Uncertainty under the Welfare State by Assar Lindbeck

Comments by Denis Kessler*

Professor Lindbeck's lecture is an important contribution for a better understanding of the future developments of both social insurance schemes and private insurance markets.

For the last 40 years, in all industrialized countries, social or public insurance schemes were considered as "the" solution, the best if not the only solution to cope with all the risks individuals face throughout their lifetime. Sickness, invalidity, unemployment, old age, widowhood... all those situations were calling for public intervention.

The common belief was that markets were unable to provide adequate protection to the consumers. Market failures were presented as unavoidable. The supply of protection through private insurance markets would not, it was argued, meet the demand due to informational problems leading to adverse selection and moral hazard. Furthermore, protection was considered a pure merit good, and this is why social insurances became mandatory (see Kessler, 1989).

There has been up to today a very large consensus to support an increased role of the so-called Welfare State. In this respect, Professor Lindbeck reminds us that the functioning of democracies leads to the permanent enlargement of social insurance schemes.

This consensus has come to an end. The state of bliss of mandatory social and public insurance schemes is over. These schemes are now under close scrutiny. They raise more and more questions. They appear to be less efficient than previously claimed. They appear to entail increasing private and collective costs.

In the meantime, private insurance arrangements, which were for a long time considered as a third or a fourth best, gain more and more support, except, maybe, in the United States. The private provision of security, of protection, through contractual arrangements, respecting the laws of the market, appears increasingly efficient. It is now more widely thought that it leads, under of course some obvious conditions, to an optimal allocation of risks both through space – between co-existing risk carriers – and through time – between successive cohorts of risk carriers.

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Indeed, it is rather extraordinary to see how the debate has gradually evolved from stressing the importance of market failures to defend collective arrangements to underlying the importance of social insurance failures to advocate market insurance coverage.

Let us now review social insurance failures. For the last 20 years a large number of studies have stressed the importance of the adverse effects of social insurance schemes. Unemployment insurance schemes partially fuel the number of unemployed, and lengthen the duration of unemployment. Pay-as-you-go social security schemes depress savings, and slow down capital accumulation. Health insurance schemes increase the cost of sickness, and so on. Of course most of the effects of income transfer schemes are still debated, and one must be cautious when addressing them. Nevertheless they cannot be ignored.

Professor Lindbeck's contribution deals with two usually ignored aspects of uncertainty of the Welfare State itself. The basic argument of Professor Lindbeck appears as a paradox: social insurance schemes are supposed to absorb risks, but by doing so, they generate specific risks.

First, Welfare State policies, if they actually reduce risks, also tend to create new and specific risks. They are what Professor Lindbeck calls "policy induced risks". His argument is straightforward. Rules governing the various social insurance schemes are subject to permanent changes. Those rules, i.e. benefits schedules, tax or contributions rates, entitlement requirements . . . , are indeed the result of the usual moveable political process. If these rules are variable, the future income stream of all consumers is uncertain. This argument is strong: it is obvious that social insurance schemes appear subject to permanent changes. These changes introduced by policy makers cannot be fully anticipated by consumers. Hence they disturb the planning of the allocation of time and goods through the entire life cycle.

Second, Welfare State arrangements change the character of market risk. This is what Professor Lindbeck calls "policy induced market risk". His argument is also straightforward: collective insurance schemes affect all economic behaviours: saving, labor supply, consumption, investment. They seem to exert perverse disincentive effects. They cannot avoid moral hazard problems. They influence macroeconomic developments and affect business cycles. On this last point, Professor Lindbeck gives a very relevant illustration: growing uncertainty about the viability of public pay-as-you-go pension schemes leads to an increase of the savings rate even if the income growth rate is low: this is a procyclical effect increasing unemployment.

We cannot but agree with Professor Lindbeck when he states that "*both theoretical considerations and practical experiences from various countries have convinced many observers . . . that the sum of all disincentive effects on work, saving and entrepreneurship are quite strong today in several advanced welfare states*".

The diagnosis made by Professor Lindbeck is very clear and alarming. What is the best therapy?

(1) It seems first that Welfare States should shrink, retreat . . . in order for them to be saved. It seems unavoidable, notably for international competitiveness reasons, but it seems also desirable, if industrialized countries are to resume their growth and reduce their unemployment rate. There is no doubt that social spending must be reduced. In many areas, public schemes are too generous. Social transfers should first and foremost be redirected to those in needs, to the poor. It is certainly by reallocating social transfers that it will be

possible to reduce them and in the meantime to preserve social justice. In this respect, let us recall the views recently expressed by D. Snower that “*we require policy rules that redirect Welfare State services back to the poor*”.

(2) New rules for social insurance schemes should be drafted, limiting costs and expenditures, reducing moral hazards. As a matter of fact, social insurance schemes should mimic, in that respect at least, private insurance schemes. Lots of devices – i. e. deductibles, options, rating, bonus-malus schemes . . . – reduce efficiently the moral hazard problem. These new rules, designed to limit the global cost of the Welfare State, should be implemented gradually so as to avoid political and public reactions. But they should be announced clearly and well in advance in order to enable the consumers to plan their lifecycle, so that successive generations know well ahead how they will be concerned by policy changes. One could imagine the drafting of social policies indexed by generation: rights and duties would be specific to each generation. This would avoid brutal changes entailing strong public resistance. This is the way to plan the *soft landing* of Welfare States and to avoid their very undesirable *crash landing*. In this regard, the idea of Professor Lindbeck of disconnecting the social security system from the yearly budget process is very interesting.

(3) Clear frontiers should be drafted between the various types of coverage: social schemes, professional schemes, individual coverage. Limits should be imposed on public and social schemes, incentives should be given to professional and individual coverage. Concerning old age income security schemes, the solution would be to distinguish clearly the four pillars. Public mandatory schemes should be the only schemes to operate on the pay-as-you-go basis. Governments should take measures (on the age of retirement, on benefit levels . . .) to limit strictly the size of the first pillar, in percentage of GDP for instance. First pillar schemes should give flat rate benefits. The second pillar would be constituted by professional pension schemes, fully funded, where benefits would be directly linked to previous contributions. The third pillar would consist of facultative individual coverage through appropriate life insurance contracts, benefitting of tax advantages. And finally the fourth pillar of retirement would lie in the possibility to work when aged, on a part time basis. Similar approaches should be followed in the field of unemployment and health (Cf. Diamond).

(4) Governments should incite consumers to protect themselves. Voluntary insurance against the various risks faced by consumers should be encouraged through appropriate tax advantages. Unfortunately, this has to be done at a time when governments experience heavy budget deficits. Clear and appropriate regulatory frameworks should be introduced so as to be sure that most of the classic market failures are removed: how can regulations be improved so as to be sure that market mechanisms function properly?

Professor Lindbeck's lecture is an important and valuable contribution to one of the most fundamental questions modern societies have to answer: the downsizing of the Welfare State, its reengineering, its redirection.

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