Welfare state – necessity not luxury

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Central Bank of Malta 50th anniversary public lecture
Valletta, 11 September 2018

LSE

Objectives of the welfare state

Increased individual well-being through
- Income security, through access to
  - Earning opportunities
  - Insurance, e.g. against adverse labour-market outcomes
  - Consumption smoothing over the life cycle
  - Poverty relief
- Maintenance and improvement of physical and emotional health
- Education for labour-market activity and personal development

- Increased family and societal well-being through
  - Family policies
  - Promoting gender equality
  - Promoting inclusion
  - Optimising inequality

Outline of talk

- Welfare state: Why?
  - Reason 1: To address distributional concerns
  - Reason 2: To address market failures
  - Reason 3: To assist economic growth
  - Embracing all 3 reasons: A device for risk sharing
- Welfare state : How
  - Designing welfare states

1 The welfare state to address distributional concerns

- Problems
  - Poverty
  - Widening inequality
- Policy responses
  - Redistributive taxes and transfers, including social insurance broadly defined
  - Investment in skills
  - Family policies

2 The welfare state to address market failures

- In a civilised society – access to adequate education, nutrition, health care, etc.
- Why do we have a welfare state?
  - Well-known: to relieve poverty
  - Less well-known: to do things that private markets would either not do at all, or would do inefficiently
- Thus the welfare state is not a socialist plot, but exists to promote equity *and* efficiency

Why might markets not do things efficiently?

- Imperfect information (the economics of information, Nobel Prize 2001)
- Behaviour different from narrow economic rationality (bounded rationality, behavioural economics) Nobel Prize 2002, 2017)
- Incomplete markets, incomplete contracts (Nobel Prize 2016; also cited in 2010 Prize)
- Distortionary taxation (necessary to finance redistribution; addressed in the literature on optimal taxation, Nobel Prize 1996)

Example: Financial capacity and literacy are shockingly limited

- Can't: financial literacy
  - In a survey, 50% of Americans did not know the difference between a stock and a bond
  - You have $100 in bank account paying 2% interest/year. How much would you have after 5 years: less than $102? equal to $102? more than $102? don't know? (Lusardi and Mitchell 2014)
- Won't: financial capacity, i.e. behaviour by financially knowledgeable person given time/energy/attention constraints

How market failures apply to the welfare state: some examples

- Unemployment insurance: asymmetric information
- Skills development: imperfect information; imperfect capital markets
- Pensions: imperfect information; non-rational behaviour; uninsurable risks
- Medical insurance: uninsurable risks (experiment called the USA; ‘The problems of US medical finance are entirely explicable in terms of economic theory. Discuss’)
- Social care: acute insurance problems, analogous to medical insurance

Government failure

- Markets may fail; but so may governments at national and sub-national level
  - Inefficiency because of
    - Incompetence
    - Limited information
    - Limited resources
  - Faulty or distorted motivation
    - Limitations imposed by political process, e.g. inconsistency between short-term cycle of politics and longer time horizon of social policy
    - Limited control over the bureaucracy
    - Corruption
- Thus
    - Market failure does not lead mechanically to government intervention
    - Intervention increases efficiency only if cost-effective

3 The welfare state to assist economic growth

- Element 1: Human capital is an increasingly important element in inclusive growth
  - Expanding access to basic education and health services increases the stock of human capital
  - Reducing inequality in education and health outcomes, reduces inequality of opportunity and of income
- Element 2: Income transfers also assist growth
  - Interaction with human capital, e.g. the ability to afford a healthy diet improves educational outcomes
  - Interaction with risk sharing, e.g. well-designed risk sharing supports business start ups and innovation

4 An overarching reason: A device for risk sharing

- The simple argument: risk should be optimised, not minimised
    - Too much risk (e.g. no welfare state or an inadequate one) is bad: for example, if there is no safety net people are less likely to risk a new start up
    - But so it too little risk, e.g. the Communist economic system

Risk sharing and the other reasons

- Distribution: risk sharing as poverty relief behind Rawls’s Veil of Ignorance
- Market failures: risk sharing addresses major failures in private insurance markets
- Growth: by allowing risk-taking, risk-sharing contributes to innovation and growth

4.1 How should we think about risk?

- Insurance raises the welfare of risk averse person
- What do we mean by insurance? No single definition
  - Narrow definition: as an actuarial mechanism
  - Broader: as device to protect individuals against risk, i.e. defining insurance in terms of its objective

The actuarial mechanism

- Actuarial insurance

  Premium = $(1+\alpha)\, pL$

  - p = probability that insured event will occur
  - L = size of loss
  - α = insurer's markup
- Different designs
  - Individual risk rating, e.g. automobile insurance
  - Everyone in same pool with premium based on average risk (Beveridge)
  - Redistribution as insurance behind Rawls' veil of ignorance

A central distinction: Risk and uncertainty

- What's the difference?
    - Risk: probability distribution of outcomes is reasonably well known
    - Uncertainty: probability distribution not well known
- The actuarial mechanism can cope with risk but does not cope well with uncertainty
- Social insurance can cope with both risk and uncertainty

Social insurance

Differs from actuarial insurance in 2 ways:

- Compulsory, hence
  - Up to a point, gets round adverse selection
  - Allows redistribution
- The contract is not fully specified, hence
  - Benefits can respond to unforeseen events
  - Enables protection against uncertainty
- Thus there are two separate but mutually reinforcing rationales for social insurance
  - As a response to market failure
  - As a redistributive device

4.2 The new social risks

- Social policy in 1950 was based on a series of assumptions about labour markets, family structures and skills
- These assumptions have become less and less true, requiring social policies that recognise a broader range of uncertainties

Changing risks: labour markets

- Postwar assumptions
  - Male breadwinner
  - Long-term, full-time employment
  - Main risk: short-term unemployment
- Today
  - Rapid technological change makes lifelong jobs less frequent and labour markets more fluid: portfolio careers, with spells of employment, part-time employment, self-employment, unemployment, outside formal labour force
  - Precarious employment – zero-hour contracts, gig economy
  - Some convergence between OECD and informality in developing economies
- Issues include
  - Decreasing usefulness of contributory systems related to employment status
  - Rising inequality

Changing risks: family structures

- Postwar assumptions
  - Husband the main (often the only) source of income
  - Couples were married and stayed married
  - Main risk: widowhood
- Today
  - Many more women work
  - Many more marriages end in divorce
  - Parenthood is less closely tied to marriage
- Issues include
  - Policies to widen choices between paid work and family obligations, including access to affordable child care
  - Designing pensions in a gender neutral way (though noting that ‘gender equality’ is a complex concept)

Changing risks: skills

- Postwar assumptions
  - Skills once acquired were lifelong
  - Main risk: redundant skills (relatively rare)
- Today, as a result of technical change
  - Need for more, and more-highly skilled, workers
  - Shorter shelf-life of skills
- Issues include the need for
  - More education and training
  - More diverse education and training
  - Repeated education and training, i.e. lifelong learning
  - Financing large-scale education and training

The future is bleak in OECD for those with medium skills

Source: OECD

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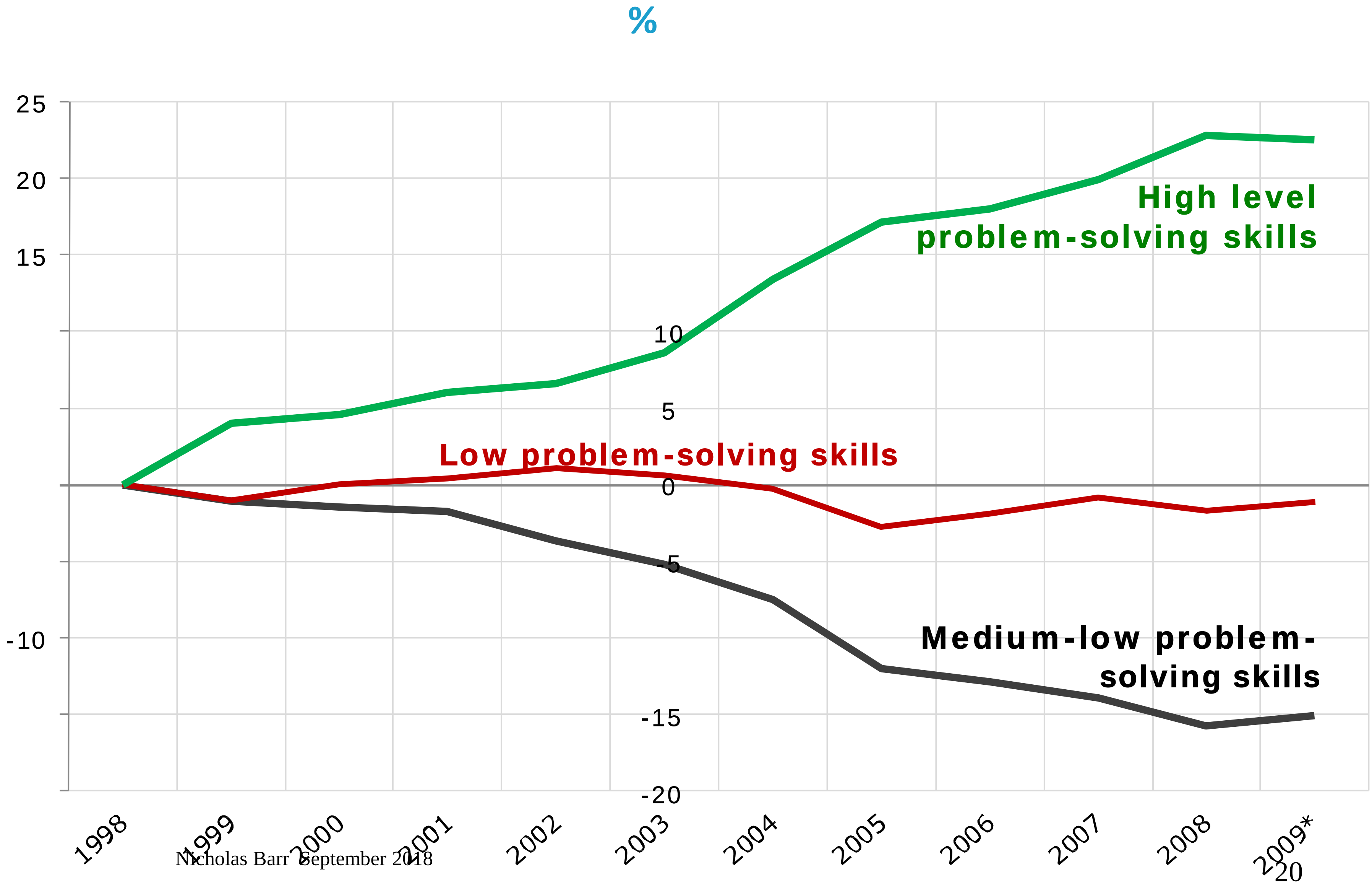

4.3 New or more salient systemic risks

- The world faces major uncertainties
  - Economic (another economic crisis?)
  - Political (e.g. instability in the Middle East)
  - Technical (globalisation, robots, nuclear safety)
  - Environmental (climate change)
  - Social (changing age structure)
- These problems are
  - Uncertainties, and
  - Mostly systemic
- Both aspects reinforce the centrality of the welfare state – in the past mainly a device to address individual risk, today also to address systemic risk

5 Designing welfare states

5.1 The Ministry of Social Security agenda: Fitting policy to social circumstances

Addressing income risks: working life

- The policy agenda includes
    - Providing income to the jobless
    - Restoring earning opportunities, e.g. training
    - Expanding earning opportunities, e.g. child care
- Is there a case for a universal basic income?
    - More fragmented careers
    - The robots are coming (maybe)

Addressing income risks: retirement

- A variety of approaches, including
- Non-contributory pensions
  - A response to the new social risks
  - Interesting example: the Netherlands
- Well-designed earnings-related plans: no single best system
  - DC (TSP, NEST)
  - DB (Canada)
  - Hybrid NDC (Sweden, Norway), industry plans (the Netherlands)

Addressing income risks: getting it wrong – the UK example

UK pensions policy is based on a strategic incoherence

- During working life: policy assumes people will not make good choices, hence nudges in the form of auto-enrolment in NEST which has
    - A default for people who make no choice
    - Choice from 4 other funds
- From earliest pension age: policy assumes people will make good choices, hence pension freedom, i.e. complete freedom of choice over
    - Whether to annuitise and to what extent
    - How fast or slowly to draw down pension wealth

Addressing health risks

- Private actuarial insurance is a bad fit for medical risks (intractable market failures)
- Employment-related social insurance contributions are a less good fit than in the past (same argument as for non-contributory pensions)
- Is reliance mainly on taxpayer finance of health care the only method left standing?
  - From general revenues, or
  - From a dedicated source

Addressing skills risks

- Finance
  - A mix of
    - Taxpayer finance
    - Well-designed student loans (e.g. income-contingent repayments – Australia, New Zealand, UK)
    - Limited user charges
  - The mix will depend on
    - The level of education
      - Tax finance: essential at young ages
      - Loans: assist in cost sharing for tertiary education
    - Ability to implement a loan system
- Delivery:
  - Quality assurance
  - Responsiveness to student and employer demand

5.2 The Ministry of Finance agenda: Fitting policy to economic circumstances

- A fundamental distinction: structure v scale

Structure

- The structure question: is this activity done more effectively by the market or the state?
- Answer
    - If there are no substantial market failures, use market allocation complemented by income transfers to achieve equity objectives
    - If market failures are significant, in-kind transfers may work better
- Structure is a microeconomic issue

Scale

- The scale question: how much can we afford to spend on the welfare state?
- The answer depends on
    - The fiscal situation
    - The political economy of the country (Scandinavia votes for higher taxes to finance more and better public services in a way that is politically not possible in the UK or USA)
- Scale is primarily a macroeconomic issue
- Privatisation (a micro issue) is *not* an answer to macro problems

Bottom line

- The welfare state is essential because it does things which private markets, for technical reasons, would do badly or not at all. This is the answer to the structure question
- But if the budgetary situation is heavily constrained, it may be necessary to spend less on such policies (the scale question)

5.3 The common agenda for the two Ministries: addressing demographic risk

- The age structure of the population has significant bulges
  - Relatively more older people in OECD and some Asian countries (notably China) creates financial stress particularly for pensions and health care
  - Relatively more young people in Africa creates financial stress particularly for education and training

The common denominator is economic growth

Thus a common interest in (partial list)

- Increasing the number of workers through
  - Efficient labour markets
  - Family policies that help to reconcile paid work with family obligations
  - Pension design that supports flexible retirement
- Increasing the productivity of each worker through investment in
  - Human capital (skills and health)
  - Physical capital, including infrastructure

6 Implementing policy

- 3 skills
- 2 parties
- 1 table

Three skills

- Strategic policy design
    - What academics do; in many ways the easy bit
    - The hard part is implementation – not just an event (passing the law) but a continuing process
- Political implementation skills
    - NOT the same as a PhD in political science, but person with practical political skills
    - These are rare people
- Technical/administrative implementation skills
    - Experience running the relevant institution
    - What size and design of computer system is necessary, e.g. to maintain social security contribution records effectively over a working life?
    - Will application form be readable after 2 weeks in trouser pocket?

Two parties

- Provider tripod
- Demand-side tripod
  - To internalise provider's suggestions
  - To filter them through detailed specific knowledge
- Thus 6 people: however
  - Fewer: in some instances a provider political person may be unnecessary
  - More: can one person handle all aspects of strategic policy design? Ditto administrative implementation

One table

- These people all need
  - To be round the same table
  - From day 1
  - To listen to each other
- Mistakes to avoid
  - Designed by PhDs, handed to peons to implement
  - ‘The Minister wants to announce a student loan system starting in September’

6 Conclusion

- The world is changing in ways that makes risk sharing more important
- The welfare state does things which private markets would do badly or not at all
- Thus privatisation is not a good response to fiscal pressures, which primarily raise issues of scale
- Ideology in the right place
    - The What?, i.e. the objectives of policy
    - Not the How?, i.e. market or state, which issue should be decided mainly on technical grounds

References

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