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The Welfare State in the Twenty-First-Century

Review of: Nicholas Barr, The Welfare State as Piggy Bank. Information, Risk, Uncertainty, and the Role of the State. Oxford University Press, Oxford 2001, 295 pp., Euro 33.95 (hard cover)

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"The welfare state is durable for a rather simple reason: the theoretical argument that underpins its existence will continue to apply".

This is the conclusion drawn by Nicholas Barr, professor at the London School of Economics, in his latest book (p. 270). Barr's appraisal is based on insights of microeconomic information, risk and uncertainty theories. However, in contrast to mainstream economic thought, he also incorporates macroeconomic conditions in his arguments and he believes that state regulation of financial markets is indispensable. The state is endogenous to market economies. Barr applies his theoretical arguments to traditional social policy issues such as provision for the case of unemployment, sickness and old age, and also to the organisation and financing of education and further training. In addition, he addresses a number of "twenty-first-century problems": (1) the demographic problem of ageing populations, (2) the resulting increase in persons needing permanent care, (3) the consequences of technological advances such as genetic screening, (4) the consequences of transition from planned to market economy in the post-communist countries, and (5) the new challenges to public social security systems posed by "globalisation". The author illustrates his theoretical arguments with a wealth of examples taken from many countries, making use of his access to relevant data as World Bank consultant. He concludes his treatment of each individual issue with a discussion of the political options available if the requirement of justice and efficiency is observed. As one would expect, he thinks that only more or less "imperfect solutions" are realisable. All of them, he believes, will have to incorporate essential welfare-state elements if the requirement of justice and efficiency is to be fulfilled. Barr argues his case so convincingly and in such an innovative way that a review of his book is nothing short of a plea to read it. Depending on the readers' individual interests, personal acquaintance with the book could take various forms. Persons theoretically or practically involved in social policy will derive great benefit from reading the entire book, while specialists could confine themselves to the introductory theoretical chapters and to their respective special topics. In the following, I shall summarise a number of arguments that seem to be of special importance to the current intellectual and political debate.

1 Theoretical basis

Nicholas Barr opens his treatise by posing the question how the lifetime income of an average working citizen is to be divided up between the period of active working life and the period of retirement so that his or her consumption expenditures are covered. Neo-classical standard economics has come up with a rational solution, described with precision by US economist Irving Fisher's (1867-1947) equilibrium model. Fisher's model is generally considered as theoretical proof that the best solution is making private provisions on insurance, investment and savings markets. The model is based on strict assumptions, such as perfect competition in markets; people interested in insurance policies and securities must have perfect information about them, e.g. about their quality. The suppliers must also be perfectly informed, e.g. about their customers' ability to pay. In reality, the information available is quite imperfect and asymmetric in favour of the seller. As is well known, it is only possible to offer insurance policies for cases which allow the calibration of probabilities necessary for the calculation of the price (premium) of a police for c based on statistical probabilities. However, in the case of major existential problems common in market economies, it is impossible to rely on such historical estimates. The probability of the occurrence of unemployment is unknown. For this reason it is impossible to offer insurance policies on the risk. This, then, is the theoretical and practical reason for the provision of income security in existential areas like unemployment, sickness, old age by the state. "Risk, uncertainty and imperfect information", Barr states, "transform the intellectual landscape by undermining the automatic efficiency of unconstrained market outcomes.” (p. 6)

Provision for the case of sickness is a different matter. Here, private insurance is possible; consequently, privatisation of public health insurance is frequently suggested as a remedy for financing problems. Barr proves theoretically and empirically that asymmetric information and personal attitude, or under-estimation of risks ("risk aversion"), are not the main reasons for the fact that the market leaves many people unprotected. The decisive factor are disparities in the distribution of risks and income. Poor persons, whose risk of illness is much greater than that of average citizens, are often unable to afford market premiums. The same applies to provisions for retirement in old age. Again, the market is unable to ensure comprehensive protection, leaving many outside. This is where in democratic societies the state assumes its role. It ensures financing by enforcing payment of contributions and taxes also by those who could afford private insurance. With the help of their contributions to compulsory insurance the state ensures that solidarity payments to "bad risks" are financed. When comprehensive provision is successful, there are welfare gains for society as a whole, reflected in higher productivity and economic growth, as well as in greater general political consensus.

It is not necessary, of course, that the state produces, offers and finances all social-policy measures directly. Many different ways of implementation are possible; what counts is effectiveness.

2 Pensions

According to the currently dominating market ideology, which has even penetrated trade unions and social-democratic parties, state provision for old age financed via compulsory contributions is to be supplemented or replaced altogether. This process is under way or quite advanced already. The "Pay-As-You-Go” scheme, or short PAYG, in which those still working, finance the pension payments to those who have retired, is to be replaced by a funded scheme where pensions are paid from a fund built over a period of years from contributions of individual members, based on accumulation of assets. Such a funded scheme is offered under market conditions by pension funds of insurance companies, banks, investment houses, etc. They are believed to be superior on principle to the PAYG scheme. Adoption of a funded scheme is to put a final stop to the financing problems of the PAYG schemes still currently in force in many countries. Even more importantly, the "market" is believed to be better able to cope with the demographic problem of ageing populations. Nicholas Barr proves with lucid arguments that the superiority of funded old-age provision is a myth. The two systems must tackle an identical problem. It is rooted in the fact that the consumption of both the rising number of retired persons and of the diminishing number of active persons must be covered by current production of goods and services. The PAYG and the funded scheme are simply two different financing systems, both defining the retirees' entitlement to future production which has to be created by the still active part of the population. (p. 14) The accumulation of contributions to life insurance or pension funds in the past cannot guarantee to the old a constant or rising supply of consumer goods via individually contracted rent payments – just as little as via the state's rent promise, which is the implicit basis of contributions in the PAYG scheme. Barr illustrates this by the case of a country's GDP being halved – a situation observable in a number of countries. If the retirees' living standard is to be maintained, that of the active population would have to drop accordingly. Contributions would have to go up drastically – something that could not be enforced. The declining supply of goods would lead to inflation. In the case of a funded scheme, the return on the accumulated assets would have to rise in a adequate proportion. However, during economic downturns, the opposite is what happens. Asset values drop, and so do distributed profits. Negative developments of this kind due to declining profits or shares may happen with funded pension systems even in the case of constant or slightly rising GDPs. (In summer 2002, English newspapers carry reports on declining pension payments in the funded English scheme.) Generally, the contributions and taxes forming the basis of the adjustable contribution procedure fluctuate much less than share values and profits in financial markets (p. 122). Therefore, in contradiction to all advertisements and commission reports, funded provision for old age is clearly less able to offer security to worried retirees hoping to keep up their living standard than old-age pension provision by the welfare state. What is decisive for both systems is growth in productivity and production. To express this, Barr uses the classical equilibrium condition of the PAYG old-age pension system (p. 96f):

Contribution (s) times average real wage (W) times number of working persons (L)

is equal to

average real pension (P) times number of persons (N).

In short: sWL = PN .

In the case of a rising number of retirees N, the standard of living can only be maintained in the long run if the sum of real wages WL rises. For, working persons will only accept bearing the burden of sufficiently high contributions to a limited extent. Any serious suggestion for reform of a pension system will have to pass being put to the test with this formula. Scrutiny in the light of this formula will reveal which suggestions are unsustainable and therefore part of pension mythology. Barr examines ten common myths asserting the superiority of funded schemes over welfare-state PAYG system and refutes them one by one (pp. 96-126). He concludes that the financing problems of public systems cannot be solved by privatisation. Rather, they need adjustment: at first of L and W, then of N and at last of P and s. One ought not to overlook that there would also be another possibility of financing public pensions: by cutting other expenditures financed through taxes and contributions. A prime candidate for this, according to Barr, is public debt. Its scaling down reduces future interest and debt repayment. However, in doing so, expenditures promoting productivity and growth should be left intact, e.g. those furthering education, research or general opening-up to what is new and different – new activities and tasks that usually have no lobbies and would have to be anchored in the actors' "mind set”.

Judging by the above considerations, Austria is drifting into the opposite direction at present. The number of active persons is too low, that of retirees is rising too fast and "the former lead in productivity is being lost" (Marterbauer, 2001). The Austrian system is unsustainable in the long run, it must be reformed in the light of the equilibrium condition. Above all, concerted efforts should be made to increase labour productivity and economic growth. That would be in the interest of both employed and retired persons, of young and old people, i.e. it would be in the general interest. Bringing this about, consequently, is a public task. Yet, what happened earlier already and is now gaining momentum through actions taken by the present federal government, is the privatisation of public tasks.

3 Technological progress and market supply

No doubt, one of the greatest advantages of interest-rate driven market economies lies in their compulsion to generate technological and organisational progress. As soon as some innovation, e.g. the internal combustion engine or the factory has been introduced, it spreads like a contagious disease. Paradoxically, this is why the private insurance business sometimes has difficulties coping with technological progress. For, private insurance is based on independent probabilities of the occurrence of damage: it cannot cover infectious risks. This applies to AIDS just like to BSE, and also to fundamental scientific advances, such as progress in genetic engineering leading to a significantly higher life expectancy of human beings.

Another deficiency of provisions made under market conditions is operative already: genetic screening methods for humans have been developed which make it possible to predict the incidence of certain inherited diseases. The probability of occurrence, at any rate, is approaching 1. Insurance, which is market-type provision for the uncertain occurrence of some damage, becomes impossible if this damage is sure to happen. Scientific progress thus means that persons may be identified as future diabetics through genetic screening and arrange their lives accordingly. What such persons cannot do, however, is taking out private insurance to improve their future financial situation: they are excluded from insurance. As long ago as in 1974, Kenneth Arrow, winner of the 1972 Nobel Prize in economics, referred to problems of this kind as the "information dilemma". "The dilemma is persistent. Improved diagnostic skills are good for the patient or for potential patients ... but in the health insurance system they may become very costly for the patient, due to exaggerated insurance premiums, exclusion from insurance or the impossibility of finding a job". (Quoted by Barr, p. 74) Barr discusses the resulting questions and available answers, again with the proviso of justness and efficiency. (p.

75-79) Once more, the problem cannot be solved without the state or without compulsory contribution and taxes.

4 Problems in post-communist countries

In the communist countries, under conditions of a low living standard and dictatorship, there was no open unemployment, no blatant poverty, and there were no particular problems with implementing social policy. Abrupt change from planned to market economy drastically altered traditional income distribution, caused increasing poverty, a marked decline in production and incomes, as well as a steep rise in unemployment when job security was removed. In such a situation, the need for social policy becomes imperative since, apart from the family, traditional supportive institutions are no longer available. This applies to social-policy measures in general and to unemployment insurance in particular. Assuring provisions for retirement under falling production is a similar case. Many of those problems are exacerbated by rising productivity, which initially leads to reductions in the workforce. Barr describes this difficult situation clearly and derives the respective social-policy measures needed: provision of a low, guaranteed basic income to combat poverty; promotion of productivity and production; raising the mobility of labour; and establishing a clear relationship between contributions and entitlement. So, once again, "the market" is unable to achieve all this without "the state".

5 "Gobalisation"

The world is undergoing rapid change. Income distribution is becoming more unequal, incomes are rising, poverty is increasing. The family structure is changing, traditional family ties are dissolving, individualisation is becoming more prevalent. Populations in the rich countries are growing older, information and money circulate across national borders at lightning speed, "globalisation" erodes the welfare state. The national location (*Standort*) can no longer afford the welfare state. ... Is there anyone who does not have to listen to or read this daily? Where are the counter-arguments? None of those statements withstand Barr's analyses. Above all, these opinions are not valid arguments in favour of privatisation and the market. The reason is that global trends affect all institutions, so private ones are also coming under pressure. Nicholas Barr therefore suggests to stop talking about crisis of the welfare state, but rather about problems it has; not to talk about the outdatedness of the welfare state but rather about its resilience. He puts forward four offensive arguments in defence of the welfare state (p.265-269):

*First***,** the welfare state not only causes costs, it also provides something. It is able to help people take precautions against uncertainties and risks through provisions which the market offers insufficiently or not at all. The welfare state alone is able to ensure that the supply with consumption goods is spread over the entire life cycle, from children's education and investment in professional training to provisions for retirement. In view of the market's failure to fulfil such existential social-policy tasks, the welfare state would even be needed if all people belonged to the prosperous middle class (p. 264). What ought to be done, therefore, is to adjust social-policy expenditures to the respective problems at hand, and not to cut them down to a minimum.

*Second, o*rganisation ("structure") ought not to be confused with scale size (“scale”). Which form of organisation is most suitable for fulfilling a particular social-policy task? Which tasks should be financed and/or produced publicly? Which ones should be partially or wholly supplied privately? The market is superior when the preconditions for its functioning are fulfilled. When the market fails, public intervention in the market may produce better results. A different matter is defining the scale of a particular service and calculating the financial resources this will require. Which scale is most adequate to a particular problem? This can only be determined by considering sustainable long-term financing.

Third, internal problems of the welfare state are not an indication that it should be abolished. When incomes rise, demand for public services changes. Housing allowances, public promotion of private savings etc. are not as urgently needed any more. Political support weakens. On the supply side, personal services in particular become more expensive. This should not be a reason for demanding that the welfare state be abolished, but rather that it should concentrate on its "core tasks" (p. 266).

Fourth, global pressures should not be overestimated. According to certain advocates of the idea of competition among locations, "globalisation" leads to a downward spiral in this competition and therefore one's location ought to be defended by lowering wages and social expenditures. This is a weighty argument. However, one might reply that social expenditures promote productivity and that the world has not been "globalised" completely. (Only one-fifth of the rising inequality of incomes in the USA is attributable to competitive pressure.) (p. 267) Deficient provision of care for the sick and the aged results in private companies filling the gap. Barr comments (268)

“Reduced public spending can therefore backfire: replacing higher taxes by higher employer costs does little, if anything to improve international competitiveness. At its worst, a budget cap on public spending could be replaced by a Hydra,s head of multiple private schemes with open end tax concessions,” and Barr adds “health finance in the USA being very much a case in point.” (p. 268).

On the other hand, there are other examples showing that the governments of OECD countries were, in fact, able to adapt the welfare state to new conditions and that they are able to distinguish between organisation and scale. One should also bear in mind that "newly industrialised" countries that are "catching up" are confronted with the same problems as countries in the lead. Both of them are obliged to perform welfare-state interventions. This way, an upward competitive spiral could be set in motion, more likely leading to a tendency for welfare-state convergence rather than to a return to the nineteenth-century.

Nicholas Barr therefore arrives at the conclusion quoted at the beginning, which deserves to be repeated:

"The welfare state is durable for a rather simple reason: the theoretical argument that underpins its existence will continue to apply". And he continues:

“Twenty-first-century changes, though they will cause the welfare state to adapt, do not undermine the overall thrust of that theoretical argument.” (p.270)

This heartens the reviewer particularly, as he had advanced the same argument long ago in his essay "Hat die Sozialdemokratie eine Zukunft?" (*Does social democracy have a future?,* Fischer 1980). The essay had been based, *inter alia,* on research applying theories of risk and uncertainty (Schönbäck 1982) summarised in the book "Der Wohlfahrsstaat von morgen. Entwurf eines zeitgemäßen Musters staatlicher Interventionen" (*The welfare state of tomorrow. Outline of a modern pattern of state intervention*, Vienna and Frankfurt a.M. 1982). The analyses and suggestions presented in this book, an outcome of research commissioned by the Austrian Federal Ministry of Finance, had been intended to encourage and serve as guideline for social reforms in Austria. Unfortunately they remained without theoretical or practical recognition. The main ideas of the 1982 book written in 1982 have now been confirmed by Nicholas Barr's work. If one were to write a modern version of *The welfare state of tomorrow*, Nicholas Barr's *The Welfare State as Piggy Bank. Information, Risk, Uncertainty, and the Role of the State* written in 2001 would be an ideal realisation of such a plan.

6 Is optimism still appropriate?

Even a book like the one by Nicholas Barr, which impresses with its clarity of thought rooted in scholarship and factual knowledge, still leaves some questions open. For example, the observer of current debates on problems of the welfare state wonders why this excellent book does not mention the guaranteed basic income. Perhaps somebody in the habit of testing proposals by means of circular flow analysis, which is based on assumed growth of productivity, production and employment, finds it more difficult to deal with the idea of a "citizens' wage" than liberal minds who consider Keynesian economics as outdated.

Barr expresses surprising optimism. He seems to assume that the better argument will win automatically. For him, there are no such things as prisoners' dilemmas and negative-sum games, nor vicious circles such as Gunnar Myrdal's circular causation with cumulative negative effects. Politicians upholding the welfare state play no part in Barr's analyses, just as little as the changed political climate after transition from bipolar systems competition to the monopolar world order of the "Washington Consensus". Political optimism would be justified if the traditional advocates of the welfare state took up the ideas proposed by Barr and if they speedily proceeded from being on the defensive to positive political action.

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