

The Crisis of the Welfare State

Robert Mundell

Reykjavik, Iceland
June 16, 2005

Conference on

**"Aging Baby Boomers, Pensions and Medical Benefits,
and
Consequences for Dynamism, Prosperity and Growth"**
sponsored by

Center on Capitalism and Society at Columbia University,
the Faculty of Economics and Business Administration
and the Institute of Economic Studies at the University of Iceland

Reykjavik, June 16-17, 2005

Edmund Phelps, Gylfi Magnússon, Tryggvæ Herbertson, Gylfi Zoega

The Crisis of the Welfare State

Part I. Population Growth and the Welfare State

Origins of the Welfare State
The Demand for Children
Health and Increased Longevity

PART II. The Crisis and its Solution

Higher Productivity Entitlements
Higher Retirement Ages Necessary
Privatizing Social Security
Towards a Household Responsibility System

The Origins of the Welfare State

- What is the welfare state? The term entered the English language in Britain, when an archbishop (Temple) coined the phrase to differentiate between the economic system in wartime Britain and the 'welfare' state of Nazi Germany. The name soon became associated with the Beveridge Report of 1942, which advocated state responsibility for individual welfare from the cradle to the grave.

The Rise of the Welfare State

- If the term "welfare state" originated in Britain, that country was not the first to conceive of or implement the concept. Socialism was an outgrowth of one of two strands of economic liberalism that was gradually elaborated in the 18th century.

The Scottish Enlightenment

- The first, developed in the Scottish enlightenment, and pragmatic-evolutionary in character, originates with Hutcheson, Hume, Smith and Burke; its *modus operandi* was to build, and improve on, a democratic free society on the foundation of existing institutions that had met the test of historical usefulness. It was evolutionary in character.
- The second was French and German socialism.

Benthamite Utilitarianism

- A curious compromise between these two ideas was Platonic or Benthamite utilitarianism, with its oxymoron slogan, "the greatest good for the greatest number."
- More generously, think of the impossibility slogan as a contraction of "the greatest good for a given number and the greatest number for a given good."

The Utilitarian Compromise

- Bentham and James Mill had convinced their friend David Ricardo that the utilitarian compromise was needed to provide a socially-attractive ideal for the emerging business class, scrapping the conservative attachment to the chimera of "natural right."

Meliorism

- In the hands of the philosophical radicals, utilitarianism came to mean progress through "meliorism," step-by-step marginal advances that would generally lead to improved working conditions for the masses.

Marx's Friend, Lasalle

- On the European continent, however, alternative brands of socialism developed under Saint-Simon, Fourier, and Marx. But it was Marx's friend, Ferdinand Lasalle who provided the inspiration for the particular brand of practical socialism that became known as Social Democracy, an idea that achieved its first major success in Bismarckian Germany.

Key Elements of the Welfare State

- Key elements of the welfare state include workman's compensation (or insurance for industrial accidents), sickness insurance, pensions, unemployment insurance, family allowances, health insurance and educational provisions.
- By these criteria, imperial Germany was in the forefront of welfare state developments, as the legislation landmarks in Table 12, documented by Flora and Heidenheimer (1981)^[1] clearly show.

Landmarks of the Welfare State

Year of Introduction of	Germany	U.K.	Sweden	France	Italy	USA	Canada
Soc. Insurance for:							
Industrial accidents	1884	1906	1901	1946	1898	1930	1930
Sickness Insurance	1883	1911	1910	1930	1943	-----	1971
Pensions	1889	1908	1913	1910	1919	1935	1927
Unemployment Insurance	1927	1911	1934	1967	1919	1935	1940
Family Allowances	1954	1945	1947	1932	1936	-----	1944
Health Insurance/Service	1880	1948	1962	1945	1945	-----	1972
General Personal Income Tax	1920	1918	1903	1960	1923	1913	n/a
Education							
Adult illiteracy < 20%	1850	1880	1880	n/a	n/a	1870	n/a
Sec. Sch. enrolment > 10%	1925	1923	1937	n/a	n/a	1915	n/a
Univ. enrolment first > 10%	1975	1973	1968	n/a	n/a	1946	n/a

Impact of the Welfare State on Key Economic Variables

- Given the advance in most western countries toward the welfare state, it is necessary to ascertain its impact on the working of the economy in general.
- An examination of the welfare state in relation to its effect on such variables as employment and hours of work involves both costs and benefits.
- The benefits are well known, the costs are more often hidden. The benefits are typically redistributive, being manifested in a reduction of poverty.

Revolution in Social Democracy

- More important than the level of the deficit, is the rise of overall government expenditure.
- This is probably the best single indicator of the Social Democracy Revolution in OECD countries over the past half century.
- Shares of Government Spending in GDP between 1963 and 1993 are depicted in the next Table.

The Social Democracy Revolution: Shares of Government Spending GDP, 1963-93

Country	1963	1993	Change
United States	27.5	34.4	6.9
Canada	24.7	48.7	24.0
Japan	13.6	26.3	12.7
W. Germany	30.4	46.6	16.2
France	33.5	51.2	17.7
Italy	26.8	51.6	24.8
United Kingdom	30.1	40.6	10.5
Australia	21.9	37.5	15.6
Austria	31.3	48.1	16.8
Belgium	28.3	55.8	27.5
Denmark	27.0	60.4	33.4
Finland	23.8	53.1	29.3
Greece	18.7	45.8	27.1
Ireland	25.0	41.0	16.0
Netherlands	29.8	56.2	26.4
New Zealand	23.7	37.5	13.8
Norway	29.3	54.1	24.8
Portugal	17.4	42.7	25.3
Spain	18.2	42.6	24.4

Spectacular Increases in Government Spending as a Proportion of GDP

- The striking feature of the table is the significant extent to which the share of GDP accounted for by government spending has increased in the three decades. The increases in the share of GDP accounted for by government spending ranged from a low of 6.9 per cent in the United States to a high of 40.3 per cent in Sweden.

The Crisis in Social Democracy

Before Social Security

- Traditional Society (Vertical-Dynastic) Three stages of man.
- Three-generation family.
- Child, Adult, Retiree

Division of Labor

- Child is dependent-learner
- Adult procreates, works and supports the aged
- Aged baby-sit the children.

The Role of the Family Farm

- The family farm or country house was an important link in the interchange of benefits within the multi-generation family.
- It is an asset that that the retirees pass on to their children in exchange for support during retirement.

Urbanization and Democracy

- **Industrial revolution leads to urbanization.**
- **Urbanization removes the family farm as a durable-asset ingredient of the inter-generational wealth exchange.**
- **The beginning of the end of the 3-generation family.**
- **Urbanization leads to universal-suffrage democracy**
- **Democracy creates the demand for redistribution of wealth from the rich to the poor**

Advent of Social Security etc.

- Social security and medical insurance lead to First increase in taxes.
- Progressive income taxes become the main vehicles for redistribution.
- First decline in stock markets.
- Social security reduces the demand for children as source of support for the aged.
- First decline of 'fertility.'

Social Security

- Social security and health benefits improve the health and increase longevity of the population.
- Increased longevity leads to increased cost of pensions.
- Second increase in taxes.
- Second decline in stock market.

Health and Fertility

- Improved health (paradoxically) increases the demand for earlier retirement and higher cost of pensions.
- Budget deficits and higher taxes lead to third increase in taxes.
- Increased taxes squeeze the working population.
- Second decline in 'fertility.'

Decline in Fertility Reduces Working Ages Population in Next Generation

- Social Security benefits established when 6-10 workers per pensioner.
- Rising Ratio of Pensioners to Workers.
- Current ratios close to 2 workers per pensioner.
- At least one country (Croatia) has fewer than one worker per pensioner.

Nature of the Crisis

- Limits reached to transfers from the rich and from the working population.
- Growth declines because of punitive taxes.
- Unemployment increases because of high labor costs, employment protection, etc., further eroding the tax base.
- Decline in fertility aggravates the crisis.
- Unfunded liabilities explode relative to tax base.
- Budget deficits, debts increase.

Model versus Real World

- Real world problem is worse...
- because of baby-boom phenomenon.
- Great depression + WWII caused dearth of births. (1930-1945)
- 2 postponements + natural rate lead to triple-whammy of 1945-1960 baby-boom.
 - depression dearth
 - WWII dearth
 - natural increase 1945-60

The Great Bulge

- BB Population bulge through maturity structure of population like a like a giant python digesting an elephant.

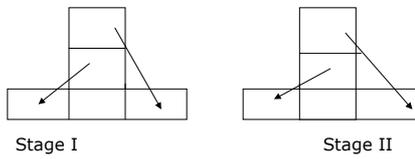
Social Security Partially Dismantled.

- Government cannot maintain its obligations. Unfunded liabilities threaten bankruptcy.
- Increased deficits and debt.
- Choice between capital levy and inflation.
- Attempt to sustain entitlements by taxes leads to emigration, reduction in productivity.
- Crisis leads to diminution in benefits.
- Steps toward privatization.

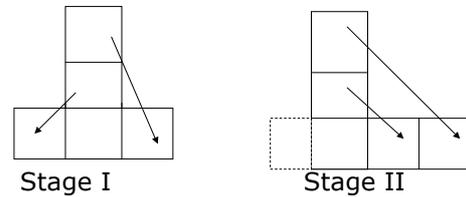
Crisis Stage

- As retirees increase and workers diminish (because of population slowdown), social security moves into crisis phase.
- Government reacts by subsidizing family formation and children.
- Tax burden on mature adults increase.

Steady State: Three Generation



Shock of Longevity and Health



There are no young people left to support the Old Generation



Need for Four-Generation Model with Increased Longevity

- Two Working Generations.
- Young worker—procreates, saves and invests and borrows (because she invests (e.g. in a house) more than she saves).
- Mature worker—saves and lends for retirement and bequest (if any).

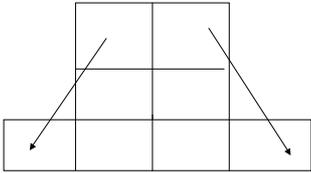
The Four-Generation Family

- Child—dependent
- Young adult—saves, invests and borrows
- Mature adult—saves, repays and lends
- Retiree—dependent

Government as Family Intermediary

- Young and mature adults pay taxes to the state to redistribute to retirees.
- As population of retirees increases due to greater longevity, tax burden on working generations increase.
- Young adults react by reducing family formation and child-rearing.

The Four Generation Solution: Longer Working Life



Takk fyrir