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Working Paper

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IUI Working Paper, No. 441

Provided in Cooperation with:
Research Institute of Industrial Economics (IFN), Stockholm

Suggested Citation: Lindbeck, Assar (1995) : Welfare State Disincentives with Endogenous Habits and Norms, IUI Working Paper, No. 441, The Research Institute of Industrial Economics (IUI), Stockholm

This Version is available at:
https://hdl.handle.net/10419/95214

Industriens Utredningsinstitut
THE INDUSTRIAL INSTITUTE FOR ECONOMIC AND SOCIAL RESEARCH

A list of Working Papers on the last pages

Published in *Scandinavian Journal of Economics.*

No. 441, 1995

WELFARE STATE DISINCENTIVES WITH ENDOGENOUS HABITS AND NORMS

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October 1995

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Sept. 5, 1995

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WELFARE STATE DISINCENTIVES WITH ENDOGENOUS HABITS AND NORMS*

Abstract:

It is assumed in this paper that habits and social norms constrain the influence of economic disincentives on individual behavior, but that these constraints themselves may subsequently be influenced by the very same disincentives. It is also assumed that an individual is more likely to obey such habits and norms if many individuals in society do so. Though such constraints on economic behavior usually recede only gradually in response to changes in economic incentives, it is argued that major macroeconomic shocks may drastically speed up the process (a "ketchup effect"). These features may generate multiple equilibria and vicious dynamics.

I. The basic idea

The basic idea of this paper is that various disincentive effects of welfare-state arrangements on economic behavior, and related economic distortions, are often delayed because habits and social norms constrain economic behavior. It will also be argued that these constraints themselves may be *subsequently* influenced by the very same disincentives. This is assumed to be the case not only for private agents but also for public-sector administrators. As a result, generous welfare-state arrangements may generate multiple equlilbria and vicious, or "hazardous" dynamics.

One reason for confining the discussion to disincentive effects, and hence to various costs of welfare state arrangements, rather than covering both benefits and

* I am grateful for useful comments on an earlier draft by Kenneth Arrow, Anders Björklund, Peter Hedström, Dennis J. Snower, Martin Paldam, Robert Zeckhauser and two anonymous referees, without implying any shared responsibility for the somewhat unconventional analysis.

costs, is simply the lack of space. Another reason is that an understanding of disincentive effects, and related hazardous welfare-state dynamics is essential if we want to avoid that the welfare state, over time, undermines its own economic foundations by way of disincentive effects on the national economy and therefore also on the tax base. (For a discussions of both benefits and costs of the welfare state, and of virtuous as well as hazardous dynamics, see Lindbeck, 1993, 1994, 1995.)

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

II. Habits and social norms

Habits are usually defined in the sociological and psychological literature as routine behavior without much cognition or evaluation, cf. Verheller and von Raaij (1985, p. 5).[1] *Social norms* are in the same literature usually characterized as "required", or (by others) expected behavior, without much explicit purpose and calculated concern for the consequences, except for the expected discomfort of breaking the norms; see discussion in Parson (1951), Lewis (1969), Scott (1971), Opp (1979), Elster (1989), Bicchieri (1990). Individual behavior in conformity with habits and social norms are often contrasted to behavior based on instrumental rationality

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[1] Compare the following characterization of habitual behavior by Katona (1973, pp. 218-19): "People act as they have acted before under similar circumstances without deliberating and choosing. Routine procedures and an application of rules of thumb by consumers as well as business exclude the weighing of alternatives".

("rational choice"), which is distinctively future-oriented, purposeful, calculating and hence outcome-oriented. The usual distinction between habits and social norms is that the latter are shared by others and sustained by their approval of compliance and disapproval of non-compliance, while habits (like "private norms") are regarded as more individualistic phenomena and not enforced by others to the same extent.[2] This distinction is somewhat blurred, however, by the observation that social norms are often assumed to be "internalized" in the sense that an individual develops an "internal sanction system", cf. Scott (1971), Coleman (1990). Once such an internalization has occurred, individuals are asserted to conform to social norms even when there are no external sanctions, cf. Hoffman (1983).[3]

In terms of utility theory (which has traditionally not been much used by sociologists), an individual who breaks an internalized social norm will experience a utility loss not only by external sanctions and related losses of reputation, but also by internal sanctions in the form of subjectively felt discomfort. We may, borrowing Etzioni's characterization of the "internalization of moral" (1989, p. 46), say that the internalization of social norm turns constraints into preferences. Thus, social norms that emphasize socially acceptable behavior, or "community values", are assumed to mould preferences and constrain the effects of a deterioration in economic incentives. The individual, therefore, feels guilt, i.e., pays a psychological price, for having broken previously obeyed social norms. This guilt may, or may not, dominate over the direct material benefits of breaking the norm.[4]

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[2] Coleman (1990, p. 243) takes this position strongly: "I will say that a norm concerning a specific action exists when the socially defined right to control the action is held not by the actor but by others." For a similar view, see also Elster (1989).

[3] Such an internalization has been described as a socialization process in which a person learns to "conform to rules in situations that arose impulses to transgress and that *lack* surveillance and sanctions", cf. Kohlberg (1968, p. 483) The distinction between external and internal sanctions goes back (at least) to the classical discussion of norms by Parson (1951).

[4] Compare a formulation by Akerlof (1980): "...social customs may act as a constraint on economic activity, preventing trades that would occur in the absence of such a code" (p. 756), and "A custom that is too costly to follow, in terms of lost utility, will not be followed and therefore will disappear" (p. 772). Moffitt (1983) also assumes that the individual suffers a utility loss if breaking a social norm.

In game-theoretic approaches, social norms are treated as equilibria of strategic interaction, reflecting clusters of self-fulfilling expectations of rationally calculating agents; for early attempts along these lines, see Lewis (1969) and Ullmann-Margalit (1977). Each individual's strategy is then a best reply to the others' strategies, where the latter are taken as given: "A norm is there because everyone expects everyone else to conform, and everyone knows he is expected to conform, too" (Bicchieri 1990, p. 841). The adherence to a social norm reflects, in this view, *a conditional choice* based on expectations about other peoples' behavior and beliefs; this means, of course, that conformity to a social norm is not a dominant strategy.[5]

The most difficult question when analyzing habits and social norms is probably to determine how they emerge and are sustained. A standard answer among sociologist is learning ("socialization"), which in evolutionary game theory (e.g. Sugden, 1986) is expressed as repetition and imitation of successful behavior, as well as the disappearance of agents that use inappropriate strategies - an idea that harks back, at least, to Adam Smith (1758). Other (complementary) explanations for the emergence and sustenance of habits and social norms are the value-creating effects of law, the dominance of some people over others, membership in voluntary organizations that expect certain types of behavior of the members, and "metanorms" that require people to express disapproval of those who violate social norms, CF Axelrod 1986.

These considerations are, of course, relevant also for understanding specific social norms that constrain the disincentive effects of various welfare-state arrangements. For instance, if work and saving during a prolonged period have been economically rewarding - perhaps they have even been necessary for survival - it is likely that habits and social norms develop that encourage such behavior, illustrating the hypothesis that successful behavior tends to be repeated and imitated. Such

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[5] The term "convention" often seems to cover aspects of both habits and norms. A typical game-theoretic formulation of a convention is: "A convention is a pattern of behavior that is customary, expected and self-enforcing. Everyone conforms, everyone expects others to conform, and everyone wants to conform given that everyone else conforms". (P. Young, 1993, p. 57) Formally, Young defines a convention as an absorbing state expressed as a number of repetitions of a strict, pure strategy Nash equilibrium. For a similar formulation, see Sugden (1986).

behavior is also favorable for other individuals, who usually do not have to support those who work and save themselves. Other examples of the role of habits and social norms in connection with welfare-state arrangements are that citizens often abstain from applying for benefits to which they are entitled, presumably to avoid stigmatization and related loss in reputation; and that many citizens spontaneously comply with legislated benefit codes and tax codes even when the risk of being caught is negligible, an example of the internalization of habits and norms that are defined by law.

Norms against living on *selective social assistance* ("welfare" in U.S. terminology) would be expected to particularly strong, because of the stigmatization of such support; this stigmatization is accentuated by the inconvenience of losing one's personal integrity vis à vis the social-assistance administrators. Such stigmatization has, in fact, been amply documented in the sociological literature; see interview studies by Horan and Austin (1974) and Rainwater (1979).[6] An econometric study by Moffitt suggests that the stigma is connected with the act of welfare recipiency *per se*, but that it does not vary with the amount of the benefit once on welfare (Moffitt, 1983, pp. 1030 and 1032-34). Most likely, individuals are less hesitant to live on, and adjust their lives to, *general social security benefits*, such as sick pay, work-injury pay, unemployment benefits, early retirement (disability) pensions and old age pensions. After all, such benefits are today often described as "citizens' rights" and "entitlements", based on contributions paid previously.

It is reasonable to assume that the adherence to habits and social norms subside only gradually if new institutions emerge that make such adherence more expensive than earlier, for instance because of more generous benefit systems and higher marginal tax rates, or because of softer control of the misuse of the benefit and tax systems. Invoking a general concept introduced by Loury (1987), we may regard social norms as "social (collective) capital" which, like other kinds of capital,

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[6] In the US, as much as 30-60 percent of citizens that are eligible for welfare do not apply; cf. Moffitt (1983)

accumulates or decumulates over decades and centuries, partly in response to institutional arrangements including economic incentives and government control systems. Honesty is one example of such collective capital, cf. Lindbeck, 1988, pp. 32-33.

I do not take a strong position in this paper on alternative explanations of the emergence and continuation of habits and social norms *in general*. I limit myself to habits and norms that are important for the functioning of various welfare-state arrangements. I then simply assume (i) that today's habits and social norms are influenced by institutions, including economic incentives and government control systems of the past; (ii) that an individual is more likely to conform to certain habits and social norms, the more individuals in society do so (a "critical mass" effect); (iii) that earlier acquired habits and social norms tend to survive also after the incentive or control systems have changed; but (iv) that a sufficiently large increase in economic disincentives, or a sufficiently large softening of government controls, creates a conflict between habits and social norms, on the one hand, and economic incentives and government control on the other, and that this will induce some (particularly entrepreneurial!) individuals to stop following earlier obeyed habits and norms, with others following suit. I will also assume (v) that major macroeconomic shocks to the national economy may drastically speed up the process by which earlier obeyed habits and norms are abandoned.

The first three assumptions imply that the national economy is protected for a while from the effects of a deterioration in economic incentives - perhaps for as much as one or several decades in some cases. As a result, welfare-state policies easily "overshoot", in the sense that politicians would have chosen to offer citizens less generous welfare-state arrangements if it had been possible to anticipate the long-term consequences for individual behavior, including less compliance to traditional habits and social norms. The fourth assumption implies that sufficiently large deteriorations in economic incentives may gradually overcome the inertia generated by initially existing habits and norm, while the fifth assumption means that a major

macroeconomic shock may result in a sudden "ketchup effect" by generating a drastic rise in the number of citizens who depend on various types of government support programs, such as unemployment benefits, public works programs, social assistance and subsidized early retirement. Such a shock may, therefore, weaken the hesitation among individuals to live on benefits; it may also reduce the efficiency of the government control of beneficiaries.

Interpersonal dependence may, or course, be analyzed without constructs such as habits and social norms. We may, for instance, simply assume that the behavior of others influences the benefits or costs, or both, of the actions of an individual with given preferences. This is, for instance, the approach in Schelling's "tipping model", in which an individual with given preferences is no longer willing to reside in a certain neighborhood if the percentage of residents of another ethnic origin exceeds a certain limit, as then the (economic and psychological) costs of living there start to exceed the benefits; cf. Schelling (1971, p. 167).

In a similar vein, Granovetter assumes that when the number (or proportion) of people who behave in a certain way exceeds a certain "threshold level", an individual with given preferences changes his own actions accordingly because the benefits of that behavior start to exceed the costs - with different "threshold levels" for each individual, cf. Granovetter (1978) and Granovetter and Soong (1989). For instance, as the size of a rioting crowd increases, the costs for an individual (with given preferences) of joining the riot fall, because of a reduced risk of being detected and arrested; moreover, the expected benefits of rioting may rise because of a greater likelihood that the rioters' targets will be achieved.

While models like these may be useful for the analysis of housing segregation and rioting, and several other social phenomena, I believe that models with "conditional habits and norms", as applied in this paper, are also useful for the analysis of the long-term consequences of welfare-state arrangements. It is true that the expected pecuniary costs of moral-hazard behavior and cheating with welfare-state benefits and taxes tend to decline when many others behave in the same way, simply

because the risk of being detected tends to fall - as in the case of a growing riot. But as will hopefully be clear from the subsequent discussion, it is also useful to assume that the hesitation of the individual to engage in such behavior depends on the psychological costs of deviating from previously established habits and social norms in society - *either* because of external sanctions and related losses of reputation, *or* as a result of the individual's own internal sanction system. Thus, it may be analytically useful to make a distinction between rational responses to changes in the costs and benefits of certain behavior, for individuals with given preferences, and induced changes in these preferences due to changes in habits and (internalized) social norms.

III. Work disincentives and government controls

The fact that tax wedges create disincentives on work (substitution effects against hours as well as intensity and quality of work) does not require elaboration. The reason why various welfare-state benefits do the same is, of course, that they reduce the difference in income when people work and when they are out of work. This effect arises *both* because the benefit systems are seldom actuarially fair, partly due to ambitions to redistribute income and wealth, *and* because contingencies that qualify individuals to receive benefits cannot be perfectly monitored by the authorities, which is bound to create moral hazard and cheating.

A good humanitarian case can, no doubt, be made for generous welfare-state benefits in connection with contingencies such as sickness, disability, unemployment, single-motherhood, etc. A basic dilemma for the welfare state is, however, that generous benefits tend to create many beneficiaries due to moral hazard and in some cases also benefit cheating. *Ceteris paribus*, the higher the sick-pay benefits, the more people will call in sick; the more favorable the conditions for disability pension, the more people will find it attractive to live on such pensions; the more generous the unemployment benefits are, relative to after-tax wages, the more people will in the long run choose to stay unemployed; and the higher the benefits for single mothers, the more single mothers we would expect, as such support is an implicit subsidy to birth

"out of wedlock", divorce, runaway fathers, and separate living quarters for formally unmarried couples.

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

Disincentive effects on work are, most likely, stronger in the long run than in the short and medium run because of the inertia created by habits and social norms. Obvious examples when we would expect this to be the case are decisions by individuals of their allocation of time between work and leisure (including "on-the-job-leisure"), the choice between household service production and purchases of services in the market, and decisions about the division of work between family members. Other examples are decisions to apply for social assistance, support for single motherhood, unemployment benefits or disability pension (early retirement). The hesitation to live on such benefits would be expected to recede only gradually, in particular when others decide to do so - an illustration of evolutionary adjustments by way of learning and imitation. Long-term benefit dependency among individuals may, therefore, develop only gradually.

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

pacification of individuals has occurred on a much broader basis in the former socialist countries than in the welfare states of Western Europe.

The other type of benefit dependency implies that some citizens actively and rationally adjust, in a calculated way, to living at the expense of taxpayers' money. We may say that they acquire subjectively felt property rights to other citizens' incomes and tax payments. This type of behavior has been observed, in particular, in some countries that are characterized by a combination of high long-term unemployment and generous social assistance and social security benefits, such as Denmark and the Netherlands. The issue has recently been analyzed empirically by four Dutch sociologists through interviews with people living on social assistance, disability pensions and unemployment benefits in three Dutch cities, cf. Enbersen, *et al.* (1993). They found that about 55 percent of the long-term unemployed in their sample had, effectively, stopped looking for work, and that more then half of these asserted that they had stopped because they had found "other activities to give meaning to their lives: hobbies, voluntary work, studying, or working in the informal economy". These observations are in line with the assertions by the American sociologist Murray (1984), to the effect that some citizens tend, after a while, to choose quite rationally and actively to live on social benefits.

We would, of course, also expect that habits and social norms limit the frequency of tax avoidance, tax evasion and benefit cheating, not to speak of various types of criminal activities (including work in the "black economy") for which income is usually tax-free, except for a stochastic "tax" in the form of punishment if caught. There is also evidence that peoples' willingness to pay taxes is favorably influenced by positive attitudes to the government's spending programs (Lewis (1982). But there must be a "price" also on honesty, in the sense that habits and social norms that encourage such behavior may be undermined if honesty becomes sufficiently expensive because of high marginal tax rates and generous benefit levels, or because tax-payers become less supportive of the government spending programs. Such developments would counteract the often hypothesized tendency of welfare-state arrangements to

mitigate criminal cultures in potentially poor neighborhoods (Freeman, 1995) The *types* of crimes that are stimulated and mitigated, respectively, and also the individuals who commit them, will of course differ substantially in the two cases.

Changes in habits and norms are perhaps particularly likely to occur when a new generation that forms its values on the basis of a new incentive system, enters working life.[7] Immigrants who have entered a country largely because of the generous benefits may also be relatively quick to utilize the existing benefit system.[8]

It is a commonplace that adjustments of individual behavior to welfare-state arrangements depend not only on the generosity of the benefit but also on the conditions for receiving benefits and on the administrative controls of the beneficiaries. From a normative point of view, it is indeed useful for the government to strive for an optimum combination of incentives, on one hand, and conditionality and controls, on the other: the stricter the conditionality and the tighter the controls, the more generous benefits are possible without serious problems of moral hazard and cheating, cf. Lantto (1991).

An example of the importance of *conditionality* is that welfare-state induced reductions in labor force participation, because of tax- and benefit-wedges, may be mitigated if the future eligibility for benefits is tied to previous work and income, which is a typical feature in the Nordic countries, even though the benefit systems are far from actuarially fair.[9] Another example is that long-term benefit dependency of single mothers may be limited by strict work- or training-requirements for the beneficiaries. The enforcement of such requirements, in combination with the provision of child-care, is most likely an important explanation for the more modest problems of long-term benefit-dependency among unmarried mothers in the Nordic

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[7] Moffitt (1983, p. 1032) reaches, in a regression analysis, the conclusion that the distaste for living on social assistance ("welfare") rises with age.

[8] In some suburbs of Stockholm, more than 50 percent of the immigrants from certain countries lived on social transfers of different types in 1994.

[9] In the case of decisions about labor-force participation, it is average rather than marginal benefits that matter, as the choice set is not convex -- the decisions being taken at the extensive rather than the intensive margin.

countries than in the U.S., where unconditioned cash support dominates; see Jäntti and Danziger (1994). But the basic dilemma that generous support to single mothers tends to expand their numbers cannot be avoided, even with the "Nordic model".

An illustration of the importance of government *controls* is that the strictness of "work requirements" in the unemployment benefit system, i.e. the requirement that the individual should accept work offers, seem to influence how many employees choose to live on such benefits. But it may be difficult for public-sector administrators to cut off unemployment benefits in situations of heavy unemployment - as illustrated by the experience in several countries during the 1980s and early 1990s; see Layard, Nickel and Jackman (1991) Another illustration of the difficulties to enforce strict government controls is that the number of people living on subsidized disability (early retirement) pensions, have recently "exploded" in some countries, in particular in periods when the lay-offs of elderly workers and unemployment has increased. In the Netherlands, 12 percent of the population of working age had such pension in 1993; the corresponding figure in Sweden was 8 percent.

Public-sector administrators may also, after some time, simply find that it is unpleasant to be harsh toward benefit applicants. It is particularly tempting for individual administrators to become more lenient if they find out that other administrators have become just that. Similarly, physicians may hesitate to be strict with people who ask for a disability pension (early retirement) because of asserted physical or psychological health problems. After all, the costs to public-sector administrators and physicians themselves of being "humane", i.e., generous with taxpayers' money, are very small. Indeed, some physicians may even make a living out of writing "humane" testimonies to the effect that individuals are disabled. Thus, endogenous changes in habits and social norms may develop over time not only among potential beneficiaries but also among the administrators and experts of the systems.

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

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

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

It is tempting to analyze mechanisms like these in terms of models with multiple equilibria (as in the earlier mentioned tipping model) - one equilibrium with wide-spread adherence to social norms, strict administrative control and few beneficiaries, another with less adherence to social norms, lax administrative control and many beneficiaries.[10] Developments like these may also be described in terms of *vicious circles*, or hazardous dynamics, in order to emphasize the dynamic process by which the number of beneficiaries may increase over time in connection with changes in habits and social norms among beneficiaries, administrators and experts. The ensuing fall in the tax bases may subsequently force the government to increase the tax rates, which tends to reduce the tax base even further because of new disincentive effects, and so on. Developments like these imply that the equilibrium position of the economy is path-dependent in the sense that the behavior of a certain individual, at a specific point of time, depends on the previous behavior of others.

Models in which, because of the influence of habits and norms, disincentive effects only gradually harm the national economy, until a sudden shock abruptly "activates" the disincentives, are analytically quite similar to dynamic models in modern ecology of "natural disasters": to begin with, pollution only modestly and gradually damages the ecological system until a sudden major disturbance (such as a

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[10] For an analysis of the unemployment benefit system in terms of multiple equilibria -- though without concern for social norms -- see Ljungquist and Sargent (1994). Akerlof (1980, p. 756), analyzing wage setting and unemployment, derives two equilibria, one where almost everybody adheres to social customs about wage setting, another where almost nobody does.

meteorological shock) abruptly shifts the system into a new and strongly inferior state, or creates a vicious circle without apparent end.

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

More generally, while a generous welfare state presupposes a national economy with high productivity and a large fraction of the population at work in the market system, forces may emerge in advanced welfare states that undermine both these prerequisites -- either endogenously or as a result of exogenous shocks, or a combination of both. Neither politicians nor economists, or other social scientists, seem to have been much aware of such long-term dynamic adjustments.

A neglect of the risks of such hazardous long-term dynamics is also apparent in many contemporary suggestions for welfare-state reform. An example is the popularity among economists of the idea to replace means-tested benefits with a "negative income tax", i.e., a combination of a fixed (unconditional) cash grant to everybody and an income tax rate. In spite of the elegance of such a system, as well as of its administrative simplicity, it has serious flaws just because it neglects the possibility of long-term adjustments in habits and social norms. Not only will people with high preferences for leisure be *systematically* subsidized by a negative income-tax system, as there would be no discretionary examination of individuals. Individuals who originally do not belong to this category may also acquire such tastes and habits after a while. As a consequence, earlier obeyed habits and social norms against such behavior may be eroded. There is, therefore, a risk that a negative income tax, in particular among young people, will over time create a large group of "drifters" who abstain from work in the official labor market, living instead permanently on grants from the

government, possibly combined with occasional incomes from underground work and, in some cases, also criminal activities.

It may be retorted that similar incentive problems arise in the case of means-tested income support, i.e., social assistance. An important difference, though, is that in the case of a negative income tax (in its pure form) it is, in principle, impossible to prevent able-bodied beneficiaries from abstaining from work, while this is possible, at least to some extent, in the case of means-tested systems as the benefits are then tied to specific contingencies such as bad health, unemployment and old age.

There may also arise more subtle, though rather speculative, long-term consequences of welfare-state policies by way of the influence of values and social norms. For instances, the egalitarian views that lie behind much of welfare-state policies may feed back on, and strengthen, egalitarianism itself. Important social norms as to what is acceptable income differences may then change. One reason is that the political discussion in highly egalitarian welfare states tends to center on distributional issues: "who gains, who loses?" This may generate such a concentration on distributional issues in the public debate, not least in the mass media, that the tolerance for income differences gradually falls, and that social and political conflicts, as a result, will rise in parallel with an equalization of disposable income. We may also speculate that the "respect" for the existing distributions of income falls when it becomes clear that this distribution is, to a considerable extent, determined by "arbitrary" political decisions rather than by anonymous market forces. As a result, the often-hypothesized tendency for distributional conflicts to subside by greater equality of disposable income may not be a monotone relation; social and political conflicts may rise after the equalization of income, by means of government policies, have reached a certain state.

IV. Saving, asset choice and entrepreneurship

We would expect that habits and social norms are important also for *saving behavior*. For instance, households have, at least until recently, "learnt" that it is

proper to save. Moreover, people have traditionally saved not only to be able to consume in the future, but also to avoid being dependent on their children or the government, and to enhance their reputation (status) and self-respect in general. Among many citizens it has probably been regarded as particularly improper to incur debt, except perhaps in connection with buying real estate. Indeed, "reluctance to being in debt" seems to be, or at least to have been, a strongly held habit and norm among households.[11]

It may, for these reasons, take considerable time before household saving is much negatively influenced by higher marginal capital-income tax rates and improved social security benefits. For instance, it would seem that households in some countries only gradually gave up their earlier acquired saving habits, including their reluctance to being in debt, during the post-World War II period, in spite of the fact that real after-tax interest rates (at least *ex post*) were often negative, and that the government provided more and more elaborate systems of social security and social assistance.

It is also likely that the consequences of tax-induced distortions of *asset choice* - often accentuated by inflation and various asymmetries in the taxation of different types of assets - develop only gradually. For instance, it was not until the second half of the 1980s that households finally seemed to have adjusted their behavior to the fact that borrowing for the purchase of various types of assets, including real estate, durable consumer goods and shares - was highly profitable. At that time, in a number of countries, households were also finally allowed to borrow freely in the wake of the deregulation of capital markets. Ironically, just when households had "learnt" to borrow, real after-tax interest rates increased abruptly in the late 1980s and early 1990s because of tax reforms and lower inflation that were not fully reflected in lower nominal interest rates. It would seem that households adjusted their saving behavior much more rapidly this time to the new economic incentive, possibly because of the

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[11] For an attempt to integrate such reluctance towards indebtedness with standard microeconomic theory of households, see Lindbeck (1963, chap. 2).

extraordinary size and abruptness of the rise in real after-tax interest rates, and perhaps partly also because of the simultaneous increase in economic uncertainty.

A more speculative point is that welfare-state egalitarianism may also influence policies towards *entrepreneurship*. As entrepreneurs often strive to become affluent, and in some cases also succeed, they may easily come to be regarded as "alien" figures in a highly egalitarian welfare state. This is, I believe, what happened in Sweden in the "egalitarian" 1960s and 1970s. One illustration is the strongly negative attitudes towards entrepreneurs in mass media during that period. A concrete expression of these attitudes is that policies in some highly egalitarian countries favor the plowback of profits at the expense of dividend payments, apparently in the belief that this limits the income (or at least consumption opportunities) of the owners. In some countries with highly egalitarian welfare policies, such as Sweden, the tax burden on small entrepreneurs also became amazingly heavy during this period, and the after-tax return extremely low (for those that were not willing to cheat with taxes). Attitudes in society toward entrepreneurs may also have more *direct* effects on the vitality of entrepreneurship. Entrepreneurship is likely to suffer if entrepreneurs do not feel that they are respected in society. The attitudes toward entrepreneurs - among politicians, the mass media and the general public - are perhaps no less important for small entrepreneurs than are the pecuniary rewards on their activities.

We may, with a slight exaggeration, say that there has been a tendency in some countries with highly egalitarian welfare-state policies, Sweden being one example, to opt for "capitalism without capitalists", and "enterprises without entrepreneurs" - probably not a very efficient economic system. These experiences illustrate how values that originally stimulated the build-up of a welfare state, after a while, may penetrate other sections of society.

V. Difficulties of reform

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

choice and entrepreneurship. It is, therefore, important to avoid pushing welfare-state disincentives into "dangerous territory", where disincentive effects seriously damage the national economy and erode the tax base, and hence undermine the economic foundations of the welfare state itself. In particular, it is important not to build up welfare-state arrangements on the assumption that private agents do not, over time, change their economic behavior in order to utilize, and perhaps even cheat with the system. It is also important to avoid creating welfare-state systems that get into serious difficulty if the national economy is hit by severe macroeconomic shocks that drastically increase the number of citizens that depend on various benefit systems.

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

It may also take a long time for researchers to discover the existence of serious welfare-state problems, partly because of the earlier discussed delay in the adjustment of basic behavior patterns of private agents. Empirical estimates of the effects of welfare-state policies suffer from a problem similar to that expressed by the Lucas critique of estimated econometric functions. Lucas pointed out that such estimates are contingent on the expectations among private agents of the behavior of politicians. The discussion above suggests that estimates of disincentive effects of contemplated welfare-state reforms are contingent on existing habits and social norms, which may change either gradually or dramatically, subsequently generating "regime shifts" for individual behavior patterns. Indeed, this econometric problem may be much more serious than the one emphasized by the Lucas critique which can, in principle, be met

either by explicitly introducing government behavior functions or by estimating so-called "deep structures" such as preferences and production functions. It is more difficult to design analytical procedures that solve the estimation problems in connection with welfare-state policies that result in changes in habits or social norms.

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

Serious problem necessarily arise when attempts are made to reform or rewind a welfare state that is believed either to be poorly designed or to have "overshot" reasonable limits. The most obvious example is perhaps that several welfare-state arrangements (such as pension rules) may be regarded as long-term contracts between the government and the citizens. As life is irreversible, the individual runs into serious problems if such contracts are broken by the government after several decades. Long-term changes in habits and social among beneficiaries may also contribute to the political difficulties of reforming or rewinding the welfare state. For instance, the subjectively experienced utility loss when a benefit is removed may be much greater than the "utility loss" of never having received it in the first place -- a hypothesis that is consistent with Tversky and Kahneman's "prospect theory" (1981), according to which the utility function is steeper to the left of the initial point than to the right of it.[12] Alternatively, we may hypothesize that preferences are endogenous in the sense that the aspiration level of individuals increases by previous achievements -- an application of the psychological theory of "the rising aspiration level" (Lewin *et al.*,

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[12] See also Thaler, 1980.

1944)[13]. Applying this theory to welfare-state benefits may explain why individuals seem to develop social norms in the form of subjectively felt "property rights" in existing benefits, i.e., in other peoples' incomes and tax payments, which means that it is regarded as "natural" to be financed by the government.

There are, of course, also other serious complications if welfare-state spending is cut substantially. First of all, it is difficult to avoid that important achievements of the welfare state are lost, such as increased economic security, income-smoothing over the life-cycle of the individual, redistributions of wealth in favor of low-income groups and the provision of various types of social services. It may also be difficult to avoid undermining some of the virtuous dynamics that are created by various welfare-state arrangements, such as increased productivity, improved neighbourhoods and less street crimes in connection with reduced poverty and better health and education among low-income groups; an expanded tax base due to higher labor-force participation among the poor, ethnic minorities and women; and perhaps also a more general acceptance among individuals of continuing economic change and related reallocation of resources, and possibly even greater sympathies for the market system as such.

The least risky way of mitigating various welfare-state distortions and of fighting vicious welfare-state dynamics, without damaging the achievements of the welfare state, is probably to concentrate the spending cuts to entitlements and other transfers to the large middle-class. It would then be possible to maintain, and possibly even expand, public-sector spending with large elements of investment in human capital, in particular perhaps among potential low-income groups. The problem is the political feasibility of this strategy.

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[13] Katona (1951) has applied this theory to different types of economic behavior, though without any attempt to integrate the analysis with traditional microeconomic theory of households. Such an attempt is, however, made in Lindbeck (1963, chap. 2) for the case of wealth accumulation.

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