

THE CASE FOR A TARGETED CRITICISM OF THE WELFARE STATE

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Criticism of the welfare state would be more effective if it were better targeted. That is why we begin by clarifying the meaning of the welfare state. We then distinguish three dimensions of the welfare state and use them to show the extent of differences between welfare states. Next, we identify countries that appear to face the greatest challenges regarding the sustainability of their welfare states. We conclude with some remarks on how to make criticism of the overgrown and badly structured welfare state more effective.

Some Clarifications

It is best to define the welfare state not through its noble goals but through its instruments.

Instruments of the Welfare State

At the minimum they include social transfers in cash (e.g., PAYGO pensions, unemployment benefits, family allowances, and programs for the poor) and social transfers in kind (especially publicly financed health and education but also some programs for

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the poor). To these components of social spending, one can add, as two additional instruments, tax subsidies (e.g., subsidies to the employer-financed health insurance in the United States, see Feldstein 2005) and “social” regulations like the minimum wage, rent controls, and employment protection. In this article, we focus on social spending because it is by far the most important instrument of the welfare state and there is abundant data. However, occasionally we will also refer to the two other policies.

Welfare Arrangements

It is useful to regard the welfare state as a special kind of welfare system, which we define as arrangements to deal with various risks facing individuals—such as acute poverty, sickness, and accidents. A brief look at history reveals the existence of various welfare arrangements—for example, family (kin) based, religion based, civil based, corporate based, and market based (insurance through jobs, private savings, and commercial insurance). Countries have always had some type of welfare system combining all or some of the above arrangements. The Poor Laws in Europe, which constituted the early welfare states (Tocqueville [1835] 1997), revealed the incentive problems of government support and foreshadowed those of the modern welfare state.

The concept of a welfare system (as distinct from the welfare state) is a useful communication device:

- First, it highlights a basic fact that a lack of large welfare state does not need to mean the absence of the alternative welfare arrangements.
- Second, it draws the attention to the question of what happens to these arrangements when the welfare state expands and shrinks. There is a large body of empirical literature on the crowding-out effects of the growing welfare state (e.g., Morduch 1999, Kelley 1998) and, more interestingly, for the present situation of the unsustainable welfare state, there is some literature on the crowding-in effects of the shrinking welfare state (Heutel 2009).
- Third, distinguishing various welfare arrangements should lead to a more comparative analysis of the welfare state. There are many ideologically idealized descriptions of this system and not enough comparative research that would show how different

the treatment of the welfare beneficiaries is by welfare officials and other suppliers of welfare services (e.g., family, churches, other voluntary organizations, and the employers of the commercial organizations).

Criticisms of the Welfare State

There are many criticisms of the welfare state. They can be grouped into economic, moral, philosophical, and political. The distinctions between these categories are to some extent arbitrary but still useful because different types of criticism lead to different proposed remedies. Any proposal for reform should start with a clarification of what its main goal is.

The economic criticism of the welfare state ultimately focuses on its negative impact on the long-run economic growth. The intermediate variables are the tax burden, reduced private savings, reduced employment, and chronic fiscal fragility or outright fiscal crises.

The moral criticism shows how the repeated deviant behavior (using or misusing various social benefits) erodes social norms such as honesty, a strong work ethic, and family values (Lindbeck, Nyberg, and Weibull 1999; Niskanen 1996).¹ Moral criticism also highlights how some social benefits undermine the family and lead to increased criminality, especially among young men brought up without fathers.

Philosophical and political criticism refers to the erosion of social norms that are especially important for conservative critics of the welfare state. The “liberal” (libertarian) critics focus on two related problems. First, the loss of individual freedom due to the increased taxes needed to fund the welfare state; people are “forced to contribute toward the costs of some activity which does not further his interests or may even be diametrically opposed to them” (Wicksell 1967: 89). Second, the rise of interest groups supporting the welfare state weakens civil society (Murray 1984).

As we mentioned, these criticisms differ in their focus. But they have a large common ground, which makes it easier to form coalitions for reforming the welfare state. For example, reducing tax

¹This impact is largely independent of the national culture, as strong incentives, including the perverse ones, overwhelm the cultural specificities. For example, the Germans speak of *Sozialbetrug* (social cheating).

burdens can be justified on both economic and liberal (libertarian) grounds. The elimination of the perverse incentives makes both economic and moral sense.

Dimensions of the Welfare State

In mobilizing people for reforming the welfare state, we have to go beyond a general notion of the welfare state so that people can see which of its features produce the worst excesses. An elementary step in this direction is to distinguish three dimensions of the welfare state: its size, design, and financing.

Size

The size of the welfare state is usually measured by the ratio of social spending to GDP.² Size is a very important dimension because it is strongly linked to a country's tax burden and—to some extent—fiscal fragility and the frequency of fiscal crises, all of which matter for long-term economic growth (Balcerowicz and Rzońca 2015).

Design

Welfare states differ not only in their size but also in their design or structure. To be sure, structure is related to size: countries with large PAYGO pension systems and publicly funded health services tend to have large welfare states. However, they can be designed or structured in various ways that have important implications for their future growth (Feldstein 2005, Börsch-Supan 2012).

There also are important differences in the design of the less fiscally important components of the welfare state, which matter for the strength of the perverse incentives and the resulting social traps they produce. These microstructures increase the relative utility of non-working income and include the ease of access to, the duration of, and the replacement ratios of various social benefits.

The structural issues of the welfare state include the distinction between the welfare state, which consists of many social programs,

²In comparative research, one can also use the ratio of public spending to GDP as it is almost perfectly correlated to that of social spending to GDP. This correlation reveals that the cross-country differences both in public spending and in its dynamics have been caused by social spending.

and the *universal* welfare state that would include the guaranteed income proposal (a negative income tax) originally proposed by Milton Friedman (1962) and developed by Charles Murray (2006). The main argument for the latter option is that it would abolish the extended social bureaucracy and the pressures related to the possibility of lobbying for special social benefits. The conservative critics would object that social benefits should be “deserved” (i.e., at least means tested), and not evenly distributed. There are also some serious practical problems, especially regarding the transition to the system of guaranteed income in countries with large PAYGO pension systems. Finally, even if such a transformation succeeded there would still remain the issue of how to prevent politicians from reintroducing the special programs and politicizing the level of guaranteed income.

The above remarks are not meant to disqualify the guaranteed income proposal. Every reform has to meet two challenges: first, it has to be launched, and second, once launched, it must be sustained. There is no reform that would solve those two problems just because of its design; and there is no good substitute for a well-organized civic effort to reform the welfare state.

Financing

The third clarification refers to the structure of taxes necessary to finance the welfare state. All taxes harm economic growth but direct taxes are worse in this respect than indirect ones (Acosta-Ormaechea and Yoo 2012).

In assessing the impact of the welfare state on economic growth we should, therefore, consider the differences in the tax structure. In looking at this issue from the point of view of political economy, one would perhaps prefer to have a worse tax structure on the assumption that increasing direct taxes generates more taxpayer resistance than relying on indirect taxes. However, we are not able to assess this difference empirically. Besides, even if it were politically more difficult to increase direct taxes than indirect ones, the pressure for increased spending could overwhelm taxpayers’ resistance. In other words, the strategy to “starve the beast” may not be effective (Niskanen 2006). It appears again that there is no good substitute for civic efforts aimed at the source of the problem—namely, the pressure to increase social spending.

The Diversity of Welfare States

Let us now use our three dimensions of the welfare state—size, design, and the mode of financing—to show how diverse welfare states are in the world. True, many, if not most of them, suffer from serious problems, but the mix of welfare states and their intensity differ across countries. Therefore, the combinations of required solutions differ, too. Let us start with the size of the welfare state.

Differences in Size

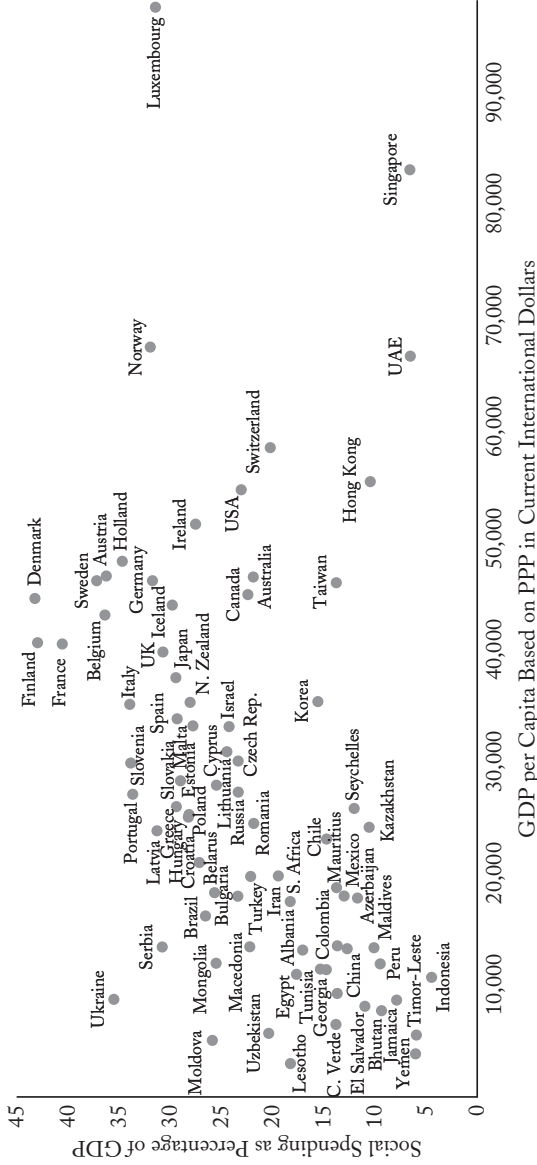
As one can see from Figure 1, there is a huge variation in the ratio of social spending to GDP at all levels of GDP per capita. There is a weak positive correlation between these two variables, which gets stronger when we eliminate the outliers. But it is the outliers that are very interesting. The size of the welfare state among the richer countries (those with per capita GDP of Intl\$40,000 or more, based on purchasing power parity in current international dollars) ranges from 7 to 16 percent of GDP in Singapore, Taiwan, Korea, and Hong Kong, and from 40 to 45 percent in Denmark and France. Sweden spends less than these outliers thanks to reforms introduced in the 1990s.

It may come as a surprise that the United States spends more than Canada, Australia, Switzerland, and Russia and only slightly less than Israel and the Czech Republic. All these countries constitute a group of moderate spenders, but only in relative terms. Therefore, one cannot strongly object to Arthur Brooks's (2012) statement that "America is already Europe," especially when one considers the extent of occupational licensing and the blocking power of the teachers' unions in the United States.

The range of social spending to GDP among poorer countries (up to Intl\$20,000) and middle-income economies (Intl\$20,000 to 40,000) is almost as wide as among richer countries. The highest spenders in the first group are Ukraine, Serbia, and Brazil, and the lowest are Indonesia, Peru, China, and Mexico. In the second group, Portugal and Slovenia are the highest spenders and Chile and Kazakhstan, the lowest (Figure 1).

The post-socialist countries in Europe inherited a large welfare state due to a PAYGO pension system and socialized health care, and most of them have a social spending to GDP ratio of 25 percent or more. This contrasts with China, which accelerated its growth since the late 1970s, while letting its social spending decline from more than 30 percent of

FIGURE 1
GDP PER CAPITA AND SOCIAL SPENDING, 2013–14



SOURCES: IMF *Government Finance Statistics*, OECD.SOCX, OECD.Stat, World Bank, Eurostat, Taiwan *Statistical Data Book 2015*, and IMF *World Economic Outlook*.

GDP to less than 15 percent. It was largely following the earlier Asian Tigers’ strategy of creating welfare through economic growth and the related job creation rather than through the expansion of social spending. The opposite strategy, as practiced in some Latin American countries (e.g., Brazil and Uruguay), does not have a good track record.

Differences in Design

Design or structure is a very important dimension of the welfare state, because large structural differences bring about large differences in outcomes. However, it is impossible to rank countries according to the quality of the design of their welfare states because there is no single synthetic index to adequately measure it. Nevertheless, there is a massive literature on the perverse incentives created by the various combinations of social welfare benefits, taxes, and “social” regulations on which one can draw. For example, countries differ in the “participation tax,” which shows the fraction of any additional earnings that is “taxed away” by the combined effects of higher taxes and reduced benefits when one takes a job (Figure 2).

FIGURE 2
PARTICIPATION TAX RATES AS PERCENTAGE OF GROSS EARNINGS, 2014



NOTE: Participation in work at 100 percent of average wage from inactivity, one earner couple with two children.

SOURCE: *OECD.Stat.*

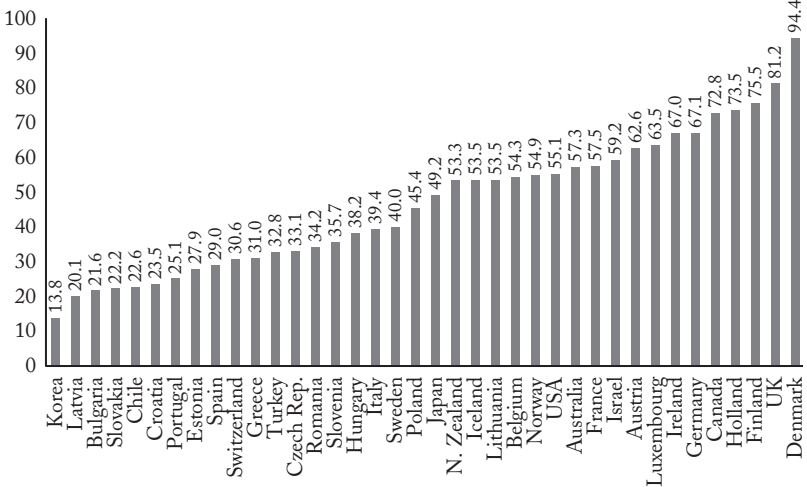
There are also huge differences in the marginal effective tax rate, which shows the fraction of any additional earnings that is “taxed away” by the combined effect of higher taxes and reduced entitlements when an individual increases the number of working hours (Figure 3).

Finally, the implicit tax on continued work for the pensioners ranges from less than zero in Poland, Iceland, and Denmark to more than 70 percent in Luxembourg and Slovenia, and more than 90 percent in Greece (OECD.Stat data).

The leftist anti-capitalists tend to deplore what they call “social exclusion,” and to blame it on free markets. In reality, blame should go to the perverse features of the welfare state, which condemn some people to inactivity and thus undermine their family life. High marginal taxes on taking on a job or on working more or longer are just one example of this category (Tanner and Hughes 2015).

Another “social trap” is created by high reservation wages resulting from excessive minimum wages or excessive levels of social

FIGURE 3
MARGINAL EFFECTIVE TAX RATES FROM
PART-TIME TO FULL-TIME WORK AS A
PERCENTAGE OF GROSS EARNINGS, 2014



NOTE: Part-time to full-time work from 50–100 percent of average wage; one earner couple with two children.

SOURCE: *OECD.Stat*.

benefits. Those instruments of the welfare state are especially destructive when combined with poor public education that prevents certain groups from permanently moving out of poverty. Moreover, if these groups happen to be minorities, extreme tension is likely to appear.

Finally, there are big differences in the tax structures among welfare states. Some countries rely more on direct taxes than on indirect ones, especially Denmark, Norway, Finland, Belgium, Switzerland, the United States, and Canada. Others, like Sweden, Greece, and the post-socialist countries, collect more indirect than direct taxes. Most of the big spenders (except Sweden) and moderate ones among the richer countries have a worse tax structure than the post-socialist economies.

A particularly bad situation exists in those countries that have big PAYGO pension systems financed by high payroll taxes (e.g., Belgium, Austria, Italy, and Greece). They combine a big welfare state with taxes that are particularly detrimental to legal employment.

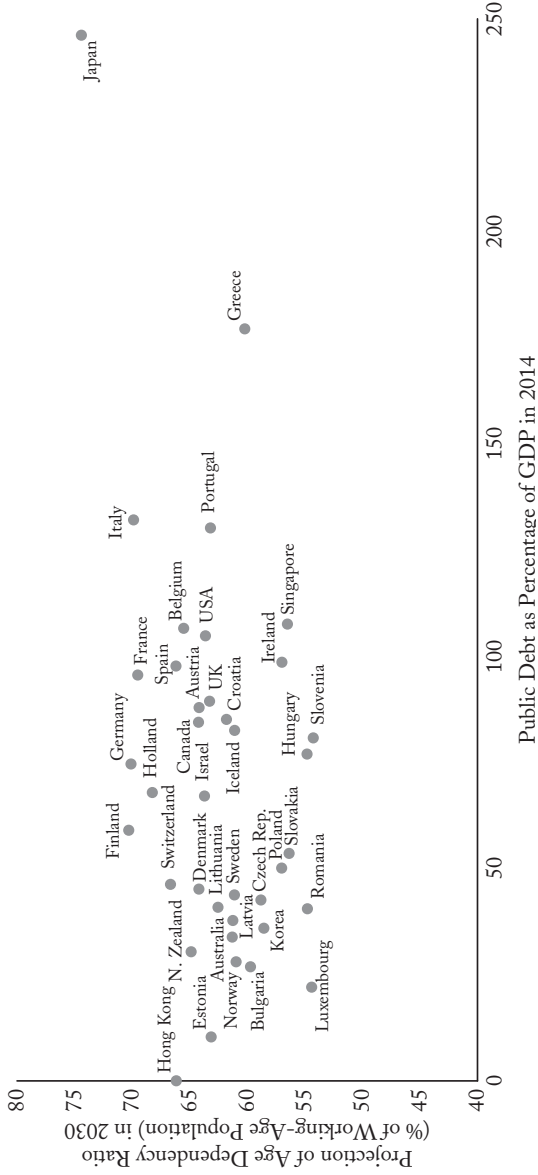
Different Challenges Faced by Different Welfare States

A small minority of countries have managed to keep a relatively limited welfare state (see Figure 1). The challenge for them is to prevent their limited welfare states from expanding. The growing problems of large (and often badly structured) welfare states should perhaps make it easier to be successful in that task. One also would hope that there would be less propaganda focusing on the “European social model.”

However, most countries in the developed world and many poorer economies face the problem of how to contain an already large welfare state and, if possible, to reverse its growth. The situation in this group differs depending on their debt to GDP ratio and on the pace of aging of their populations (Figures 4 and 5). One also would like to know the outlook for long-run economic growth, but it is very difficult to ascertain because it depends on policy choices and thus on politics, which are difficult to predict.

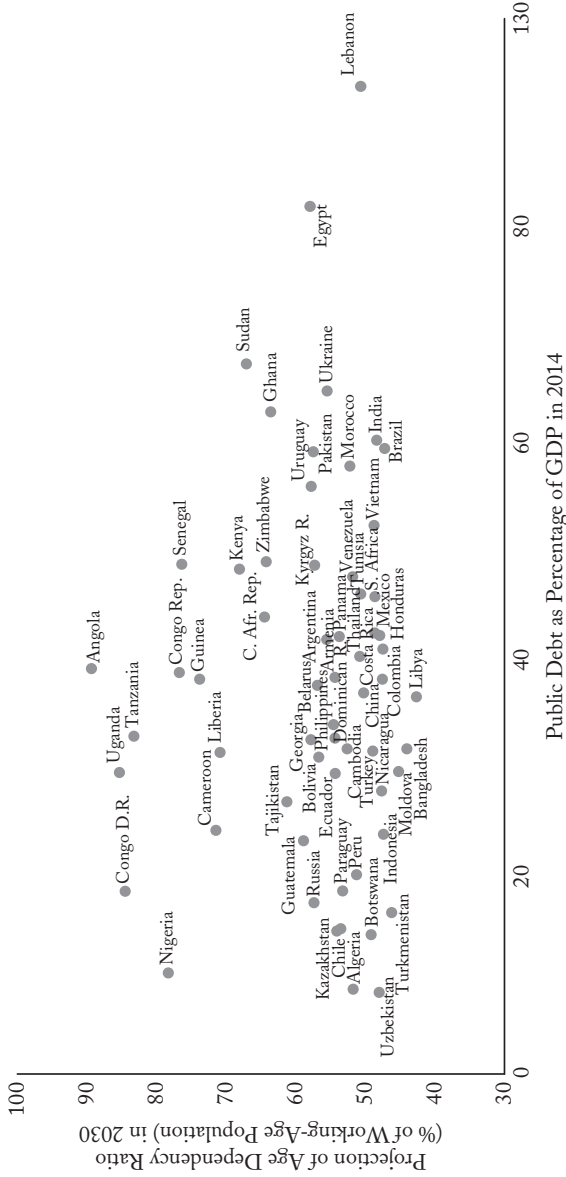
As one can see, the worse combinations of public debt and aging characterize Japan and Greece, followed by Italy and Portugal. On the opposite side we have Hong Kong (no public debt), Israel (good demography, moderate public debt) followed by Australia, Denmark, Switzerland, Korea (moderate aging, moderate public debt). It is striking that the Scandinavian countries appear to be in a

FIGURE 4
 PUBLIC DEBT AND THE PROJECTION OF AGE DEPENDENCY
 RATIO IN DEVELOPED AND CENTRAL EASTERN
 EUROPEAN COUNTRIES



SOURCES: IMF World Economic Outlook and World Bank World Development Indicators.

FIGURE 5
PUBLIC DEBT AND THE PROJECTION OF AGE DEPENDENCY
RATIO IN LESS DEVELOPED COUNTRIES



SOURCES: IMF World Economic Outlook and World Bank World Development Indicators.

better situation than Italy, Spain, France, and Germany. In addition, other large countries (the United States and Britain) are facing fiscal pressures due to a relatively high public debt.

There is a large variation among the poorer countries, too. We should remember that a lower public debt to GDP ratio among them constitutes a similar debt burden as faced by richer countries with much higher ratios of public debt to GDP. We can then see that Egypt, Brazil, Pakistan, and Uruguay face a difficult fiscal situation.

Most poorer countries (but not China) will not be burdened in the near future by a growing old age dependency ratio. In contrast, especially in Africa, they will have a growing share of working-age younger population. And, in the absence of job-creating reforms, this would lead to growing political tensions.

The solutions to the various socioeconomic problems, including those of the overgrown welfare states, are at two levels: (1) the economic level, where one must identify the best mix of policies, and (2) at the political-economy level, where one must ensure that these policies are introduced and sustained. There is no shortage of well-developed and professionally credible proposals at the first level. For example, curbing the excessive pension spending would require reforming the inherited large PAYGO systems—moving to a defined contribution system and increasing the retirement age—and raising the share of the funded system (Feldstein 2005, Börsch-Supan 2012). Similarly, there are well-thought-out solutions for the health care sector (e.g., introducing HSAs) and for unemployment benefits (e.g., the privatization proposal offered by Feldstein 2005). There is also a large body of empirical literature showing how to deal with various “social traps” (see, e.g., OECD 2014 and 2016).

Clearly, and not surprisingly, the key issue is the political economy of reforming the welfare state. We now turn to that topic in our concluding remarks.

Conclusion: The Political Economy of Welfare Reform

Policies, including institutional reforms, are actions of politicians that result from the interplay of various factors. For example, wind-fall gains in various forms (oil bonanzas and sudden reductions in the interest rates) reduce politicians’ and the public’s incentives for fiscal consolidation and encourage the growth in public spending. In contrast, some crises may even force the nonreformers in power to

do what they blocked before. Differences in the personalities of ruling politicians also matter—for example, there would have been far fewer or no fundamental reforms in Britain if it was not for Prime Minister Thatcher. There are complex interactions between situational variables, personality factors, and interest groups (Balcerowicz 2015). In the following, we will focus on the last factor.

Interest groups can be divided into statist and anti-statist. The former are driven by ideological or pecuniary motivations and aim at keeping an expanded state or even increasing the scope of interventionism. The latter, on the other hand, aim at reducing the scope of the state and are motivated by their beliefs in the value of individual freedom, the rule of law, and limited government. One of the reasons statist groups often prevail may be the simple fact that they include groups that are motivated by the prospects of pecuniary benefits (e.g., budgetary subsidies, tax preferences, and anti-competitive regulations) from expanding the size and scope of government.

However, statism does not need to prevail: much depends on the activity of the anti-statist groups and individuals. Let us, therefore, finish with some remarks on how these forces can better oppose the welfare state and press for reform. Here are some suggestions:

- Show that shrinking and restricting the welfare state leads to a better welfare system (a greater role of voluntary organizations and markets). Instead of just fighting the welfare state, libertarians and other anti-statists should fight for a better welfare system in the broad sense as discussed in this article.
- Unmask the logical deficiencies of key concepts used by the welfare statist groups such as “social rights” and “social justice” (de Jasay 2007).
- Focus on the main deficiencies of actual welfare states and not on “the welfare state” as such. Show how an overgrown and unreformed PAYGO pension system penalizes the younger generations. Show how bad public education and various social traps create the “socially excluded” groups. Show that a huge gap exists between the rhetoric of the welfare states and the results of their policies.³ Take away the “high moral ground” that the welfare statist groups claim to occupy.

³See, e.g., Goulard (2014) on the French welfare state: “The government’s priority is to defend those who are already best protected.”

- Expose the mainstream fallacy that the present welfare state results from various “market failures.” No market failure can explain the growth of the welfare state. Moreover, there are private market alternatives to a growing welfare state that are crowded out by that growth.
- Focus on the doctrines and resulting policies that obstruct reforms of the welfare state. One obstruction is the inequality debate, which confuses inequality of opportunity with that of income, and confuses fighting poverty with fighting inequality. A further impediment to reform is the revival of crude Keynesianism in the guise of an anti-austerity doctrine. Finally, unconventional monetary policy, by fueling asset bubbles, has contributed to the inequality of wealth, thus strengthening the political pressures for increased redistribution.
- Present and unmask policies that favor the rich such as restrictive zoning, crony capitalism, and insufficient competition. Demand the elimination of these privileges in the name of libertarian egalitarianism.

These are just a few examples of how to make the anti-statist case for a better welfare system more effective.

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