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The Welfare State as Piggy Bank

Information, Risk, Uncertainty, and the Role of the State

Nicholas Barr

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For Gill

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Preface

This book is about economics and its application to the welfare state. Its core message is that—contrary to widely held views—the welfare state exists for reasons additional to and separate from poverty relief, reasons that arise out of pervasive problems of imperfect information, risk, and uncertainty. Flowing from that analysis, the book argues, secondly, that the welfare state is here to stay, since twenty-first-century developments do nothing to undermine those reasons—if anything the reverse. To argue that the welfare state is robust does not, however, mean that it is static. A third set of arguments concerns the ways it can and will adapt to economic and social change, including discussion of the direction of change and also specific (and in some cases novel) solutions.

The book grows out of a series of papers whose intellectual roots lie in my earlier work on the microeconomic foundations of the welfare state, notably the first (1987) edition of *The Economics of the Welfare State*. Presented as an integrated whole—the purpose here—they tell a more powerful story than each individually. This book contrasts with my earlier volume, first, in its exclusive focus on the efficiency argument for the welfare state, an underdeveloped area that this book strengthens. Its analytical reach is thus narrower but deeper. Secondly, the analysis is international: it applies to the advanced industrial countries, includes discussion of post-communist countries, and reaches out towards middle-income developing countries. Finally, the story is forward looking, with some chapters explicitly about twenty-first-century issues.

Topics that are new, or that go further than previous discussion, include: forces leading to convergence of private and social insurance; genetic screening and its impact on insurance; approaches to financing long-term care; a new slant on options for pension reform, including pension design in the face of fluid family structures, and where workers are occupationally and internationally mobile; designing loans to finance investment in human capital, including options that incorporate an element of social insurance; and new ways of involving private finance in tertiary education, including new forms of domestic and international financial instruments.

In the academic world, the book will be of interest, first, to economists, as applying the economics of information systematically to the welfare state, and to colleagues in departments of social policy because of its subject matter. The book should be of interest also in related areas such as political economy, as an explanation of the durability of certain types of institution despite apparently adverse economic and political pressures, and to colleagues studying post-communist transition or economic development. The book is also acutely relevant to policy-makers in the OECD, and in post-communist and middle-income developing countries, including Treasury officials bent on fiscal sustainability, policy-makers in departments of Social Security, of Health, and of Education, who have to assess how to reshape institutions in the face of twenty-first-century pressures such as demographic change, global economic competition, and technological advance, and officials in international organizations such as the International Monetary Fund, the World Bank, and the United Nations. Readers with selective interests or short of time should read Chapters 1 and 2, after which any of the remaining chapters can be read as free-standing.

My intellectual debts are many and great, though none of the kind people mentioned below should be held responsible for remaining errors. The idea of the book emerged from conversations with Howard Glennerster and Julian Le Grand, both of whom read and commented on the whole. Conversations and writing with them over more than twenty years has been a wonderful education. I am grateful also to two anonymous reviewers, and to Hilary Walford for her customary sparkling copy-editing. Chapter 2 (the underpinning economic theory) draws on chapters 4 and 5 of *The Economics of the Welfare State* (Barr 1998*a*). Chapter 3 (unemployment insurance) is based on a long-ago discussion paper on which I received helpful comments from John Hills, Julian Le Grand, Richard Jackman, and David Piachaud. Chapter 4, based on my graduate lectures on health finance, benefited from helpful comments from Alain Enthoven. The discussion of genetic screening in Chapter 5 draws on my evidence to the Parliamentary Select Committee on Science and Technology prompted by Dr Jeremy Bray, at the time the Chair of the Committee. Tanya Burchardt commented helpfully on the section on long-term care, which draws on my evidence to the Royal Commission on Long-Term Care.

The section on pensions draws on my times at the World Bank—periods of splendidly robust fights, alarums, and debates—and on a period of quiet reflection as Visiting Scholar at the International Monetary Fund in spring 2000. I am grateful to the IMF for permission to draw on the resulting IMF Working Paper 00/139, on which Chapter 7 is based. I have benefited from discussions with many colleagues at the World Bank over the past ten years, latterly including Robert Holzmann, David Lindeman, Michal Rutkowski, Alan Thompson, and Dimitri Vittas. I am also grateful to colleagues in the Fiscal Affairs Department at the IMF, including Ke-Young Chu, Peter Heller, Richard Hemming, George Kopits, and Vito Tanzi, and to participants in two seminars at the IMF in April 2000. Others who have commented on the material in the pensions chapters include Phil Agulnik, Gary Burtless, Peter Diamond, Pierre Pestieau, Stanford Ross, and Lawrence Thompson. The section on pensions in the context of labour mobility benefited from comments from participants at a seminar at HM Treasury in 1997.

The section on education draws on writing in the context of UK policy debate from the late 1980s onwards, deepened by involvement in policy development in Australia and New Zealand and, latterly, in some of the advanced post-communist countries. I owe a huge debt to Iain Crawford, my companion-in-arms in the UK debate, and to joint work with Jane Falkingham. I am also grateful to Tony Atkinson and Nick Stern, as successive Chairs of the Suntory–Toyota International Centre for Economics and Related Disciplines, for encouragement and financial support for my early research, to the Nuffield Foundation for financial support, to Mark Blaug for tutorials over the years on the underlying theory, to Mervyn King for pointing towards the link to social insurance, to Bruce Chapman for many illuminating conversations, and to Colin Ward for sharing his wisdom about implementation and, most particularly, about private finance.

The discussion of post-communist countries draws on two periods at the World Bank, one in operations, the other as one of the authors of the World Bank's 1996 *World Development Report: From Plan to Market*. My particular debts are to Ralph Harbison, to Alan Gelb, and to the late and greatly lamented Michael Bruno.

My wife, Gill, listened patiently to my doubts and enthusiasms, argued ferociously when she thought I was wrong, diagnosed with unerring accuracy writing that did not work, and put up (more or less) cheerfully with truncated weekends. My final and enormous thanks are to her.

Nicholas Barr

November 2000

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‘When a man sets out upon any course of inquiry, the object of his search may be either light or fruit—either knowledge for its own sake or knowledge for the sake of good things to which it leads . . . there will, I think, be general agreement that in sciences of human society . . . it is the promise of fruit and not of light that chiefly merits our regard . . . That is true of all social sciences but especially true of economics.’

A. C. Pigou, *Economics of Welfare*, 1920

Chapter 1

Introduction

1. CORE ARGUMENTS

Of the many purposes of the welfare state, two stand out:

- as a series of institutions that provide poverty relief, redistribute income and wealth, and reduce social exclusion (the 'Robin Hood' function);
- as a series of institutions that provide insurance and offer a mechanism for redistribution over the life cycle (the 'piggy-bank' function).

The redistributive purpose of the welfare state is enormously and enduringly important, and, not least for that reason, there is a large literature on the topic. The piggy-bank function, in contrast, has received relatively little attention and is not widely understood. This book is intended to redress the balance. Building on economic theory, it develops three central arguments that apply to industrial countries and to post-communist and middle-income developing countries: the welfare state has an important piggy-bank function that is additional to and separate from poverty relief; secondly, and consequentially, the welfare state is here to stay; thirdly, the welfare state will adapt to economic and social change.

THE WELFARE STATE AS PIGGY BANK. Even if all poverty and social exclusion could be eliminated, so that the entire population were middle class, there would still be a need for institutions to enable people to insure themselves and to redistribute over the life cycle. Though private institutions are often effective, they face predictable problems, and attempts to address those problems inescapably involve state intervention. Thus the welfare state exists not only to relieve poverty, but also to provide insurance and consumption smoothing. That does *not* mean that the state is necessarily the main—still less the only—actor, nor that its role is immutable either over time or across countries. The configuration can vary in ways that are one of the main subjects of this book.

The argument that the welfare state has an efficiency function is important. The resulting gains to well-being are potentially enormous and affect the entire population. Thus it should not be surprising that Falkingham and Hills (1995) (one of the few pieces of research to tackle the topic) estimate that between two-thirds and three-quarters of UK welfare-state spending is life-cycle redistribution, with only a third or less on poverty relief. In quantitative terms, it might therefore be argued that the piggy-bank aspect is *the* key function of the welfare state.

The argument is important, secondly, because it offers guidance about how most effectively to pursue key equity objectives—for example, access to food and to health care. Food is generally sold at market prices, and the poor are given access through targeted income transfers that enable them to pay those prices. With health care, in sharp contrast, access in most countries is through free or subsidized medical treatment, not just for the poor but for the generality of the population. As discussed in more detail at the end of Chapter 2, the choice of these very different instruments is not accidental: the conclusion of the efficiency arguments about market-versus-state also illuminates the equity question of cash-versus-kind.

The welfare state's efficiency function also casts a new light on arguments about middle-class 'capture'. These tend to suggest that receipt by the middle class of welfare-state benefits is *necessarily* an adverse feature. This book suggests that the issues are more subtle than that. Finally, the argument sheds new light on the view that universal benefits foster social solidarity. This might well be the case; but it is no longer the only argument for universal benefits.

THE WELFARE STATE IS HERE TO STAY. The book's second central argument flows directly from the first: the welfare state is here to stay. The reasons for its existence, including risk and uncertainty, will continue to apply, as evidenced by discussion in later chapters of a series of twenty-first-century issues. The pressures discussed below (which apply equally to private institutions), if anything, strengthen the importance of insurance and consumption smoothing. If insecurities, as some writers argue, are greater than in the past, it may be that state institutions are *more* necessary.

One piece of muddled thinking—the failure to distinguish structure from scale—should be nailed immediately. Structure is concerned with whether an activity is more efficiently conducted in the public or the private sector; as argued throughout the book, the issue is primarily microeconomic, focusing on the extent of market failures and the ability, or lack of it, of government to address them. Scale, in contrast, is concerned with the optimal level of spending on an activity; it is largely a macroeconomic issue, particularly of fiscal sustainability. Fiscal pressures are an argument for fiscal containment, not *per se* an argument for privatization. Analogously, global competition may exert downward pressure on the scale of spending on the welfare state, but that is not an argument for dismembering it.

THE WELFARE STATE WILL ADAPT. Neither of the previous arguments implies that the welfare state will be static. Its form—as in the past—will adapt to changes in the world within which it operates: declining job security has implications for the nature of unemployment insurance; declining family stability implies, for example, pensions for individuals rather than, as in the past, for husbands on the assumption that this would also cover wives; demographic change will tend to exert downward pressure on benefit levels; and increasingly easy international transmission of information and capital (so-called globalization) may create pressures to convergence.

Parallel to these largely global forces, a series of country-specific objectives and constraints will also influence the future shape of the welfare state. The economic, political, and institutional requirements of particular policies are a recurring theme in the chapters about reform options, and of particular salience when discussing the reforming post-communist countries: some forms of health finance depend critically both on political will and on administrative capacity; private pensions have major private-sector prerequisites but are also dependent on effective government and continuing political support; student loans depend on the capacity to collect repayments. Thus the welfare state will adapt: some adaptations, particularly responses to the universal pressures in the previous paragraph, are fairly predictable; others, particularly those connected with different country objectives and different configurations of constraints, will show significant variation.

Effective reform rests equally on good policy and effective implementation. A fourth argument is different in kind from the others: it applies far more widely than reform of the welfare state; and it is not rooted in theory but is deeply practical. Effective reform has two co-equal ingredients: the need for well-designed policy is obvious; in addition, that policy has to be implemented effectively. It is sometimes forgotten that the essence of reform is not in words on paper or in ministerial speeches, but in institutions—job information systems, walk-in medical clinics, pension payments, schools—that work well. Bad implementation of a potentially good reform not only leads to outcomes that fail to achieve its objectives, but can also discredit the underlying policy.

Effective implementation has two roots. First, as just discussed, any reform has institutional prerequisites. In their absence, a simpler reform, which respects country-specific constraints, needs to be adopted or the reform postponed until institutional development allows. Secondly, the best-designed policy will fail for lack of political support, or if it cannot be administered. Effective reform depends simultaneously on three very different sets of skills: the ability to design a coherent policy strategy; the ability to engender political support that is sufficiently wide, deep, and durable; and the ability to put into place effective administration. The word 'simultaneously' is key: the world is littered with policies that failed because they were designed by policy-makers who then handed them on to

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