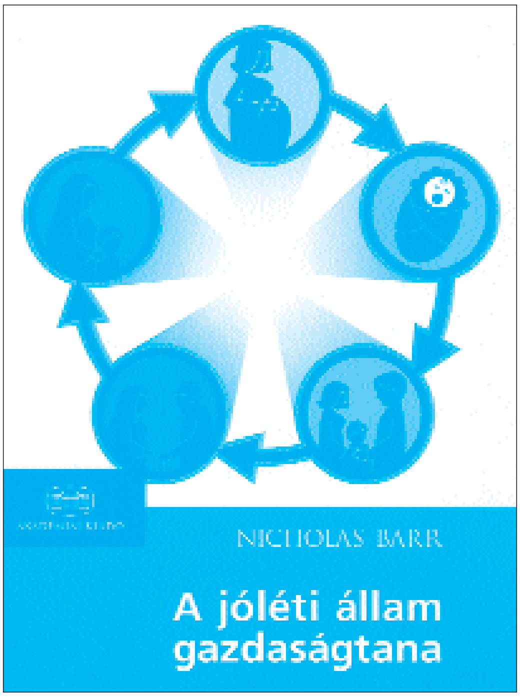
Nicholas Barr

The economics of the welfare state



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The author, British economist *Nicholas Barr* is a professor at the London School of Economics. Working for the World Bank between 1990 and 1992, Barr participated in developing plans for income transfers and for funding the healthcare system in Central and Eastern Europe and Russia. He also worked as a consultant for the British, Chinese and South African governments. *The Economics of the Welfare State* is one of his chief works, published in four editions since 1987. At the time of the regime change, the author spent considerable time in Hungary. In cooperation with British and Hungarian experts, between 1991 and 2001, he took part in developing the concept of student loans, among others.

A Hungarian translation of the book was published in 2009. Its topicality is undoubted, given that the functioning of the welfare state, the scope of the welfare state functions and the degree of their representation – which is the focus of the book – is currently also a practical, in addition to a theoretical issue for debate in Hungary. It provides important help to higher education because, by virtue of its structure, students at any level of higher education may benefit from it. It may come as valuable reading material on how the state works for experts of law, sociology and business. The volume is a textbook and a manual at the same time.

The book is primarily built on experience in the Anglo-Saxon economy, abundantly addressing the welfare states (the state activity aimed at welfare) of Great Britain and the United States of America. For the Hungarian edition, however, the author provided a foreword that briefly presents the development of the Hungarian welfare state and the social political background in Hungary. As a valuable supplement, the translator *András Vigvári* provides a summary of the characteristics of the Hungarian welfare state in the appendix, which addresses both theoretical and practical issues.

As a starting point, the author takes a clear stance in favour of the need for the role of the state even in the circumstances of market economy, as the existence of the welfare state is also supported by arguments of efficiency other than equity. The whole book is focused around three major issues: the problems of maximising social welfare (i.e. the question of efficiency), social justice, and, finally, the problems of measurement and definition.

The book is divided into three main sections.

■ *Part One* reviews the key notions and theoretical correspondences needed to understand the functioning of the welfare state. A crucial finding here is that, beyond establishing the fundamental conditions of security and providing frameworks to market conditions, the duty of the state is not more than help those that live all their lives in poverty. Under these circumstances, no welfare state would be needed at all. In practice, however, due to risks and uncertainty – deriving from imperfect information – the state plays a central role on a continuous basis. Under such circumstances, the duty of the state also includes insurance services (to provide coverage against risks) and smoothing consumption ("piggy bank function"), in addition to helping the underprivileged (the "Robin Hood function" of the welfare state).

The first few chapters of Part One present the historical development of the welfare states in the UK and the USA, while the next chapters address theoretical issues of the welfare state (interpretation of social justice and the economic theory of state intervention, as well as the theory of insurance against risks). Definition of the state's duty shows great variance in the various theories. For libertarians, the key aim is to ensure personal liberty. A suitable means of implementing it may be unlimited private markets. As opposed to that, Marxists consider equality as the main aim, and attribute a primary role to the state in attaining it. The third major ideology, liberal theory is not unified in terms of objectives, but is unified in considering private property not as an end in itself but only as a means to attain aims.

To conclude the first part of the book, the problems of definition and measurement of poverty and inequality are addressed. Examination of poverty has an extraordinary significance; still there is no uniform stance concerning who to consider poor. On drawing limits, one must determine what to regard as the unit of such analysis (individuals and households), what to use as the basis of defining poverty (exclusively considering income, or also other factors), and what period to use as reference. In terms of the concepts of poverty, the author calls attention to the differences of absolute and relative approaches; in the reviewer's opinion, full presentation of the topic would require additional presentation of subjective and social political concepts of poverty, because the value judgement of the population (expressed in subjective concepts) and the definition of the basis of awarding social benefits (the social political concept) are also significant approaches.

Further chapters of the book present application of the analyses to the various fields of the welfare state.

■ *Part Two* addresses cash benefits. The author lays down the conditions for efficiency of insurances against risk, which are needed for a given insurance to be provided by the private sector. Should these conditions not be met, the duty of providing such insurance is shifted from the private sector to the state. Such a case is insurance for the case of unemployment, among others. In this field, moral risk presents a great problem, inasmuch as the insured may influence the probability of their unemployment and re-employment. On analysing old-age pensions, distinction between the pay-as-you-go and the funding pension schemes is assigned key significance. Today, decreased employment and the more populous age group of pensioners represent serious problems, solution to which is seen by many in the exclusive adoption of the pay-as-you-go pension scheme. In his theoretical reasoning, Barr points out that “funding and PAYG are not substantially different in their ability to cope with demographic change” (page 318). It is because decreased employment leads to decreased total output, whatever the pension scheme is. “Only output produced but not consumed by workers is available for pensioners to consume” (page 316), irrespective of the pension amounts. If pensioners in the funding system had a higher amount of pension funded by their earlier savings compared to what they would get in a PAYG system from the contributions of the currently employed generation, they could consume more even in that case, because it would generate an inflation process. The critical value in solving this problem is output, meaning that the problem of decreasing workforce can be resolved inasmuch as the decrease in supply can be prevented (for example, through increasing productivity).

An important group of cash benefits constitute the means of moderating poverty, i.e. supports. After taking into account and evaluating the various forms of support, the author arrives at the conclusion that “the poverty trap in one form or another is largely inevitable” (page 369). What this means is that the implicit tax rates – i.e. how many units of benefits an individual loses by earning one unit of income from work – are so high that they represent a remarkable curb to work supply and reduce the propensity to work. This problem may be alleviated in terms of benefits by, according to Barr, “calculation for fixed periods” (page 362). In this way, the rise in income during the period of use does not mean immediate discontinuation of the benefit. The key conclusion in the part on cash benefits, beyond the foregoing, is that, on the one hand “the choice between private and public solutions is more of a technical than an ideological issue” (page 389).

■ *Part Three* addresses benefits in kind (the health care system, public education and higher education). Concerning these fields, the objectives of the policies are clarified first, and then the methods that ensure attaining them. The systems seen in practice are evaluated based on familiarity with the aims and the desired methods; subsequently, suggestions are formulated concerning improvements on these systems. The latter analyses are explained in the book primarily in the context of the existing practice in the United Kingdom.

Concerning health care, the author rejects the view that the state must arrange for establishing such. At the same time, the financing role of the state is instrumental, in his opinion, because health care meets the conditions needed for market efficiency and equity only to a minimum extent. Deteriorated efficiency derives from imperfect information provided to the consumers, external economic effects, financing by third parties, as well as non-competitive conduct of physicians, among others. On health status surveys, however, it should be remembered that health is also influenced by factors external to the health care sector (income, nutrition, healthy way of life, broader socio-economic factors).

Education and higher education are discussed in a separate chapter in the book, which is justified by the fact that – although the underlying economic theory is similar for the two areas – they validate the role of the state to different extents. In education – similarly to health care –, “many of the assumptions necessary for market efficiency fail; the main problems being imperfect information, imperfect capital markets and external effects.” (page 490) According to the author's reasoning, the role of the state in education in terms of equity is material because a close correlation is observed between the quality of education and the socioeconomic status. The book considers improvement in the performance of the schooling system conceivable in the framework of state financing and production, in other words, disagrees with establishing a mixed education system (containing both state and private elements). Similarly to health care, it must be noted, however, also for education that school performance may derive from a number of different sources other than the education system (financial, human and social capital of the family, as well as natural, innate abilities).

For higher education, the book arrives at a different conclusion: financing must be mixed (i.e. containing both public and private elements), and for services, a larger role of the market forces would be needed. The author mentions three material elements in reform strategy: variable and deferred tuition fees (universities should be allowed to determine the amounts of their tuition fees, and repayment should be a duty of graduated students); adequate and general loans depending on income available to all students; as well as efficient measures taken to improve access. Such reforms would facilitate investment in human capital, and could prevent the problem of quality deterioration seen in higher education for years, which represents an important argument of efficiency. In addition, loans may also improve equity.

■ What can be said about the book *globally* is that it discusses the welfare state and the major welfare functions of the state thoroughly and in detail. A remarkable virtue of the book is that it examines such a sensitive issue – most often addressed with a political undertone – in an objective way. A key message of the book is that the welfare state is necessary, as it "handles the most important problems of market failures; meets equity aims endorsed by many; and contributes to important comprehensive objectives such as social cohesion." (page 537) It discusses the subject in the context of the crucial problems of our days such as globalisation, demographic changes, the effects of changes in the family structure and the employment structure, and in its reasoning, successfully unites the approaches of economics, sociology, law and public administration. For all these reasons, it may well generate broad interest among the representatives of various sciences. Comprehensibility of the explanations is facilitated by explanations of the various notions going back to basics. Comprehensibility, quick reference and more in-depth understanding are assisted through brief summaries at the end of each chapter, questions for further discussion, further reading and a glossary provided at the end of the book. Explanations contain few mathematical correlations, and the essence can be followed even without understanding the formulas, which contributes to wide usability of the book. The theories presented are often illustrated with practical examples. In the reviewer's opinion, it would have been reasonable to present examples and practices of multiple countries, instead of relying on the Anglosphere only. This shortcoming is to some extent compensated for by the abovementioned appendix prepared by the translator on the subject of Hungary.

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