of long-term unemployment. The depression, illness, family disruption, and crime that we associate with unemployment falls primarily on the shoulders of the long-term unemployed. When people fall into the unemployment trap, their skills erode, they lose their motivation to find jobs, and employers become wary of hiring them. Thus the longer they are unemployed, the lower are their chances of employment. Current unemployment benefit systems provide little countervailing incentive for the long-term unemployed to find work. To give workers with different unemployment histories a level playing field, the program would provide progressively larger incentives for firms to hire workers with longer unemployment spells. Since the long-term unemployment rate has no significant effect on wage growth, reducing the number of long-term unemployed would not be inflationary.

The program could provide a substantial stimulus for training. Firms would use the vouchers to train their new entrants only if they intend to retain their recruits after the vouchers have run out. Thus the training for the unemployed would automatically come with the prospect of long-term employment. This is something that existing government training schemes do not offer. Many of the existing schemes also run the risk of being ill-suited to people's diverse potential job opportunities, whereas under the proposal firms would naturally provide the training most appropriate to the available jobs. And while existing training schemes are costly to run, this proposal would impose no additional cost on the government.

The program would also function as an automatic stabilizer: as the economy moves out of recession, the unemployment pool shrinks, thereby reducing the amount spent on wage subsidies. Thus the program would provide maximum wage subsidies when unemployment was highest, and would automatically phase itself out of existence as the economy approached full employment.

The average unemployment benefit package in most advanced industrialized countries amounts to 40%-80% of the average wage in these countries, corresponding to 40%-80% wage subsidies. But now supposing that only *half* the funds financing the current unemployment benefit package were used to finance the wage subsidies, then the average subsidy would amount to 20%-40%. In many countries this would have a substantial effect on employment, particularly because the subsidies are unlikely to have any pronounced effects on real wages.<sup>5</sup> That would still leave half of the funds financing the current unemployment benefit package to cover "deadweight loss" (vouchers going to employers who would have hired unemployed people anyway) and "displacement" (employers evading the restrictions of the program by replacing existing employees with those who attract a subsidy).

The fall in unemployment would also give some governments the opportunity to expand their tax base by raising the retirement age for both men and women to 70. The cost of the Welfare State to the tax payer has exploded not just because these services have been getting steadily more expensive, but also because many governments artificially depress the number of tax payers through its retirement legislation. Not only do people live longer than they used to, but they also continue to be productive for longer. By putting many elderly people out of work long before they cease being productive, governments increase the number of depends on the Welfare State and reduces the number of providers. Raising the retirement age would keep society from hamstringing itself in

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<sup>5</sup>On the one hand, a tightening of the labor market tends to improve employees' fall-back positions in wage negotiations; on the other, the subsidies would improve firms' fall-back positions as well.

this curious way.

### *10c. The Social Safety Net*

The two proposals could be expected to tackle many, but of course not all, of the main inequities that commonly arise in market economies. They would have to be supplemented by a safety net for those who are either unable to work (e.g. the elderly, the sick, or the disabled) or working more productively in the household sector (e.g. some single mothers with infants). Here income tax credits, medical care cover at reduced premiums, and housing benefits are called for. Inevitably such provision will would generate some inefficient government bureaucracy and wasteful attempts by individuals to exploit legal loopholes, but these costs are unlikely to be significant relative to the inequities the safety net addresses. On the contrary, having avoided some of the sources of cost explosion in the Welfare State, the government could then afford to provide a generous safety net for the nation's poor.

## **11. Conclusion**

George Bernard Shaw said, "Reformers have the idea that change can be achieved by brute sanity." The proposals above are inevitably vulnerable to this pitfall.

I have argued that since free enterprise performs a massive coordination and motivation feat, it is generally advisable to correct its failings in delivering Welfare State services not by suspending market forces, but rather by redirecting them. Clues on how this is to be done can be found by evaluating the costs and benefits that go uncompensated under free enterprise and by remaining sensitive to inequalities. Then it becomes the business of economic policy to readjust the incentives that buyers and sellers face so that, in pursuing their own ends, they automatically take the public

interest into account. In short, it becomes the business of economic policy to twist the Invisible Hand, not to amputate it.

Perhaps it is here that the proverbial "Third Road" between laissez-faire capitalism and the centrally-planned Welfare State is to be found. Even if brute sanity is not sufficient to get there, it surely can't do any harm to have sanity on our side.



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