Introduction

The Welfare State has in recent years been rediscovered by economists. When I first began work on the economics of social security in the 1960s, the subject scarcely appeared in the economics literature. The study of poverty was regarded as a matter for social administration, social policy or other disciplines. Even with the War on Poverty and the negative income tax experiments in the United States, the subject still tended to remain outside the mainstream of economics.

The situation has altered dramatically. The economics of the Welfare State is now centre stage, entering debates about the macro-economy and about the wealth of nations. Reform of the Welfare State is seen as one of the key policy issues of the 1990s. In OECD countries there have been calls for cuts in social security spending in order to solve the fiscal problems of national governments. In the European Union, social protection is being reviewed with regard to its impact on international competitiveness. In the world at large, the World Bank is calling for rethinking of the role of pensions under the title of ‘Averting the Old Age Crisis’ (World Bank, 1994).

The present collection of essays may be seen as contributing to an active policy debate on the future of the Welfare State, with particular reference to social security. There are, however, two important differences from much of the recent economic writing. First, I believe that the role of the Welfare State can only be assessed in relation to the objectives which it is intended to accomplish. Too often when reading critiques one gets the impression that social security performs no useful function. Yet the programmes were introduced to meet certain goals, and one has to ask how far these goals could be achieved if the programme were cut or eliminated. Moreover, there is a tendency for the function of social security to be equated with the relief of poverty, whereas this is only one of several objectives of programmes such as retirement pensions, child benefit or unemployment insurance. The Welfare State is designed to provide a sense of security to all, not just to focus on those below the poverty line.
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The second important difference from much of the recent writing is that I do not start from the position that the Welfare State must necessarily have a negative impact on the working of the economy. If one reads what economists write about social security, one learns that unemployment insurance has caused a rise in the ‘natural’ rate of unemployment, that payment of disability benefits has caused people to leave the labour force early, and that pay-as-you-go state pensions have lowered the rate of capital accumulation. This focus on the disincentive effects in turn has led to calls to scale back spending. However, as is increasingly being recognised in economic theory, we are not starting from a first-best position, from which any government intervention must cause a distortion. In a world of uncertainty and imperfect information, income transfers can have a positive influence. Income maintenance not only alleviates poverty, but also provides a sense of security, thus contributing to efficiency objectives. People are more willing to take risks, to retrain or change jobs, in a society where there is adequate social protection. Historically, social insurance grew up alongside the modern employment relationship, providing a guarantee against catastrophic loss of income through unemployment, sickness or accident. This was a positive inducement for workers to enter the formal market economy, just as retirement pensions may form part of an active labour market policy. There are positive, as well as negative, effects on economic efficiency and growth.

The existence of positive functions for the Welfare State does not mean that it is not in need of reform. Indeed, I have been proposing reforms of social security in the United Kingdom for more than a quarter of a century. The persistence of poverty even at times of relatively full employment was evidence of shortcomings in the post-war Welfare State and of the need for change to meet changing social and economic circumstances. Challenges have come from demographic developments, from new patterns of family formation and dissolution, from the increased participation of women in the labour force, and from the new economic climate. The essays in part III deal with various aspects of reforming social security. They treat, among other issues, the fashionable solution of increased targeting and the European dimensions of social security; and they introduce new ideas for reform in Britain, such as a Participation Income and the Minimum Pension Guarantee, both designed to move in the opposite direction from the current policy of reliance on means-tested benefits.

Such proposals for reform are based on analysis of the existing Welfare State in part II. This analysis does not consider all aspects of spending, concentrating on social security transfers and within this field giving particular attention to retirement pensions and unemployment benefits. The essays stress the need to look at the fine structure of transfer
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programmes. I do not believe that the Welfare State can simply be analysed as an aggregate. Different programmes have different objectives and different effects. The term ‘Welfare State’ is indeed understood in different ways in different countries.

The essays in this book are largely concerned with the impact of the Welfare State on the incomes and living standards of individuals and their families. Two ways of reducing the proportion of GNP spent on social security may have quite different implications at the individual level. The wider availability of evidence from sample surveys has allowed these effects to be analysed, and the results are used in a number of chapters. This perspective also means that the role of the Welfare State has to be seen in the wider context of the distribution of resources. Since 1979 we have witnessed a rise in income inequality in the United Kingdom, the United States and certain other countries – although not in all European countries. Part I of this book describes the background of income inequality and poverty, against which the calls for a reduction in the Welfare State have to be assessed.

The essays do not form a continuous narrative. At the same time, they are linked closely together by the themes outlined above. In what follows, I provide a brief introduction to each of the three parts – the distributional background (part I), analysis of the current Welfare State (part II) and future policy (part III). It also has to be borne in mind that the chapters were written at different dates between 1989 and 1994, and that the factual information has not been updated.

I Income inequality and poverty in Britain and Europe

The subject of the first part of the book is the distribution of income and poverty in the United Kingdom and in Europe. It is concerned with the problems – conceptual and empirical – of measuring the extent of inequality, and with inquiry into what lies behind the observations.

Chapter 1 is entitled ‘What is happening to the distribution of income in the UK?’. It was widely believed for a long time in the post-war period that income differences were gradually declining in advanced economies. In terms of the popular Kuznets curve, we were in the second phase of the \( \gamma \)-shaped relation between inequality and national income. Chapter 1 shows that in the UK this ceased to be the case towards the end of the 1970s. Measured income inequality increased substantially during the 1980s.

Decomposition of the observed changes in income inequality in the UK suggests that several factors were in operation. Between the mid 1970s and the mid 1980s there was a discrete reduction in the proportion of families with income from work, resulting from unemployment, disability and
sickness, from earlier retirement, and from non-participation in the labour force. This was combined with rising dispersion in the distribution of earnings, which continued steadily over the 1980s. After the mid 1980s, there was also a significant decline in the relative incomes of those not in work, associated with the fall in state benefit levels relative to average earnings. Those dependent on state benefits began to fall behind.

Some of these factors leading to increased inequality may be expected to apply to all advanced countries, such as the widening gap between low-paid and high-paid workers. Other factors, such as the policy towards benefit levels, are likely to differ from country to country. It is therefore interesting to ask how far the experience of the UK is the same as that in other European countries. Chapter 2 examines the evidence about income inequality in 15 European countries (and the United States, as a point of reference), drawing on evidence from the Luxembourg Income Study and national sources, and written jointly with Lee Rainwater and Tim Smeeding. The first purpose is to establish what is known about the relative levels of inequality in the different countries. Such an exercise faces a number of problems, and the first section warns readers that they are about to enter a statistical minefield. In contrast to some earlier international comparisons, a clear pattern emerges, with distinctly lower income inequality in Scandinavia and Northern Europe, and a higher level in Southern Europe and Ireland, which are closer to the United States in this regard. The Gini coefficient, for instance, ranges from around 20 per cent in Scandinavia to 30 per cent or more in Italy, Switzerland and Ireland.

The rise in inequality in the UK -- some 8 percentage points in a decade -- is large in relation to these international differences. Moreover, it stands out in comparison with the trends in other countries. While there are a number of countries in which inequality appears to have increased during the 1980s, after a period of falling inequality, the changes are typically smaller in size. In some countries there is no marked trend, and in others the downward trend continued.

As the general level of incomes has risen, those at the bottom have tended to fall behind. This has led to concern about poverty in the European Union, measured concretely by the European Commission in terms of a poverty line set at half of each member country’s average income. Chapter 3 describes the progress which has been made in improving knowledge about low incomes in the European Union and the problems in making substantive progress in reducing poverty. The chapter was written in 1989. Since then the situation has improved in terms of knowledge, particularly on account of the work at Erasmus University, led by Aldi Hagenaars, whose early death in 1993 was such a great loss. The substantial situation in terms of the extent of poverty has not, however, shown a great improve-
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ment. According to the most recent estimates of the European Commission, in 1988 16 per cent of the population of the twelve member states were living below the poverty standard (European Commission, 1993a, p. 100).

The measurement of poverty raises many conceptual problems. Even an apparently clearcut standard like 50 per cent of average income is susceptible of different interpretations. These aspects are examined both in chapter 3 and in Chapter 4, which is concerned with the approaches adopted in the measurement of poverty in a range of OECD countries. The measurement of poverty is not purely a technical matter, and the choice of definition depends on social judgements. An obvious example is the selection of equivalence scale used to compare the needs of different sizes of households. This affects not only the magnitude but also the composition of the low-income population. Poverty among children may appear to be a priority with one scale, but the elderly to have higher priority with another. The role of these and other differences is illustrated in chapter 4 by case studies of France, West Germany and the UK.

In order to understand more fully the causes of poverty and of rising income inequality, we need to look behind the overall distribution. Chapter 5 takes one particular group in the UK – the early retired. In examining distributional issues, it is often convenient to consider sub-groups defined by their employment status, or other characteristics, and I have referred to the decline in the relative income of those not in work. However, within these sub-groups there may be very sizeable inequality. In the case of the elderly we have seen increasing polarisation, or what Titmuss (1955) called ‘two nations in old age’. In chapter 5, Holly Sutherland and I ask whether the same is true of the early retired, a question prompted by the sharp rise in the proportion of men aged 55–64 who are economically inactive. While any classification is to some extent arbitrary, we find that there are three identifiable groups within the early retired: those retiring with a substantial portion of their income from occupational pensions, those deriving their income largely from health-related benefits, and those dependent on Income Support. A corollary is that there is one group (occupational pensioners) where there is some relation between retirement income and past earnings, and two groups whose living standard is largely influenced by flat-rate benefit levels.

The discussion of social security in chapter 5, and earlier in chapter 1, may be seen as a bridge to the review of the existing Welfare State in part II.

II Analysis of the Welfare State

The essays in this part of the volume seek to provide an economic and institutional analysis. Both elements seem important. One can only
examine the economic impact of transfer programmes within a fully specified economic model. Such models provide a framework for thought and point to relationships which may not otherwise be apparent. It is not, for instance, widely known that it is theoretically possible that a cut in unemployment insurance benefits may reduce total employment (chapter 10), or that a switch from state to private pensions may reduce the rate of capital formation (chapter 6). At the same time, social security programmes do not arise in a vacuum. We need to look at their historical origins, examining how methods of dealing with poverty in pre-industrial societies broke down with the advent of the modern employment relationship (chapter 11). We have to consider the political economy of benefit determination (chapters 7 and 9). My aim in these essays is to illustrate these points with regard to certain features of the social security system.

Much of the recent economic evaluation of the Welfare State has reached negative conclusions, arguing that it needs to be reconsidered and -- in some views -- dismantled. Chapter 6 examines the indictment of the Welfare State and the specific charge that it is a barrier to economic growth. The purpose is not to reach a definite conclusion, but to clarify the precise nature of the case made by the opponents of the Welfare State. Such a clarification seems necessary since the argument is often not made transparent. Concentrating on the long-run potential growth rate, rather than on the failure of the economy to reach its potential, I consider the impact of transfers as illuminated by the recent studies of economic growth, with especial reference to retirement pensions and the financing of education. In part the analysis makes use of standard growth theory, showing how the substitution of a private for state pension may affect the rate of savings. In part it is necessary to extend the model, for instance by introducing an explicit investment function and examining the operation of the capital market. In such a richer model, the switch from state to private pensions may negatively affect the rate of capital formation, reversing the conclusion which is conventionally drawn.

Recent critiques of the Welfare State do indeed provide a good illustration of the role of rhetoric in public debate. The ambiguities in such discourse are the subject of Chapter 7, which traces the evolution of thinking about a national minimum in Britain and its relation to the determination of benefit levels. This is of particular interest in view of the distributional significance of benefit levels identified in chapters 1 and 5. How is the level of benefit determined? Is it the government’s view of the desirable national minimum? Or is it a compromise between this objective and the desire to control public spending? Beveridge gave the impression that these two could be reconciled, but the position remains ambiguous. If, as in the United States, the UK government were to adopt an official
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poverty line, then this would make apparent the gap between promise and performance.

The impact of the Welfare State depends a great deal on its institutional fine structure. Chapter 8 is the first of four dealing with retirement pensions (chapters 8 and 11) and unemployment benefits (chapters 9, 10 and 11). The chapter provides a thumbnail sketch of the evolution of state pensions in Britain, and is particularly concerned to set them in a European context. By international standards, the rate of replacement offered by the state pensions system, flat-rate plus the state earnings-related pension, is not generous, and it will become even less so if the present policy is continued of allowing benefit levels to fall relative to average earnings. Nor does Income Support guarantee an adequate safety net. For these reasons, consideration needs to be given to reform – see chapters 14–16.

Income maintenance for the unemployed in the UK has been put severely to the test since the late 1970s. As is shown in Chapter 9, the reaction of the government to mass unemployment has been to make unemployment benefits less extensive and less generous. Why has this been so? I examine some of the answers which may be given to this question, drawing on the theory of public choice. The account in chapter 9 gives prominence to the interests and concerns of voters but recognises that these may be influenced by the ideological views of politicians and by the goals of civil servants. The relative contribution of these different explanations is relevant to those, such as myself, making the case for reform. Are they arguing against the expressed wishes of the democratic majority? Is it possible that people vote for a harsh political platform but would prefer not to be offered this choice?

The need to investigate the fine structure of the benefit system is exemplified by the frequent references in the economics literature to unemployment benefit as ‘the wage when not working’. As is shown in Chapter 10, the institutional features of unemployment insurance are essential to understanding its economic impact. Contrary to what is typically assumed in economic models of the labour market, receipt of unemployment insurance depends on the past employment record: people may be ineligible where they have been dismissed for industrial misconduct, and benefit may be terminated where an unemployed person refuses a job offer or fails to search for new employment. This casts serious doubt on the standard job search model, since the unemployed cannot with impunity reject job offers which fall short of their reservation wage. It casts doubt on the efficiency wage model where workers dismissed for ‘shirking’ are assumed to receive benefit. In chapter 10, I describe a model which takes account of these institutional features and which demonstrates that unemployment insurance can play a rather different role from that usually assumed. The model is one of a ‘dual’ labour market, with a primary sector
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typified by large-scale industrial enterprises), in which employers pay an efficiency wage premium but job separations occur continually, and a less-favoured secondary sector. Unemployment insurance is complementary to employment in the primary sector of the economy. Seen in this way, cutbacks in unemployment insurance, as with the 1994 Jobseeker’s Allowance, makes primary-sector employment less attractive, encouraging a shift from ‘good jobs’ to ‘bad jobs’.

The relation between social insurance and the labour market is the subject of Chapter 11. Continuing the theme of chapter 10, I argue that the development of social insurance is best understood in terms not of failure of the insurance market but of the operation of the labour market. State retirement pensions and unemployment insurance arose with a particular form of labour market, and their role may be expected to evolve as that labour market situation changes. Put another way, the risks against which social insurance provides protection are themselves social constructions. In order to understand the role of state benefits, and of parallel private provision, which exists for pensions but not typically for unemployment, a richer model of the labour market is necessary, and a sketch of such a model is given in chapter 11. The model goes beyond the dual labour market structure of chapter 10, allowing for both permanent and contract workers in the primary sector. Incorporation of such features of the labour market is necessary to understand the past formation of social insurance and to assess the implications of proposals for reform.

III Targeting and the future of social policy

In the lexicon of the debate about reform of the Welfare State, two of the most popular concepts are those of ‘targeting’ and ‘social safety net’. The essays in part III may be seen as an attempt to sharpen the way in which these terms are used.

Targeting is an attractive idea. Many people have seen it as the solution to achieving greater effectiveness while reducing total spending, replacing expensive ‘universal’ programmes with cheaper ‘targeted’ benefits. Chapter 12 seeks first to set out the theoretical argument implicit in many of the calls for greater targeting, and to show how the assessment of relative efficiency depends on the formulation of social objectives. Here it is necessary to remember, as noted at the outset, that the alleviation of poverty is only one of the objectives of the Welfare State. Even if, as in chapter 12, attention is focused on the poverty objective, the attractiveness of targeting depends on how precisely it is formulated – we have the same problems as with the measurement of poverty discussed in chapters 3 and 4. The second main point of chapter 12 is that the choice of benefits is considerably richer than is
suggested by a simple opposition of uniform and income-tested transfers, a point which is illustrated specifically by reference to family benefits. In principle family benefits can be differentiated in many ways, which may be combined with income relation; income testing itself may take different forms. A review of European countries, Australia and Canada indicates that a wide variety of types of family benefit have been implemented in practice.

Thirdly, the design of effective targeting faces the problems of imperfect information and of work incentives. These arise with both income testing and categorical conditions, but there are some reasons to suppose that they are more serious in the former case. Translating a scheme into practice in the face of imperfect information on the part of both administrators and potential recipients is particularly demanding for transfers that require evidence of current income. Experience indicates that there is a major problem of securing adequate take-up of income-tested benefits. Concerns about work incentives, whether based on empirical findings or notions of desert, may limit the acceptable degree of income targeting.

The role of the social safety net has come to the fore in a number of contexts. Chapter 13 was given in 1992 as a lecture in Moscow (in the same hall where Yuri Gagarin held a press conference on returning from his first flight in space). Much had been written, and continues to be written, about the need for a social safety net to protect the poorest against the costs of economic transition. Much less is written about the form of such a safety net, and about whether it is indeed practicable. The aim of this chapter is to see what can be learnt from the experience of Europe and the United States. What is the meaning of safety net? How successful have Western nets proved to be in practice? It is argued that a safety net is not easy to design and typically has only limited effectiveness. The choice of policy at the macro-level should not place too much weight on the safety net.

Issues of the design of the safety net at a European level are the subject of Chapter 14. This is essential if we are to take seriously the social dimension of the European Union. At what level of government such a safety net is to be provided depends on the interpretation of ‘subsidiarity’, and this is the first topic addressed. It is argued that, whatever machinery is used to achieve social protection, the objectives of the proposed action are to be determined at a European level. There is moreover the question as to how far individual national governments are able to provide effective social protection in the face of pressure from fiscal competition. It is suggested that potentially the most worrying of such arguments are those arising from political pressure – a political economy, rather than a migratory, constraint on national policy.

A social safety net at the level of the European Union raises many
questions, particularly about its form and scope. The problems with means testing would apply to a pan-European scheme, and the UK experience is in this respect instructive. It is therefore highly regrettable that the British government is not currently taking part in the formation of the social dimension of Europe post-1992. I refer in chapter 14 to ‘exit’ and ‘voice’ as possible reactions. The British government has chosen the former, but I believe that it would be much more valuable at this stage to be exercising voice.

The final two chapters consider the future of social security in the UK, seen within a European context. Chapter 15 was given as a lecture on the fiftieth anniversary of the publication of the Beveridge Report. It asks how we should seek to provide a national minimum – and, more broadly, a European minimum – in the years to come. It argues that Beveridge was right to reject means testing, and that the objections are strengthened when we take account of the new circumstances. The means test only make sense when applied to the family or household as the unit, but this runs counter to the major change in social attitudes towards independence, as evidenced by the separate taxation of husbands and wives. Turning to the European context, and looking ahead to the ways in which European policy may be aligned, I believe that the complexity of means-tested benefits makes them unsuitable for this purpose.

The proposals examined in chapter 15 are to replace the present emphasis on means testing with a modernised social insurance scheme and a new version of a basic income. While basic income is usually seen as an alternative to social insurance, in my view it is more productive to see them as complementary, with the function of basic income being to reduce dependence on means-tested social assistance. Moreover, it is proposed that the basic income should be subject to a condition of participation, not limited to paid work but with a wider definition of social contribution.

Chapter 15 is primarily concerned with those of working age; Chapter 16 examines state retirement pensions. It argues that the present pension provisions in Britain cannot guarantee an adequate minimum standard of income in old age, and that, unless there is a change in policy, particularly with regard to state pensions, then the problem of poverty in old age is likely to remain with us. What then can be done? The simple answer is an increased basic National Insurance pension linked to net average earnings. Two objections are typically made. First, there is the cost; secondly, the second tier of pensions has evolved, and what people are seeking is different, including an understandable desire for greater individual choice. I do not myself find these objections overwhelming, but I sense that I am in a minority. It may therefore be helpful to identify an intermediate route, and this is described in the form of a Minimum Pension Guarantee. In its most