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The welfare state: a theoretical framework for justification and criticism

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Summary

■ Recent debates about the welfare state are reflections of the more general debate about the balance between the public and private sectors and about the proper roles of the market mechanism and central planning in a mixed economy. The classical view of the functions of the state was to see it as a device to overcome market failure due to externalities, public goods, and increasing returns. Modern views also emphasize its role in income redistribution, motivated both by market failure and egalitarian preferences. But the disincentive effects of taxes and social security limit the optimal amount of redistribution. This paper emphasizes the role of civil society in the production of welfare, and it also discusses:

- The distinction between welfare at home and welfare at work
- Whether the welfare state produces individual happiness in a more fundamental sense
- Future prospects for the welfare state ■

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The welfare state: a theoretical framework for justification and criticism

Agnar Sandmo*

The recent debate about the welfare state is a reflection of the more general discussion about the proper roles of the market mechanism and central planning in a mixed economy. This is an old debate in economics, although each additional round brings in new elements, due partly to the accumulation of practical experience and partly to developments in economic theory and empirical research. The present debate occurs on a background of global progress for the market system and a corresponding retreat for central planning and public-sector solutions to basic economic problems. The most dramatic event has been the breakdown of the economic systems of the former socialist countries, although the switch toward more market-based systems has also been a notable feature of economic policy in some of the more successful developing countries. The wave of market liberalism has also affected the economic policy debate in the Nordic countries; this is not the least noticeable in the more market-oriented policies that are currently being recommended by the social democratic parties, traditionally the strongest proponents of centralized economic planning.

When the modern welfare states started to emerge in the 1930s and 1940s, the background was an entirely different one. The socialist economy of the Soviet Union seemed to be highly successful, while the Western countries had undergone a traumatic period during the inter-war years with mass unemployment and periods of hyperinflation; both among economists and politicians, the belief that markets were able to allocate resources in a rational manner, was at a low ebb. As several developing countries gained independence from the colonial powers, there was also widespread agreement that the road to-

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ward development had to be paved by centralized economic planning.

In trying to explain this fundamental change in the economic and political climate, it is, of course, natural to point to the accumulation of experience and the development of new theoretical insights to explain past observations and predict the results of new policies. Albert Hirschman (1982) advanced a different kind of explanation, that is, that there is a pattern of periodic waves in the relative trust that people have in the benefits of public and private solutions to economic and social problems. Such problems are inherently complex and perhaps they do not have a solution in the stricter sense of the word; at least, attempts at solutions will always disappoint many of those who search for the ideal society. When people have concentrated on public solutions for some time, they become frustrated and turn toward the market and private solutions. But after some time, it turns out that this alternative too is full of disappointments, and once again the tide turns.

Regardless of whether a long cycle of this kind exists, there is always a danger that criticisms of past policies may be carried too far and that expectations of success for the new approach may be overoptimistic. The weaknesses of current policies are always visible, whereas alternative systems tend to be evaluated more on the basis of theoretical blueprints. Just like the business cycle, Hirschman's cycle of policy ideas may be amplified by unrealistic expectations. As economists, we should perhaps look upon ourselves as built-in stabilizers in the public debate, with part of our mission being to warn against policy overreactions. By this, I do not mean that we should always be saying that things are going too far, but that we should periodically remind policy makers and the general public that there are things to be said both for the market and for central planning. There are some good arguments for the welfare state and some severe criticism that can be made of it. Both should be taken seriously in a balanced view of its present state and its future development.[1]

This paper attempts to provide a brief survey of the main benefits and costs of welfare state policies. Section 1 sets out the classical justification for government activity in terms of the desire to correct market failures. Although the state that emerges from this analysis is

[1] There are several recent surveys of the economics of the welfare state. Lindbeck (1997) provides an evaluation of the Swedish model. Atkinson (forthcoming) provides a more theoretical treatment of central policy issues.

a *night-watchman* state and not the welfare state as we know it, the classical functions of the state are fundamental for an interpretation of the role of government in this broader context. Section 2 discusses the role of government in redistribution and the provision of social security. The modern welfare state is closely associated with the expansion of government into these types of activities. Section 3 discusses the costs of redistribution, whether through tax policy or the social security system. Section 4 provides a reminder that the role of civil society is of central importance for normative and positive analyses of the welfare state. Section 5 briefly discusses welfare-state policy as related to the individual as a worker, in contrast to the individual's role as a consumer. Section 6 takes up the fundamental question of the relationship between income or material welfare on the one hand and on perceived happiness on the other. Section 7 looks at some of the most important challenges to welfare state policies in the years ahead.

While the main thrust of this paper is normative, in the sense of bringing the tools of welfare economics to bear on the question of what kind of tasks the state should undertake and the appropriate balancing of benefits and costs, it does occasionally touch on the positive question of why the welfare state came to develop in the way it has. This ambivalence is hard to avoid simply because the normative arguments, although sometimes in less academic versions, have played important parts in the political debate and thus helped to determine the historical development of the welfare state.

1. The classical functions of the state

Today, the English classical economists, with Adam Smith as their leading figure, are often associated with a far-reaching form of economic liberalism. One interpretation of Smith's famous analogy of the invisible hand is that all will be well if only everyone is given the freedom necessary to pursue their private interests in a rational manner. But these economists were also well aware of the possible conflict between individual and collective rationality. There may be projects that are not profitable for any single individual to undertake, but which it would still be profitable for a group of individuals to undertake collectively—investment in transportation infrastructure is one of several obvious examples. Sometimes the nature of this project

would be such that the group in question had best be the whole country, so that some centralized government power is called for.

The modern approach to questions of this kind starts with an investigation of the properties of the market system. A central result of modern economic theory is that a system of perfectly competitive markets possesses certain efficiency properties. That markets are perfectly competitive means that consumers maximize utility and firms maximize profits at given prices, that is, no economic agent has significant market power. When prices adjust so that supply equals demand in all markets, the resulting allocation of resources is efficient in the sense that there is no reallocation of resources that can improve on the existing situation for all individuals in the economy. Had this been the case, we would have been able to achieve an overall increase in the standard of living without extra use of resources, so that the initial situation would have been characterized by a waste of resources. The clue to an intuitive understanding of this result—the equivalence of competitive equilibrium and Pareto optimality—is that under perfect competition, all agents confront the same prices and face no constraints on their transactions except that given by the requirement that expenditure must not exceed income[2]. In that situation, all opportunities for mutually advantageous transactions are exhausted through the price system. Contrast this with a regime of rationing, in which agents will engage in extensive barter transactions to exploit opportunities for mutual gains that have been left unused by the official economic system.

The perfectly competitive economy is an idealized version of a real-market economy. But precisely for that reason, it is of major interest as a benchmark for the evaluation of the efficiency of real markets. The efficiency property of the competitive economy holds only under certain conditions that have to do with the structure of the economy. One condition that must be satisfied for the efficiency result to hold, is the absence of *externalities*, that is, situations where one agent's actions have harmful or beneficial effects on other agents without economic compensation being paid through the market. Pollution is an obvious example of negative externalities, while individual literacy provides an important example of positive externalities.

[2] In an inter-temporal context with competitive markets for lending and borrowing, this constraint should be understood in a lifetime perspective; the discounted value of expenditure must not exceed the discounted value of income.

So in the presence of externalities, unregulated competition does not lead to efficiency. Another efficiency problem arises with the presence of *public goods*, goods for which consumers and producers cannot be excluded from benefiting, such as national defense or the legal system. If the supplier of such goods cannot collect payment for their use on a voluntary basis, the market obviously cannot function. The third classical case of *market failure* (the generic term for these cases) is *increasing returns*, which are the cost advantages related to large-scale production. These advantages must be so significant, relative to the size of the market, that private production will necessarily involve substantial market power.

It seems natural to conclude that where there is market failure, there is a case for government intervention in the market mechanism. But there is a fallacy here, *viz.*, the assumption that if the government steps in, it will automatically do things right. Economic analysis has gone far in analyzing optimal policies to correct market failure, but there is no convincing theory that says that when given the opportunity to choose the efficient solution, the government will automatically do so. Thus, a pragmatic view of the role of the state, as a promoter of efficiency, is that it should not be called in as a substitute for the market unless the market inefficiency is substantial. In other words, the market allocation of resources may be tolerably efficient even if it is some distance away from the theoretical ideal.

It is evident that the efficient operation of the market mechanism in a modern, industrial society presupposes the existence of certain institutions that are necessary to sustain it. Security of contracts can only be achieved within a political and legal system that both produces the rules by which the market system is assumed to operate and sanctions individual behavior that violates the rules. In general, the institutional infrastructure that surrounds the market is an important example of a public good.

2. Expanding the role of government

The classical view of the role of the state can be seen as that of overcoming some structural inefficiencies in the market system. But the function of the price mechanism is not only to allocate resources, it is also to distribute income. The distribution of income in the market economy reflects the prices established in the markets for factors of production—labor and capital—and the distribution of productive

endowments. This distribution does not follow from the application of any principle of justice; it is simply derived from the forces of supply and demand. A pure market system may generate a very unequal distribution of income and standards of living, and to promote equality has gradually come to be seen as one of the primary tasks of government. This is a major extension of the classical view of the role of the state.

It is often not realized how comparatively new the extended view of the role of the state actually is. In 1904, a Norwegian government commission on the tax system wrote that:

> ...the purpose of taxation is only to satisfy the revenue needs of central and local government, while it cannot be accepted as within the scope of sound tax policy to contribute to a leveling of the existing wealth and income relationships among the members of society.

Needless to say, this was a view that underwent radical change in the course of the next few decades. The motivation behind the gradual introduction of social assistance, social security, progressive taxation, extended availability of health and education services, and so on is a highly complex one, and I cannot possibly do justice to it here. But because I later emphasize some of the justifications for this development, as seen from a modern perspective, here I should also emphasize that there was undoubtedly a strong element of paternalism in many of the plans that were created during the welfare state's formative years.

A strong argument for government action in several areas of welfare-state policy was that individuals, if left to themselves, would not be able to make the right decisions because they were myopic and uninformed. Hirdman (1989) described this well and emphasized the similarity between the writings of the early thinkers on the welfare state, particularly in Sweden, and those of the utopian philosophers of previous centuries. This is a line of thinking that is not in much favor among modern economists, who prefer to base their arguments on the principle of consumer sovereignty, that is, on the idea that consumers are the best judges of what is good for them.[3]

[3] Technically, the emphasis on efficiency in welfare economics is based on the acceptance of an individualistic social-welfare function of the Bergson-Samuelson type, whereby a social optimum is also an efficient allocation of resources. If one

Can a preference for equality in the distribution of income be derived, at least conceptually, from individual preferences? William Vickrey (1945) and John Harsanyi (1955) first advanced the idea that it can. They suggested that we should think of preferences over income distributions in terms of this thought experiment: imagine that you are asked to choose between two lotteries, each of which gives you an equal chance of becoming any one member of each of two societies. They showed that if in your choices between the two lotteries, you conform to the well-known Neumann-Morgenstern axioms for rational choice under uncertainty, you should choose the society in which the *expected utility* of the lottery is highest. If, in addition, you assume that individuals are risk averse, so that they would always prefer the expected value of an uncertain prospect to the prospect itself, it follows that if the two societies have the same average income, you would always prefer to participate in the lottery for the society with the smallest degree of inequality. In other words, risk aversion implies inequality aversion.

The philosopher John Rawls (1971) took a similar approach, but his concept of risk aversion was different, leading him to the conclusion that the best society is that which gives the best outcome for the worst-off person. Of course one may object that this notion of lotteries behind a veil of uncertainty regarding your own position in society is somewhat far-fetched; such lotteries do not actually exist. But the point of the exercise is rather to set up a framework for thinking about the just organization of society in a manner that is detached from your knowledge about your position in it. Perhaps it gives more meaning to ask what kind of society you would like your grandchildren or great-grandchildren to grow up in. My conjecture would be that most people would like them to grow up in a society in which they would be able to live reasonably well even if they should turn out to have poor health and low productivity in the labor market, although the cost of this might well be diminished chances of becoming very rich. But it must be realized that the strength of this

does not accept the individualistic postulate, efficiency in the Pareto sense loses much of its appeal. If one holds the *leftist* view that equality implies the same income for all, one is probably not moved by the argument that this is inefficient. Similarly, critics of the welfare state, who hold the *rightist* opinion that everyone has an inalienable right to the use of his own income, would attach little importance to the argument that an expansion of taxes and public expenditure would increase efficiency.

preference for equality is likely to vary a good deal from one individual to another.

There are other ways in which to argue that equality, as such, is a good thing. For example, it is possible to argue that equality is good because it fosters social stability, leads to less crime, and so on. But note that these elements might be brought into the description of the outcome of the lotteries, so that in choosing between lotteries with much and little inequality of income, you would also take account of these consequences of income inequality for your own welfare.

It is sometimes fruitful to draw a distinction between interpersonal and intrapersonal redistributions of income. So far, we have been concentrating on the former, that is, on redistribution between persons with different endowments. But part of the redistribution that occurs through the institutions of the welfare state can rather be seen as socialized insurance. I know that if I become unemployed, I will receive unemployment insurance. This is a form of redistribution from the employed to the unemployed. But it is also a form of redistribution that I could have organized myself through the appropriate insurance markets. Similarly, my old-age pension is one that I could have obtained through private saving and insurance transactions. Although the empirical distinction between the two kinds of redistribution is problematic, there is a good case for arguing that some, probably the larger share, of the redistribution implemented in the welfare state are just substitutes for private decisions regarding saving and insurance. This is more difficult to justify by the ethical thought experiments that were previously discussed, and their justification requires a different line of argument.

Some writers, such as Barr (1987), have argued that the large amount of intrapersonal redistribution, which is carried out in the welfare state, can be justified by the lack of adequate risk coverage in private insurance markets. One reason for the lack of insurance markets is the problem of *adverse selection*, which was made familiar to economists through the famous article by Akerlof (1970). Akerlof took the used-car market as his prime example of one where there is asymmetric information between sellers and buyers, but his formulation has immediate applications to insurance markets. Suppose insurance companies offer unemployment insurance as a regular insurance policy. They do not know the individual policy buyer's probability of becoming unemployed, but they have actuarial information about the average risk of becoming unemployed. Their initial premium reflects

this average risk. But at this insurance premium, the policy is unattractive to individuals who have the lowest risk of becoming unemployed, so they will not buy the insurance. The result is that buyers, as a group, now have a higher risk of becoming unemployed than the population as a whole; when the insurance companies discover this, they must raise their premium. This leads to new withdrawals of low-risk customers, and the end result may be that the market vanishes altogether. This is obviously a case of market failure, because the outcome is that a real risk has become uninsurable. One remedy for this market failure is that the government comes in to declare that unemployment insurance is compulsory.[4] This does not completely establish a case for social insurance, because it is clearly possible to have compulsory insurance organized through private companies. The case for public provision of compulsory insurance is a rather complex one; let me just mention a few points that seem to be particularly relevant.

If insurance is obligatory, while consumers have a choice between several insurance companies, companies will compete to attract customers. If the provisions of the insurance policy are not regulated in every detail by the government, one would guess that competition would result in some consumer benefits through the tailoring of policies to individual needs. But by the very nature of a social insurance scheme, the adjustments to individual needs must be rather marginal, so that the benefits of competition cannot be very substantial. If this is the case, competition for a given total number of customers might result in some wasteful marketing expenditure. Here, it is far from clear that the benefits of competition would, on the whole, be positive.

Insurance companies sell policies on an actuarial basis. Although a certain *ex post* redistribution is built into any insurance scheme—from the healthy to the sick, from those who die young to those who live long—the Scandinavian social-security schemes have, in addition, a strong element of *ex ante* redistribution; with increasing income, the benefits attached to social security *premia* (in the form of taxes) decrease. This redistribution would be hard to achieve in a private system, and defenders of the existing system claim this redistributive function as one of its benefits. But the same kind of redistribution among the old and disabled could presumably have been achieved

[4] See Pauly (1974) for an early discussion of the case for compulsory insurance.

through the tax system; moreover, there does not seem to be any convincing argument why we need a redistribution system for the old or disabled, which is separate from that for the population as a whole.

A final argument that might be advanced in favor of public provision relates to the negative aspects of the concentration of wealth in the insurance companies that would arise under a fully funded private system, especially if the number of companies is small. Although this argument has a counterpart in concerns about the concentration of wealth in the hands of the government under public provision, the public system can be established on a pay-as-you-go basis which alleviates the problem of wealth concentration.

The issue of public versus private provision of compulsory insurance raises several difficult issues, which cannot be settled here. But it is of some interest in itself to note that the case for public provision is apparently a much more problematic one than the case for a compulsory system. It is easy to imagine that the choice between private and public provision may become one of the central policy issues in the debate about the future of the welfare state.

The desire for insurance, whether it be social or private, stems from risk aversion. We have also seen that the desire for social equality can be derived from the existence of risk aversion. But if people are really averse to risk and inequality, why should we not go all the way toward a society with the maximum of safety and equality? The answer is that as we pursue policies that lead to a diminished dispersion of incomes, we tend to create incentives that also lead to a lower *average* income. The explanation for this lies in the social costs of insurance and redistribution.

3. The social costs of insurance and redistribution

One interpretation of the efficiency of the perfectly competitive market system is that through the price mechanism, all economic agents pay the marginal social costs and receive the marginal social benefits of their own decisions. Decentralized decisions work in the public interest.

The welfare state implies far-ranging systems of insurance and taxation. Although it is possible, in theory, to envisage systems of taxation and income transfers that are *neutral* regarding individual de-

cisions,[5] in practice, these two systems have the common feature that they distort the equivalence between individual payments and receipts on the one hand, and social costs and benefits on the other[6]. The result is that individual decisions do not lead to an efficient social outcome. The conclusion to draw from this observation is evidently not that all social insurance and taxation schemes should be abolished, but that the distortionary costs should be thought of as the price of redistribution. The benefits of redistribution should, on the margin, be weighed against its costs. The more distortionary the tax and transfer scheme is, the less the optimal amount of redistribution will be.[7]

The degree of price distortion is usually measured by the percentage deviation between the producer and consumer prices. But this deviation alone does not determine the amount of efficiency loss. If either supply or demand is completely price inelastic, the actual use of the taxed commodity in consumption and production will be unaffected, so that no efficiency loss arises, despite the tax distortion. A deviation from an efficient allocation of resources will only arise if supply and demand are elastic regarding the tax-induced price change. So the amount of efficiency loss from the tax system depends both on the degree of price distortion and on the elasticities of demand and supply. Because these elasticities vary among markets, the overall efficiency loss from the tax system will depend on its design. To minimize the overall loss, taxes should mainly be levied at commodities that are inelastic in supply or demand. An implication of this result is that it is better to collect a given revenue through a broad-based tax system—one that has comparatively low tax rates applied to a broad definition of the tax base—than through a system with a narrow base, where the marginal tax rates must be high. This insight lies behind the reforms of the tax system that were carried out in

[5] Here, neutrality means that taxes and transfers have pure income effects and no substitution effects. In that case the redistributive scheme changes the market outcome from one equilibrium to another with a different distribution of resources between individuals, but both equilibria are efficient in the Pareto sense.

[6] But note that there are some important cases where taxes actually serve to increase the efficiency of competitive markets. In particular, this can happen with the use of environmental or *green* taxes. See Sandmo (1995) for a further discussion.

[7] See Sandmo (1991) for a formal model of the optimal amount of redistribution under distortionary taxation.

several countries in recent years; see Agell, Englund, and Södersten (1996) for an account of the Swedish experience.

While taxes tend to produce a diminished tax base, subsidies tend to create a higher subsidy base than would otherwise be the case. The social-security and social-assistance systems provide income subsidies for people in particular social states, and if people can, to some extent, control which state they will be in, we have a distortion of choices on the transfer side of the welfare state similar to the one which arises on the tax side. So the efficiency loss from the redistributive activity of the welfare state is two-sided:

1. High taxes induce behavior that is motivated by the desire to avoid taxes
2. High rates of subsidy to compensate for income loss will tend to increase the number of people who qualify for support

Note that not all changes in behavior induced by the system of income transfers are necessarily undesirable. Thus, unemployment compensation may lead to a higher *natural* rate of unemployment. But if part of the intention behind this compensation scheme was to give workers more time to search for an alternative job, this particular increase in the length of the average unemployment period might be a welfare gain on the part of the individual. Moreover, to the extent that it results in better job matching, it might even be considered an efficiency gain for the economy as a whole.

In this connection, *optimality* clearly refers to the maximization of some social welfare function, in particular to a welfare function which, in line with the discussion above, reflects inequality aversion. Although we may find it hard to believe that a social welfare function exists in any descriptive sense, it may still be a useful approach to the study of economic policy to imagine oneself in the role of a social planner who is concerned with the standard of living of all citizens and who tries to achieve a fair compromise between conflicting interests. But to understand the way that welfare-state policies have actually emerged, it will be necessary to follow the road pointed out by modern research on positive political economy; see Dixit (1996). A positive analysis may sometimes point in rather different directions from that of normative welfare economics. To take one illustrative example: the welfare economics approach indicates that distortions due to taxes and transfers should be minimized, and this means that the costs of redistribution should be as low as possible, given the available policy instruments. But political parties that are against sub-

stantial redistribution may realize that a highly distortionary system will provide a barrier against it; hence, they may be skeptical toward reforms that reduce the barrier. This prediction emerges from the analysis by Brennan and Buchanan (1980), and it would be interesting to confront it with empirical evidence. But this is no simple task, because one would have to study not only the outcomes of the political process but also the arguments used to support different positions. In addition, the position taken by a political party on a specific tax-reform issue would presumably reflect not only its view as to the appropriate size of the public sector, but also the interests of its own electorate regarding the distribution of the tax burden. What the conclusions of such a study would be seems quite uncertain. It is a fact that the efficiency oriented tax reforms of the 1980s and 1990s have been presided over by governments both of the left and the right, so that a general confirmation or rejection of the Brennan-Buchanan hypothesis is hardly to be expected.

4. Civil society, markets, and government

Much of economic analysis has been written on the assumption that the economy can be seen as organized into two sectors: the private and the public. The private sector is then treated as being exclusively market-based, with transactions being made between consumers and firms as regulated by formal contracts and with money payments.[8] But this dichotomy abstracts from some important arenas for the allocation of resources. The members of a family make decisions on within-family use of resources, and other decisions of a similar nature are taken in voluntary organizations and informal groups of neighbors and friends. This is what is known as the civil society—the third sector of society and the economy. It is obviously possible—and for several purposes indeed fruitful—to take civil society as being treated implicitly within our modeling of decisions made by consumers and firms. But to understand the development and functioning of the welfare state, it is sometimes very important to bring civil society to the forefront as the third main sector of the economy.

Many of the services now being produced in the public sector of the welfare state previously belonged in civil society. This is most

[8] Actually, money in the literal sense of the word plays hardly any role in the formal theories of welfare economics. But in a broad interpretation of the theory, this is its *vision* of how markets work.

notable when one considers the care for the very young and the very old. In traditional society, the care of small children was a family task, and so was that of looking after the old and infirm members of society. This became problematic with the development of an industrial economy which, among other things, required a higher degree of geographical mobility than had previously been the case. An industrial worker who became sick or unemployed (possibly as the result of an industrial accident) would, to a much larger extent than before, be on his own, so that a real need developed for institutions that could provide some of the security that had previously come with family and neighborhood networks.[9] In more recent times, there can be little doubt that the sharp growth in institutions of child care and homes for the elderly are closely related to the increase in labor force participation rates for women. This observation is important not only for understanding the history of the welfare state. When considering reforms of current welfare-state policies, we should be aware that attempts to dismantle the public-sector part of the welfare state may lead not only to the emergence of private institutions on a market basis but also to increased production of welfare services in civil society. So privatizing the welfare state can take two forms. One is to substitute private for public formal institutions, that is, transfer of parts of the public sector to the private market sector. Another is to let civil society take over tasks that are presently the responsibility of the public sector.[10]

It has frequently been pointed out that recent decades have seen some significant changes in the composition of the group of *welfare clients* in the more narrow sense of those who qualify for social assistance. To an increasing degree, these include, for example, children from dissolved homes, juvenile delinquents, drug addicts, and other dropouts from the labor market. Many of these problems stem from the weakened position of the family in society. The problems open up difficult ground for economists. We have been used to thinking about market failures and more recently about policy failures. Should

[9] The emphasis on the importance of the changing nature of the labor market for understanding the emergence of the welfare state can be found in many places in the literature; it has been given particular prominence in Atkinson (1991).

[10] In Norway, there is currently a lively political debate about the best way to assist families with small children, the main alternatives being more daycare centers or larger cash subsidies to families with small children. In the latter case the expectation is that more parents would chose to stay home with the children; this is clearly a form of privatization, where the private sector, in this case, is the family.

we also get used to talking about failures of civil society, particularly about family failures? This is evidently difficult for a profession that has based welfare economics on the principle of consumer sovereignty with a rather unclear delineation between the individual and the household. Our standard explanation for changes in consumer behavior, which cannot be ascribed to changes in prices or incomes, is that they must be due either to changes in tastes or in the technology of household production. This leaves little room for the analysis of changes in social norms that have been of central concern to psychologists and sociologists and that have recently begun to be explored by economists; see Lindbeck (1995). Of course it is possible to argue that these matters had better be left to the other social sciences and that economists should concentrate on what they know best. But there is little reason to believe that norms exist and are formed in isolation from the set of economic incentives in the economy, particularly those incentives that have been created with the approval of democratic governments. If policies influence norms, norms will influence behavior patterns which in turn feed back on policies. A broad view of welfare state policies must take this interaction seriously.

5. Welfare at home and at work

Traditionally, the welfare state has been much concerned with the welfare of individuals both as consumers and as workers. In many instances, welfare at home and at work are so closely related that a distinction between them seems meaningless. An obvious example is that the emphasis on *good jobs* not only aims at providing people with meaningful work in pleasant working environments but also with a decent standard of living in terms of consumption through high earnings. But there are also possible conflicts. The classic example is the case of the minimum wage. The introduction of a minimum wage is intended to improve the standard of living for those with the lowest incomes and possibly also to improve job satisfaction. But the textbook treatment of this shows that the result is more ambiguous. If a minimum wage is introduced in a competitive labor market with full employment, the situation does indeed improve for those workers who are still employed after the introduction of the minimum wage. But one result of this market intervention is that some workers will now lose their jobs because their marginal productivity is less than the minimum wage. As a result of this measure, some of those

who were worst off, in terms of earnings, have now become better off. But others have actually become even worse off than they were before.[11]

There is a lot that can be said about this example; in particular, it simplifies the world considerably in assuming a competitive labor market with no informational problems. Still, it does capture an important issue and has colored the thinking of economists regarding many other measures designed to improve the welfare of workers. For example, job security legislation is a good thing for those workers who already have a job, but for those who do not, the new rules may discourage firms from hiring new workers and thus increase unemployment.

The high level of European unemployment has often been ascribed to the fact that wages (or, more generally, labor costs) for low-skilled workers are too high. This is in contrast to the U.S. labor market that to a larger extent appears to offer jobs to low-skilled workers at correspondingly low pay. One of the challenges for the welfare state is evidently how to provide jobs for all, without introducing unacceptably large wage differentials. One possible line of reform is to differentiate taxes on labor so as to lower the costs of employing low-skilled workers; see Phelps (1994) and Sørensen (1997). A conceivable objection to this proposal is that it introduces yet another distortionary tax differential. But this misses the point, which is that this particular tax reform aims at correcting another distortion in the form of an inefficiently designed structure of wages.

6. Welfare and happiness

A welfare state should create welfare among its citizens, and if it is successful, people should feel happier. But do they? This question was first raised in the economic literature by Easterlin (1974), who surveyed several investigations in which people were asked to rank their subjective perception of happiness or satisfaction with life.

[11] Many countries do not formally have a minimum wage; this is, for example, the case in Norway. But it has long been the policy of the dominating trade unions to give the wage settlements a *low-wage profile*, designed with the purpose of raising the wages of the lowest-paid workers. This is very similar to the system of a minimum wage.

The conclusions that he drew from this study can roughly be summarized as follows.

In a cross-section of a population, there is a positive association between income and happiness; those in the highest income groups rate their own degree of happiness higher than those at the bottom of the income scale. But when one looks at time series that cover a period of increasing incomes, there is no significant relationship between income and happiness. Similarly, comparisons between countries with very different income levels reveal little if any positive connection between income and satisfaction with life.

These results appear to be consistent with the hypothesis that what yields satisfaction is *relative* income; in other words, satisfaction is generated not so much by one's material standard of living as such as by one's standard in comparison to that enjoyed by others. In a cross-section of a population, the happiest people are those who earn the most, relative to others. But during a period of economic growth during which all incomes increase, although in roughly the same proportion, perceived happiness remains the same. More recent research on similar types of data by Oswald (1995) modifies Easterlin's conclusions regarding the non-dependence of happiness on absolute income, but not by very much. On the other hand, Oswald's research uncovers that unemployment is a main source of unhappiness in the sense that it decreases perceived satisfaction with life much below the level that would otherwise be implied by a low (relative) income.

Why would utility or perceived happiness depend on relative income? The explanation may be sought in the importance of so-called *positional goods*. These are goods, where the utility that one derives from them, depends in an important degree on the consumption of others. The way that others eat, dress, or furnish their homes may set standards for one's own consumption. For any one consumer, who takes the consumption patterns of others as given, an increase in income offers more satisfaction, among other things, because it allows that consumer to increase positional goods consumption. But in the long run, most consumers will find that their incomes will grow at the same rate as that of others, who will also increase their positional goods consumption. It follows that the *ex post* increase in satisfaction is less than envisaged *ex ante*.[12]

[12] Persson (1995) shows that the relative consumption or income hypothesis may explain the existence of relatively high marginal tax rates on income, even in so-

Traditionally, economists have been skeptical to the value of interview data, such as those used by Easterlin and Oswald. But it is difficult to see that this type of information can really be collected in any other way. Another line of criticism is to argue that the only way in which we can observe happiness is through the study of the choices that people actually make. If people make decisions that increase their incomes and consumption, it must be that these decisions make them happier. But the weakness of this argument is that it abstracts from the social context in which choices are made. If a social context exists at all, it must somehow be captured in the notion of externalities between people, and once this is acknowledged, it no longer follows that individual and uncoordinated decisions lead to an outcome which is collectively rational. One does not have to be a firm believer in the empirical results of the Easterlin-Oswald line of research to concede that it raises some fundamental questions for the meaning that we attach to notions of the good society.

7. Prospects for the future

In *Hedda Gabler*, Henrik Ibsen introduces us to two scholars whose ideas about the way to do academic research are very different. Jørgen Tesman asks Ejlert Løvborg about the contents of his new book and is told that it is a continuation of his previous one. This leads to this dialogue:

> *Tesman*: But my dear Ejlert, that one comes down to our own times!
>
> *Løvborg*: It does. And this one deals with the future.
>
> *Tesman*: With the future? But, good gracious, we don't know anything about that.

Every economist knows that prediction is difficult for several reasons, and it is especially difficult when it comes to predict the future of an entire economic system. The future of the welfare state will largely depend on structural developments in the economy, such as the development of productivity and of the demographic composi-

cieties with an egalitarian distribution of pre-tax incomes. The point is that a high tax rate serves to internalize the externalities created by positional goods.

tion of the population. But it will also depend on political choices, and it is here that prediction becomes especially difficult. Rather than speculate about the most probable development of the welfare state, I note by way of conclusion a few issues that might be central in future policy debates about the organization of the welfare state.

Restoring and maintaining full employment may be the major issue for the welfare state in the years ahead.[13] I have already noted the challenge in combining flexibility in the structure of labor costs with incomes that are high enough to secure a decent standard of living at the bottom end of the income scale. There are many suggestions in the academic literature as to how this could be achieved, for example, in the form of a negative income tax or via selective employment subsidies. Perhaps it is time for more courage in trying them out.

Inefficiencies in public production of welfare services has been seen as a serious problem in many countries. One solution is to privatize some of these services, possibly in the form of exposing them to competition from private firms. But the implementation of such reforms raises several problems, one of which is the rather neglected issue of *institutional stability*. In the market sector, the entry and exit of firms is a positive sign that the market is working. In markets for health and social services, the lack of a stable institutional structure could well be a major welfare problem for clients who depend on stable long run relationships.

Sometimes one sees that the welfare state is associated with a subsector of government, that is, the ministries or agencies who are particularly concerned with transfer payments, health care, social services, and such. This may easily lead one to neglect the fact that individual welfare also depends crucially on what the government does within the traditional areas of public-sector activity, such as crime prevention, communications, and the environment. The fact that these tasks are of a public good nature means that it is more difficult to organize political pressure groups around them. An important task for future welfare-state governments will therefore be to protect the classical functions of the state.

The areas in which pressure groups can be expected to be particularly active are those where public expenditure can be targeted toward particular subsets of consumers or firms. Such expenditure

[13] In Norway, the restoration has for all practical purposes been achieved, but the maintenance issue will obviously be of relevance there as well.

will often be in the nature of private, not public goods, and it will often be imperative to take a critical view of the arguments why provision of such goods cannot be left to the market. This raises a question of the design of political institutions. In a system that encourages the formation of pressure groups, politicians easily become prisoners of the system. The design of incentives in the welfare state should include the design of political institutions.

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