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IMPROVING THE PERFORMANCE OF THE EUROPEAN SOCIAL MODEL – THE WELFARE STATE OVER THE LIFE CYCLE

by

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- The Welfare State over the Life Cycle

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Abstract

The achievements of social-welfare arrangements in Western Europe are well known: considerable income security, relatively little poverty and, in some countries, ample supply of social services. But there are also well-known weaknesses and hence considerable scope for improvement. Three types of weaknesses are considered in this paper: social-welfare arrangements are often not financially robust to shocks; individuals make undesirable behavioural adjustments in response to welfare-state arrangements and their financing; and social-welfare arrangements are often poorly adapted to recent changes in socio-economic conditions and preferences of individuals. I discuss these weaknesses, and alternative methods to mitigate them, in the context of various types of welfare-state arrangements that the individual may encounter over the life cycle.

JEL Classification codes: H00, H4, H5

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Introduction

Welfare-state arrangements are more comprehensive in Western Europe, or Europe for short, than in other parts of the world. As a result, welfare-state spending (including expenditures on education) typically hovers in the interval of 25-35 percent of GDP among European countries (gross figures, OECD statistics). The achievements are also impressive. In particular, there is considerable income security over the individual's life cycle, largely as a result of social insurance. Governments have also boosted the consumption of various types of (personal) social services with strong elements of investment in human capital – in particular, education and health care, as well as child care in some countries. Poverty has also been mitigated, not only as a result of social insurance but also via selective income support and social services that are made available for low-income groups. In countries where the children of low-income groups enjoy a relatively large share of aggregate education services, the factor incomes of these groups have also improved.

Some welfare-state arrangements also contribute to favourable economic and social *dynamics.* For example, when aggregate investment in human capital is stimulated, future labour productivity is boosted, which in turn improves the future aggregate tax base. As a result, in a long-term perspective, these types of welfare-state spending may even be "self-financing" for the government – an example of virtuous welfare-state dynamics. In countries with wide-ranging ("universal") welfare-state arrangements, income mobility over the individual's life cycle also seems to be relatively strong (Björklund and Jäntti, 1993). Moreover, it is often hypothesised that high income security contributes to tolerance for continuing reallocation of resources. We may also speculate that income security and poverty relief, up to a point, tend to boost social and political stability. Indeed, there is some empirical support for this speculation (Alesina and Rodrik, 1994).

What, then, are the main weaknesses of today's social arrangements in Europe? Hence, what are the basic arguments for welfare-state reforms? In very general terms, it is useful to distinguish between three types of weaknesses.

First, the financial viability of some welfare-state arrangements is not very robust to shocks, for instance, in demography, productivity growth, macroeconomic fluctuations and unemployment. Indeed, a combination of such disturbances is a basic explanation for re-occurring financial problems for the welfare state in recent decades.

A main reason is that promised benefits are usually not contingent on the performance of the national economy and hence on the development of the aggregate tax base.

Second, the architects of European welfare states were not sufficiently attentive to the possibility of undesirable behavioural adjustments of individuals in response to welfare-state arrangements and their financing. I refer, for instance, to the fact that tax wedges create deviations between social and private return to effort by favouring leisure, home production, barter of goods and services, and work in the shadow economy – not to mention tax avoidance and tax evasion. It is also a commonplace that taxes often distort decisions about saving and asset choice. Moreover, tax-induced disincentives of investment in human capital (in particular if taxes are progressive) counteract, or even reverse, the stimulation of such investment via education subsidies. These various consequences are, of course, the background for the common observation that social policies may conflict with efficient allocation of resources and high capacity utilization of factors of production, including labour. Indeed, it was an emerging understanding of these types behaviour adjustment that helped initiate tax reforms in various countries in the late 1980s and early 1990s.

There is also an emerging understanding that welfare-state arrangements are subject to “moral hazard” and benefit cheating, i.e., induced behavioural changes that make new (and unintended) groups of individuals eligible for welfare-state benefits. I will, however, also hypothesise that problems of moral hazard and benefit cheating have recently been accentuated by the erosion of social norms in favour of work, or against living on benefits – a process that may render the earlier mentioned virtuous circles *vicious* (Lindbeck, 1995).

Third, some socio-economic conditions that existed when the present welfare states were built up have subsequently been transformed. I refer, in particular, to increased instability and heterogeneity of families, a rise in female labour-force participation, higher unemployment, better educated citizens with more individualistic values, tighter international economic integration, and the emergence of new information and communication technology (ICT), with potentially important consequences for the organization of social insurance and social services. So far welfare-state arrangements in Europe have only partially been adjusted to these developments.

When considering the possibility of mitigating these problems and limitations by reforms of various welfare-state arrangements, the classical conflict between insurance, incentives, administrative controls and distributional concerns are often difficult to avoid. It is then, however, also important to keep the earlier mentioned achievements of the welfare state in mind to avoid de-railing some of these.

Welfare-state arrangements differ considerably among European countries. In general terms, these differences concern the relative role of the state, the family and the market for providing income security, redistribution and personal services. Countries also differ with respect to types of government intervention, such as the emphasis on universal benefits tied to citizenship (a typical feature of social arrangements in the Nordic counties), selective benefits to the poor (which are important in Anglo-Saxon countries), and occupational benefits tied to employment in different production sectors (arrangements that are particularly apparent in some countries on the European continent). Moreover, while social arrangements in continental European countries usually are strongly family-oriented, they are often tied more to individuals in the Nordic countries. The range of subsidized, or government-provided, household services also varies considerably among countries (here the Nordic governments spend the most).[1] I will, however, keep my discussion at a sufficiently general level to emphasize *common* welfare-state achievements and problems in various West European countries, although differences among countries will also be pointed out. I organize the paper as a "journey" over the individual's life cycle from the cradle to the grave – from childhood, via working life (both when healthy and when sick) to the retirement period.

I. Childhood

Three types of welfare-state arrangements seem to dominate with respect to childhood: health services for pregnant women and the newborn; child care during infancy, and schooling later on. There is hardly any controversy today about the proper role of the government concerning the first type of government intervention. We know that deficient health among pregnant women and small children tends to handicap the latter for life, and hence function as disinvestment in human capital – and that government subsidies or provision of health care for these groups alleviate such problems. The importance of government intervention is also quite non-controversial in the case of schooling. Although the main justification in the political arena is probably a combination of paternalism and distributional concern (including altruism), economists have also emphasized the difficulties for families to borrow with expected future human capital as collateral and positive external effects of investment in human capital.

There is more controversy concerning the proper role of the government in the case of child care. One important reason for emerging interest in government financing and organization of child care is the gradual drop in nativity in most European countries. While a reproduction rate of 2.1 (the number of children per women of reproduction age) is required for a constant population, abstracting from net migration, the rate in the EU today hovers around 1.5 percent. Although, to begin with, fewer children reduce the economic burden for individuals of working age, it is well understood that the financial viability of government-financed pension systems and old-age care outside the family are threatened.

This, of course, is the background for proposals to boost nativity by redistributing income to families with children regardless of whether this is brought about via differentiation of taxes by number of children or via outright income transfers. However, in most countries it seems to have been easier for politicians to gain electoral support by transfers to the elderly than to families with small children, perhaps because voters in the latter group constitute a highly heterogeneous minority that is difficult to organize politically.

In addition to transfers to families with children ("child allowances"), some governments also encourage parenthood by tax-financed leave from work to take care of newborn children, "parent leave" for short. In the Nordic countries, such leave is currently allowed for about a year. It is likely that such arrangements help explain why nativity is somewhat higher in these countries than on the European continent. A serious controversy, though, is whether it is a proper role of the government to influence deliberately the allocation of tasks within the family for the purpose of inducing males to devote more time to childcare. Indeed, governments have taken this role in some countries, including Denmark and Sweden, by tying the rights to paid parental leave to the individual rather than to the family.

Another controversy concerns legislated rights of parents for tax-financed leave to take care of sick children. Again, a justification is to encourage parenthood.

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[1] Esping-Andersen(1990) was among the first to group countries into geographical and ideological

The system, however, is wide open to moral hazard and cheating. For instance, a recent study in Sweden concluded that about 10 percent of parents who claimed such benefits on a specific day were, in fact, on the jobs and/or had their children at day-care centres rather than at home (RFV, 2002).

There are also good reasons to provide economic support to single parents (usually mothers), not least to prevent child poverty. But the greater the generosity to this group, the more single mothers would be expected – via childbirth by unmarried women and divorce. Thus, it is unavoidable that such support functions as a subsidy to single parenthood – another example of moral hazard. It is also tempting for a parent to pretend to be single when, in fact, the individual lives with someone else. Administrative controls to counteract such tendencies are bound to create problems of personal integrity and hence to generate serious political resistance.

Are there, then, any arguments for additional government intervention in the field of child care? Yes, there is a ("second-best") efficiency argument for subsidizing child care *outside* the home to counteract the consequences of high marginal tax rates on labour earnings, which favour tax-free household work, including child care – at the expense of taxed work in the ordinary labour market and purchases of household services. In particular, subsidies of childcare outside the family make it easier for females to combine labour-force participation with parenthood. The Nordic countries have moved further in this direction than most other countries. This probably helps explain the relatively high labour-force participation among females in these countries. Indeed, it is approximately the same, 70-75 percent, as in the United States, where marginal tax rates are lower than in Europe and the relative prices of purchased child-care services lower as a result of a wider dispersion of wages. Family policy in the rest of Europe still is rather closely tied to the "male-breadwinner" model, although labour-force participation of married women has recently increased, typically to the interval 45-55 percent (outside the Nordic countries). This is an important example of limitations, or at least time lags, in the adjustment of social-policy arrangements in view of changing socio-economic conditions and individual preferences.

The different government involvement in the area of child-care among European countries is reflected in statistics on government spending on formal day

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clusters on the basis of such considerations.

care. While such spending is between one and two percent of GDP in Denmark, Sweden, Finland and Austria, it is below 0.5 per cent in other European countries, expect in France where the figure is about 0.7 (OECD, 2002, average for 1995-98).

In some Nordic countries (such as Sweden), however, the size of child-care subsidies outside the home is larger than necessary to compensate for the tax distortion – at least for families with more than one child. As a result, policy-induced distortions of the allocation of child care, and hence also of female labour-force participation, have changed sign for families with more than one child. One conceivable explanation as to why such policies have been pursued may simply be that political decision-makers are not aware of the net incentive effect of government intervention in this field. Another explanation may be that politicians regard high female labour-force participation as a goal in itself, a position often taken by feminist participants in the policy discussion. In the case of intellectually understimulated children, however, there is a specific (paternalistic) rationale for favouring child care outside, rather than inside, the family, namely the traditional "head-start" argument. Indeed, there is empirical support for the asserted positive consequences for children of such head start arrangements (Leibowitz, 1996).

A trivial policy conclusion in this context is that politicians have to consider carefully whether, and when, they want to favour child care within the family (as in most countries on the European continent) or outside the family (as in the Nordic countries in the case of families with more then one child) – or if they would prefer a neutral stance. The latter would clearly require *some* subsidies of child care outside the home in order to compensate for the general tax distortion in favour of household work. One unavoidable problem, though, is that taxes would then have to be higher than otherwise. Moreover, as often happens when we try to counteract one distortion by a new policy intervention, other distortions are created. In this specific case, the total volume of childcare (by the family *and* others) would be favoured relative to the consumption of other goods and services (Rosen, 1997).

In many countries, there is increasing controversy in the case of both child care and schooling about whether the government should be neutral or partisan toward *alternative* providers of subsidized services. Observers anxious to "homogenize" the future adult population in terms of types of knowledge and values tend to favour government-operated institutions. Those who emphasize freedom of choice instead tend to favour a neutral stance on the part of the government towards alternative providers, by allowing the subsidy to follow the child – the "voucher method". A general argument for more freedom of choice in this field is, of course, that competition, free entry and freedom to choose may boost economic efficiency and allow parents to satisfy individual preferences concerning methods of child care, teaching methods and, within certain bounds, types of curriculum. The gradually rising level of education among parents has also increased their demand for such freedom of choice, for the same reason as individuals demand more differentiated products in private markets when income rises. Although several countries today tend to move in the direction of increased freedom of choice for childcare, the speed varies considerably. Somewhat surprisingly, school vouchers are more usual in the "collectivist" Sweden than, for instance, in "individualistic" United States.

The most common argument *against* freedom of choice in these areas seems to be a risk that children will be increasingly segregated in terms of their parents' education, profession and income. But in societies with considerable geographical segregation of housing, vouchers may rather contribute to desegregation of child care and schooling in these dimensions. Parents in poor neighbourhoods can use vouchers to enrol their children in preferred institutions, located in more affluent neighbourhoods with more highly educated parents. This probably explains why blacks in some parts of the United States have recently favoured voucher systems. In the case of child care, vouchers may alternatively be used to buy service at one of the parent's places of work. This may also contribute to desegregating children in terms of parents' education, profession and income, since the composition of the workforce within firms is often more varied socially than is the population across neighbourhoods. Freer choice is more likely to accentuate segregation in other dimensions, such as in terms of values and interests, in particular if confessional institutions become important. So far, the lack of reliable empirical studies of the consequences in this respect makes it impossible to ascertain what the effects on segregation, or desegregation, actually are – or perhaps rather under what circumstance the effects go in one direction rather than the other.

Critics of parental choice in the case of child care and schooling have also asserted that the quality of government-operated institutions would suffer due to a tendency for talented children and personnel, in particular teachers, to move to private and cooperative institutions. A usual counterargument is that competition tends to improve the efficiency and quality of *all* institutions, partly by encouraging experimentation, partly by forcing low-quality public agencies out of business. Empirical research on this issue is in its infancy. But available studies have not provided support for the hypothesis that the quality of government-operated schools would suffer from more choice and competition – rather the opposite (Bergström and Sandström, 2001; Hepburn, 2000; Hoxby, 2002).

II. Employment and Income-Security

In the case of healthy individuals, the most important welfare-state interventions during an individual's working life are probably macroeconomic (monetary and fiscal) policies, minimum wages, job-security legislation, unemployment benefits, active labour-market policy and social assistance. The consequences of policies in these fields in Europe may be roughly summarized as good income security but poor employment performance.

The most obvious expression of the employment failure in Europe, of course, is the breakdown of full employment in the mid-1970s and early 1980s, and permanently high unemployment ever since. Typically, the open (official) unemployment rate has increased from 2-4 percent in the 1960s and early 1970s to 8-12 percent subsequently. There has been a related fall in the employment rate (for the population of working age) from about 70 to about 65 percent. Although unemployment in Europe gradually fell during the boom in the late 1990s, there is still a long way to go before returning to pre-shock levels. Since "full employment" has always been regarded as an important component, and indeed prerequisite, for a successful welfare state, its breakdown is certainly an important blow to the ambitions of social policies in Europe.

When trying to explain the poor employment performance in Europe, many observers have referred to an asserted rise in structural unemployment, or "equilibrium unemployment", i.e., broadly speaking the level of unemployment that cannot be eliminated, except temporarily, by an expansion of aggregate demand. This assertion is often supported by reference to structural developments in the labour market, such as changes in the composition of the labour force, higher minimum wages, more generous unemployment benefits and stricter job-security legislation that makes hiring more hazardous. It has, however, turned out to be difficult to identify changes in structural factors large enough and widespread enough among countries, to explain such a huge asserted rise in the equilibrium unemployment rate. As an alterative, or at least a complement, we may regard the poor employment record in Europe in the last decade as a consequence of a *combination* of negative macroeconomic shocks and various mechanisms of unemployment persistence, i.e., mechanisms through which the (un)employment level moves only very slowly towards the pre-shock level (Lindbeck, 1996; Blanchard and Wolfers, 2000).

The origin of negative macroeconomic shocks hardly needs elaboration: the oil-price hikes (in 1973 and 1979) and subsequent periods of highly restrictive economic policy to bring down inflation and budget deficits. Moreover, I agree with those who argue that there have been shifts in the composition of labour demand relative to supply in favour of high-skilled workers, although the evidence is indirect ("circumstantial") rather than direct. But there has also been increased dispersion of wages and/or unemployment rates *within* narrowly defined subgroups of workers with quite similar occupations and statistically recorded skills. This observation is consistent with the (untested) hypothesis that the ongoing reorganisation of firms has favoured individuals with certain *idiosyncratic* characteristics, in particular, high versatility and ability to take initiative and to cooperate with others in the production process (Lindbeck and Snower, 2000). In societies with rigid relative wages, demand shifts in favour of skilled workers and workers with specific personal characteristics are bound to create unemployment problems, thereby adding to the consequences of negative macroeconomic shocks. Except for the case of monopsony in the labour market (within a certain interval of wage rates), we would also expect that "administrative" squeezes of the distribution of wages in the 1960s and 1970s have contributed to higher unemployment among workers with low expected productivity. This holds regardless of whether the administrative squeeze was brought about via higher minimum wages or via an egalitarian ("solidary") wage policy by unions.

Against this background, it is natural to hypothesise that increased flexibility of relative wages would improve the employment performance for low-skilled workers, although a widening of the dispersion of wages may then be unavoidable. Since wages in the private sector are usually set by free bargaining, what the government can do in this sector is mainly opt for more relative wage flexibility in the public sector, be restrictive with minimum wage legislation and avoid legislation that makes collective bargaining agreements binding for non-organized workers.

A number of persistence mechanisms have also been identified in the literature (Lindbeck, 1996). When discussing the possibility of mitigating the consequences of such mechanisms, it is useful to distinguish between policies operating via the behaviour of labour-market *outsiders*, i.e., individuals with unstable (or altogether without) jobs, and labour market *insiders*, i.e. workers with highly protected jobs.

In the case of outsiders, governments may mitigate unemployment persistence by either "harsh" or "lenient" policy measures. Examples of the former are less generous and stricter administration of unemployment benefits, possibly accompanied by shorter periods during which such benefits can be collected, and policies that keep the level of social assistance distinctly below the after-tax earnings of low-skilled workers. Suggestions regarding these types of policies, of course, illustrate the classical conflict between insurance, income distribution, incentives and administrative controls.

Subsidized, or even government operated, retraining of low-skilled workers is perhaps the most celebrated example of "lenient" methods to help outsiders get jobs. While such policies certainly keep down registered unemployment during training periods, there is hardly any convincing evidence that such policies improve the likelihood that the individual finds a regular job afterwards.[2] In terms of regular aggregate employment, the quantitative results of such policies have therefore been rather disappointing (Calmfors, Forslund and Hemström, 2001; Martin and Grubb, 2001).

While retraining is intended to move workers' productivity closer to existing, non-market-clearing wages, public-works programs and selective employment subsidies for low-skilled workers (such as so-called recruitment subsidies) instead try to mitigate the employment consequences of such wages. The latter types of programs certainly provide jobs for individual workers. Empirical studies indicate, however, that regular jobs elsewhere are crowed out to a considerable extent, typically by about 50 percent (Calmfors, Forslund and Hemström, 2001). Thus, again, the effects on aggregate employment are rather modest per dollar spent; this seems to be the case, in particular, if the programs are very large (covering several percent of the labour force).

[2] By contrast, the experience of vocational training in the ordinary school system has been quite useful in keeping down youth unemployment, as illustrated by the experience in Austria, Germany and Switzerland, where youngsters are offered a combination of theoretical and vocational training in the form of apprentice systems. It is less clear to what extent such apprentice systems have kept down aggregate unemployment.

"In-work benefits", i.e., income supplements to the "working poor", follow yet another track in the battle against persistent unemployment. In this case, low wages are combined with disposable earnings high enough to encourage labour supply and to make the "working poor" somewhat less poor. This may be regarded as a *selective* negative income tax, reserved for low-income people who actually work. Although such arrangements avoid the disincentives for labour force participation of a *general* negative income tax, they cannot prevent disincentives for hours of work and investment in human capital, in the latter case because the subsidy is reduced by higher wages. Thus, when employment subsidies or in-work benefits are raised, there is a case for a simultaneous increase in subsidies to education or training so as to counteract the disincentive effects on investment in human capital of the former, although the budget cost for the government would then be raised.

One specific type of labour market policy, namely government-operated labour market exchange, or placement services, seems to have been more successful than other similar policies in mitigating unemployment persistence, provided such services are highly active and combined with strict administration of the unemployment benefit system (Martin and Grubb, 2001, and references therein). As in the case of training programs, success, of course, presupposes that there are vacancies in the national economy, hence that aggregate demand on domestic output is sufficiently high.

An alternative, or perhaps rather a complement, to interventions designed to influence the behaviour of labour-market outsiders are measures to reduce the market powers of *insiders*, i.e., workers with stable jobs, protected by labour-market legislation and unions. I refer, for instance, to lower legislated costs of firing, and hence indirectly also lower costs of hiring workers. Since such costs tend to stabilize employment at whatever level it happens to be, the consequences for aggregate employment are positive if unemployment happens to be low initially, but detrimental if it happens to be high. As often pointed out in the literature, the effects of such costs on the *average* level of unemployment over the business cycle are uncertain. But the more the insiders exploit such legislation to boost real wages, the more likely it is that the average level of unemployment is reduced over the business cycle. This, then, is another illustration of the necessity of striking a trade-off between insurance and incentives, in this case as a result of a conflict of interest between insiders and outsiders in the labour market.

Many observers have also referred to rigidities in product markets – both as a result of taxes and government regulations, and as a consequence of spontaneous obstacles within the private sector. To the extent such rigidities reduce competition in product markets, the labour demand curves will shift inward and becomes less elastic, both for individual firms and for the aggregate of firms (Layard, Nickel, Jackman, 1991; Nicoletti, *et.al*., 2001). As a result, aggregate labour demand tends to fall. Moreover, various government restrictions on the entry of firms means that the supply response to increased aggregate product demand is constrained, which would also be expected to contribute to unemployment persistence. Nicoletti et.al. (2001) conclude that combination*s* of rigidities in product and labour markets, which are common, tend to be particularly harmful for the performance of the labour market.

It is also tempting to hypothesise that rigidities in capital markets reduce the output and employment response to positive shocks in aggregate demand, and hence contribute to unemployment persistence. Obvious examples are the difficulties for small and medium-sized firms to obtain capital, for instance, because banks are heavily involved with established firms. Thus, to improve the employment situation in European countries, reforms in capital markets are also likely to be helpful.

It is true that a great number of minor *ad hoc* changes in labour-, product- and capital-market legislation have been carried out during the last decades, but different policy measures have often worked in different directions in terms of the effects on unemployment persistence. According to available studies (for instance, Bertola *et al.*, 2001 and Nicoletti, *et al*., 2001), it is doubtful whether the *sum* of all changes in rules and regulations in labour, product and capital markets implemented so far have actually facilitated a return to full employment (Bertola et.al., 2001) – except for a few countries such the Netherlands and perhaps the UK.

We may also hypothesize that long periods of unemployment weaken social norms in favour of work, or against living on various types of benefits. As a result, "unemployment cultures" may emerge (Lindbeck 1996.) If this (also untested) hypothesis makes sense, here is an additional persistence mechanism, and a further argument as to why governments should try hard *both* to counteract large negative macroeconomic shocks (mainly by aggregate demand management) *and* to fight persistence mechanisms.

As a result of the stalemate in the areas of structural reforms in many countries, the insider-outsider divide in the labour market has continued. An insider-outsider divide, however, also exists in other areas. An example is the provision of social benefits, such as unemployment benefits, sick pay and occupational pensions, which often are tied to regular work, which means that labour market outsiders do not benefit much. Another example is rent control, which has created a strong insider-outsider division in the housing markets in many cities. When an individual is an outsider in all these markets – the labour market, the housing market and social benefits – so-called "social exclusion" is unavoidable. Obvious examples of groups in this situation are school dropouts, some immigrant groups, drug and alcohol addicts, individuals with physical and mental handicaps, etc.

Why then are the political systems in Europe so limited in their ability to undertake institutional reform for the purpose of mitigating persistent unemployment? One explanation may simply be that neither politicians nor the electorate – not even all economists – are convinced that policy measures of the types discussed above would be of much help in reducing persistently high unemployment. If so, then in my view, it would be difficult to understand why Europe has serious long-lasting employment problems in the first place. It is also likely that powerful interest groups – labour unions, incumbent production firms and incumbent financial institutions – have blocked many potentially useful measures.

III. Sick-leave Insurance and Health Care

Important arguments for government intervention in the fields of sick leave and health care are that some individuals are myopic (a paternalistic argument) and that others tend to free ride on the altruism of others (they assume that someone will help them if they are too sick to work or need health care in the future). There is also an income distribution argument for government intervention, since low-income groups often cannot afford voluntary insurance policies. The economics literature also emphases deficiencies in the markets for health insurance due to asymmetric information between insurance providers and individuals who seek insurance. As a result, health insurance becomes expensive and the market for health insurance will be thin – either because of "adverse selection" (when the insurance provider cannot judge the health status of individuals), or because of "cream skimming" (when insurance companies have the ability to select low-risk individuals as customers). In most developed countries, the political response to these problems has been mandatory sick-leave insurance and government-subsidised or government-provided health care.

It is, however, well known that government interventions in these fields encounter serious problems today. In the case of sick-leave insurance, moral hazard is difficult to avoid. After all, individuals have considerable discretion in deciding whether they are in sufficiently good shape to go to work or not. Although the prevalence of moral hazard is difficult to prove rigorously, there are indicators that it actually is a problem. For instance, it is difficult to explain differences in sick absentees among countries by differences in health indicators (Kangas, 1991); health statistics may, however, not correctly reflect the actual health status. Another indicator is that varying requirements concerning doctors' certification of sickness, and the strength of administrative controls, help explain the incidence of sick absentees among countries (Kangas, 1991). Moreover, a tighter labour market tends to increase the number of sick absentees. Empirical studies suggest that this phenomenon does not only reflect a statistical "selection effect", when more people with health problems become employed in business upswings. It is also likely that it is less risky for an employee to stay at home when the labour market is tight (Arai and Skogman Thoursie, 2001; Askildsen, 2002). One supporting evidence of this interpretation is that people with temporary job contracts have fewer sick days than people with permanent job contracts (Arai and Skogman Thoursie, 2001; Ichino and Riphahn 2001).

But how, then, do we explain the *rising trend* in sick absenteeism in recent decades in some countries? Until recently, a stepwise increase in the generosity of benefit rules may have been a fitting explanation, since sick absentees seems to increase by the generosity of benefit levels (Barmby *et al.* 1995; Henrekson *et al.*, 1994; Johansson and Palme, 2001)). More recent increases in sick absentees, however, have often taken place during periods of unchanged rules. How, then, do we explain this?

The gradual aging of the population is one obvious explanation. But more complex forces seem to be at work. A quite popular hypothesis is that sick leave has risen due to a deterioration of so called mental working conditions, including more stress at work. If this hypothesis would actually make sense, an obvious policy measure would be experience-rated insurance fees, i.e., higher fees not only for firms with many work injuries but also for firms with high sick absenteeism for other reasons. But, is this hypothesis really consistent with the observation that sick absentees have increased only in *some* countries, mainly the Netherlands, Norway and Sweden?

The remedy would be more complex if the rise in sick-absentees could be attributed to developments within the family, for instance, scarcity of time in connection with greater female labour-force participation. Since women are still more responsible for household work than men (according to time budgets), this explanation would be consistent with the observation that females account for considerably higher sick absence than men. It is also suggestive that sick absentee among women has increased, in particular, in countries with high female labour force participation and generous insurance rules (RFV, 2002:11).

If this attempted explanation for increased sick absentees makes sense, one remedy might be to make it easier for households to obtain services from outside. For instance, suppose that the marginal tax rate is 50 percent for both the buyer and the seller of household services (such as caretakers of children, craftsman or gardeners). The buyer has to earn four times as much before tax as the seller gets after tax in order to finance the purchase of additional services in the market. It is easy to understand that households choose to produce services themselves in such societies, and that this helps explain the scarcity of time within families where both spouses participate in the labour market. If it turns out to be impossible to mitigate this problem by lower marginal tax rates, an obvious alternative is subsidies of the purchase of certain household services in the market, or even government provision of some such services. Indeed, such policy measures have recently been implemented in Belgium and France. It is unavoidable, however, that new distortions would then emerge, since all types of household services that are close substitutes to the household's own production can hardly be subsidized; moreover, even higher taxes would now be necessary.

There may, however, be more complex explanations for the rise in sick absentees in countries with generous sick-leave benefits. Social norms in favour of work, or against living on sick-leave benefits, may have receded over time – in a similar fashion as "unemployment cultures" seem to have developed in some geographical areas. In this way, moral hazard would have been accentuated by a gradually more "liberal" interpretation by the individual himself of the rules of sickness absentees. For instance, suppose that the number of individuals with sick pay has increased as a result of more generous benefits or a reduced risk of losing one's job because of lower aggregate unemployment. Individuals would then be likely to feel less guilt (or shame) to call in sick when, in fact, they are able to work; for a general discussion of such mechanisms, see Lindbeck, Nyberg and Weibull (1999).

Social norms against plain *cheating* with sick-leave benefits may also have weakened among certain groups. For instance, recent opinion polls suggest that a majority of the adult population in Sweden believes that it is all right to stay home with paid sick leave without being sick – for instance, when a women is pregnant, when an individual takes care of relatives, or simply when someone feels miserable at the thought of having to go to work (RFV, 2002b). Another indicator of cheating with sick leave is that a significant number of males call in sick when important sports events are shown on television (Skogman Thoursie, 2002**).**

Another example of either moral hazard or benefit cheating is that individuals move between different benefit systems in response to changes in relative benefit levels. This is exactly what happened in Sweden in the 1980s, when the benefit level in the work-injury system was raised above the level in the sick-pay system, with the result that some individuals shifted from sick benefits to work-injury benefits. Metaphorically, people suddenly discovered that their backache had been caused by injury at work rather than by sitting around watching television at home. A study in Sweden also suggests that the rules of unemployment benefits influences the propensity to live on sick-pay (Larsson, 2002). It is also striking that sick leave is particularly high in regions with high unemployment in Sweden. Since there is hardly any evidence that this can be explained by geographical variations in health conditions, it is likely that some individuals simply choose sick benefits rather than (less generous) unemployment benefits. Thus, there is a case for having the same benefit level in all benefit schemes among which individuals can move freely at their own discretion, for instance, between sick-pay insurance, work-injury insurance, unemployment benefits and early retirement.

There is still not enough reliable empirical research to make us confident about how to reduce the incidence of sick absentees. There is, however, probably a case for a broad approach, hence relying on many different measures. Incentives for firms to improve the work environment via experience-rated sick insurance fees and policies that reduce time stress among family members are very general policies for this purpose. When changes in the rules of the sick-pay insurance are considered, there is an obvious trade-off between stronger incentives, tighter administrative controls, and more active “rehabilitation” measures, designed to help individuals return to work. Stronger incentives include more waiting days and more coinsurance, i.e. lower benefit levels. Tighter administrative controls include stricter requirements of doctor’s certificate and visits by administrators in the individuals’ home. Useful rehabilitation may require tight cooperation among health-insurance providers, health-care institutions and employers.

So much for sick-leave insurance. Problems connected with *health care* are also quite complex. In general terms, a basic problem is how tax financing or insurance should be combined with economic efficiency. For instance, countries with mandatory health-care insurance, such as Germany, often find it quite difficult to control costs, which is a general problem when a “third party pays”. (The same problem arises in voluntary health-insurance programs, for instance, in the United States.) Countries with tax-financed health care, like the UK, have often been more successful at putting a lid on costs by implementing strict budget limits. But this creates serious problems of access, reflected in queues and long waiting time, as well as complaints about poor quality of services. The standard suggestion for shortening such queues is to expand the resources that are available for health care. But, then, it has to be specified whether this should be achieved via cuts in other spending programs or via higher taxes.

There is also a more fundamental objection to simply pouring additional resources into health care. Research indicates that health conditions in rich countries today are more highly related to life style than to the volume of health care provided (Fuchs, 1986). From this point of view, policies that induce individuals to choose a healthier life style sound like an ideal solution to the problem of galloping costs in the health-care sector. The question is how this could conceivably be brought about. Although government-provided, or subsidized, information about health hazards is now generally accepted in the case of smoking and drugs, it is difficult to determine how far the government can stretch its life-style advice without being regarded as excessively paternalistic. Direct government intervention by means of incentives and regulations is another option. Such intervention is generally accepted in the case of taxes on cigarettes and alcohol as well as in the case of compulsory use of seat belts. But would the general public also condone high taxes on fatty foods and laws prescribing helmets for cyclists? It may be tempting for a government to argue that overweight people and cyclists without helmets create negative external effects on the government-subsidized health-care system and hence on the taxpayer. There would then be a rather short step to recommending that the government intervene by using taxes, subsidies or regulations to change people's behaviour – even though the government itself, albeit for good reasons, has created the externality (via mandatory, collectively financed health care).

Another important consideration in connection with government-operated health care is the issue of individual freedom of choice. Here a well known difficulty with allowing free choice is that information about diagnosis and treatment of health problems is highly asymmetric between patients and health providers. As a result, it is often argued that freedom of choice would not be of much value in this area. But with a gradually better educated population, and with so much health information on the Net, this asymmetry is likely to diminish considerably over time (Lindbeck and Wikström, 2001). There are strong incentives to use the new information and communication system (ICT, including the Internet) to acquire knowledge about a particular disease, without having to be knowledgeable about medicine in general. This will probably boost the demand for freedom to choose a health clinic, hospital, physician, nurse, etc. This in turn raises the question of *how* such freedom of choice should be organized. Distributing vouchers with the same value to individuals is certainly not a very useful device in this case because of the heterogeneity of health-care needs. But within the framework of either health-care insurance or tax-financed health care, it is certainly possible to allow considerably more freedom of choice than at present in most countries. Public-sector administrators in the health-care sector may also outsource health-care services to different (public and private) producers among which individuals are allowed to choose.

My trivial conclusion is that there is a case for encouraging experimentation in health care even when the government basically finances it. This obviously requires considerable freedom of entry for non-governmental service providers – health clinics, hospitals and self-employed physicians and nurses. Examples of such experimentation include occupation-related health care, health clubs and Health Maintenance Organizations (HMOs), private health-care centres and hospitals (including hospitals run by foundations). Most likely, such experimentation would result in a *network* of public and private health providers. Complex problems of supervision and regulation may, of course, arise along with the entry of many types of health-care providers, not unlike such problems in privatised industries, such as electricity and telecommunications. It would therefore be a good idea to build up rather elaborate systems of supervision and regulation in conjunction with experimentation and increased freedom of entry.

IV. Pensions and Old-age Care

The justification for government provision of pension annuities is rather similar to the justification for mandatory unemployment benefits and mandatory sick-leave and health-care insurance: to counteract the consequences of myopic behaviour, free riding and deficiencies in voluntary insurance markets.

Politicians have, however, also been eager to use mandatory pension systems as tools of income redistribution. In the case of pay-as-you-go (or simply “paygo”) pension systems, politicians, then, have been particularly generous to the first generations of paygo pensioners, who often received pensions with a capital value five or ten times the capital value of their own contributions to the pension system. Of course, this gift has to be paid for by subsequent generations; indeed, it can be shown that the present value of the gift to the first generation is of the same size as the capital value of the loss for subsequent generations (Lindbeck and Persson, 2003).

What, then, are the main problems inherent in contemporary paygo pension systems in European countries? When individuals have been promised certain pension benefits, which is the case in so-called defined benefit (DB) systems, there is a lack of financial viability in the event of unexpected stagnation of the tax bases, for instance, as a result of changes in demography and productivity growth. There may also be unintended behavioural adjustments among individuals in response to the pension system itself. For instance, government provision of pensions is likely to have contributed to the earlier discussed fall in nativity, since such arrangements make it less necessary for couples to have children of their own to support them in old age. Moreover, generous conditions for early retirement help explain the fall in the *de facto* retirement age, which is about 57 today in Europe. Mandatory pension arrangements also create disincentives for work during active years because of the implicit marginal tax wage in paygo pension systems, since the return is usually lower than market interest rates. Paygo pension systems often also reduce saving and hence the capital stock in particular as a result of the “gift” to the first generation of paygo pensioners.

Owing to these problems, various types of pension reforms have recently been discussed, and to some extent already implemented. Three types of reforms have predominated: (i) marginal reforms of existing paygo systems; (ii) shifts to contribution-based, i.e., defined contribution (DC) systems, with individual accounts, still of the paygo type (often denoted "notional contribution defined", or NCD systems); and (iii) partial or total shifts to actuarially fair, fully funded systems.

(i) So far, *marginal reforms* have dominated, mainly as a response to recent threats to the financial viability of existing paygo systems. These reforms have been characterized by *ad hoc* increases in contribution rates and/or cuts in pension benefits (possibly in the form of modification of price indices). Often the actual implementation of reforms has been postponed quite far into the future (McHale, 1999) to avoid sudden, unexpected deterioration of pension entitlements. But a problem with such postponements is that they may be followed by additional postponements later on.

If the threat to the future financial viability of a pension system arises due falling birth rates, obvious remedies are attempts to boost either nativity or the immigration of young workers – although the political realism of the latter option may be limited by fears of ethnic conflict in the future. If the financial problems are instead a result of greater longevity after retirement, a natural remedy is to increase the statutory pension age and remove subsidies to early retirement. After all, increased longevity is presumably correlated with a greater capacity to work at a high age. Several countries have also closed a number of "pathways" to early retirement outside the ordinary pension system, not only by stricter rules for receiving disability pensions, but also by reducing the possibilities for elderly, unemployed workers to receive long-term sick leave or early retirement.

Ad hoc adjustments often take time to be agreed on and implemented, which means that serious financial problems for the pension system may emerge in the meantime. Unpredictable *ad hoc* adjustments also create uncertainty for individuals regarding the future rules of the game. Both problems may be mitigated to some extent by introducing automatic adjustment mechanisms in the pension system, i.e., strict rules for how pension benefits or contributions should be adjusted to various types of shocks. For instance, rules may be established about the extent to which benefits and contributions should be automatically adjusted in response to specified changes in expected longevity after the statutory retirement age, or in response to expected deficits in the pension system. For instance, per capita pension benefits may be adjusted downward in proportion to a recorded rise in expected longevity of pensioners. Or contributions may be adjusted upward to balance the pension budget.

(ii) A number of countries, including Italy, the Netherlands, Lithuania and Sweden, have recently carried more radical reforms of their paygo pension systems by shifting to NDC systems. Broadly speaking, the pension benefit of an individual in such a system is proportional to his accumulated lifetime pension contributions. In order for such a system to become financially viable, the proportionality factor, and hence the return on mandatory pension saving, have to be tied to the growth rate of the tax base of the economy. Since this growth rate is usually smaller than the return in financial markets, a NDC system may therefore be described as "quasi-actuarial" in contrast to an "actuarially fair", fully funded system, where the return is determined by conditions in financial markets.

A main advantage of shifting to a quasi-actuarial system is that the implicit marginal tax wedge would be reduced because of a tighter link between an individual's contributions and his subsequent pension benefits. (Some steps in this direction could also be taken in earnings-based pension systems by tying pension benefits to lifetime earnings rather than to earnings during only the individual's last x years or y best years.) With realistic assumptions, the tax wedge would be cut approximately in half when moving from a completely non-actuarial to a quasi-actuarial system – often from about 20 to about 10 percent (Lindbeck and Persson, 2003). Such a reform also implies that existing subsidies to early retirement would basically be removed. It would then also be relatively easy to allow individuals free choice of retirement age.

To avoid situations where the removal of incentives to retire early results in high unemployment for elderly workers, it is, of course, also important to increase elderly workers' opportunities to get jobs. Otherwise, they may simply be shifted from the pension system to other benefit systems, e.g., unemployment insurance, sick leave, disability pensions or social assistance. This is an additional argument for labour-market reforms to bring about increased flexibility of both working hours and wages – at least for the elderly.

(iii) There is also a recent trend to more funding of pension systems. A main argument for a *total* shift to such a system is that the return on the mandatory pension system would then coincide with the return in financial markets, and hence that the implicit tax wedge would be removed. It should be kept in mind that this gain materialises only for future generations, after the pension claims of the old paygo pensioners have been paid and financed by taxes on some transitional generations. By such “front-loading”, a shift to funded pension systems would also boost the aggregate saving rate of the national economy. This, of course, is like suggesting that a pension reform should be used as a tool for changing the distribution of income in favour of future generations. Technically speaking, such a rise in aggregate saving and investment rates does not require a pension reform. A rise in aggregate saving could alternatively be brought about by a higher government budget surplus or increased incentives for private saving. Proposals, then, to use pension reform to raise aggregate national saving seem to reflect attempted “framing” to make it politically easier to achieve national goals for aggregate saving.

There is a stronger case for a *partial* than for a total shift to a funded, actuarially fair pension system. Indeed, some countries have recently started to move in this direction, or are at least contemplating such a move. A main advantage would be that people could then enjoy a more diversified portfolio of pension claims than in *either* a pure paygo system, in which the risky return is connected to the growth rate of tax base, *or* a fully funded system in which the risky return depends on developments in financial markets. The diversification effect would be particularly strong if the portfolios of the funded system included a large fraction of foreign assets. In other words, by having some pension claims based on the return on foreign assets, a pensioner would be less dependent than in a paygo system on what happens to the national economy in his own country.

The ”political risks” probably also differ between paygo and funded pension claims. This is an additional argument for combining paygo and funded systems. A usual assessment is that the risks of political interventions in pension entitlements are smaller if they are funded, since such system may “borrow” property rights from private pension contracts – another illustration of “framing”. Government-operated funded systems are, however, connected with other risks than private pension funds. In particular, government-operated pension funds may lead to irresistible temptation for politicians to intervene in the management of fund assets. There is also a risk that politicians, or their representatives, will be appointed to the boards of firms in which the fund owns shares. As a result, large pension funds in mandatory government-controlled pension systems may result in a highly politicised national economy – in fact, rather similar to a highly nationalized economy. It is much easier for power-prone politicians to seize powers over existing, government-initiated pension funds than to pursue outright nationalization of firms "from scratch". To reduce such risks, it is crucial that the funds are privately managed from the outset, and that the individual is allowed to choose fund manager.

Another concern is whether we want the pension system to function as a device for income redistribution and risk sharing *within* generations. Existing paygo systems often do so to some extent. Such redistribution and risk sharing tend to disappear with a shift *either* to a quasi-actuarial paygo system (with a strong link between contributions and benefits) *or* to an actuarially fair, fully funded pension system. If such risk sharing is regarded as a desirable feature of a pension system, then it serves as another illustration of the conflict between insurance and incentives. It is, however, technically possible to construct tools other than pension arrangements to bring about redistribution and risk sharing among and within generations. Obvious examples are fiscal-policy devices such as intergenerational government debt policies and progressive taxation.

Existing paygo pension systems also create income sharing and income insurance *within families*, in particular by protecting widows and their children. One way to provide such protection, also within quasi-actuarial and actuarially fair pension systems, is simply to assign a spouse legal property rights to the other spouse's pension claims in the reformed system. This would also protect spouses in the event of divorce. Should the same rules apply in the case of cohabitation?

The slowdown in productivity growth in Europe during recent decades and the aging of the population create serious financial problems not only for government-operated pension systems, but also for *old-age care.* Moreover, this sector has been hard hit by "Baumol's Law", according to which the relative costs of labour-intensive services gradually increase because of slower productivity growth than in manufacturing. After all, old-age care consists mainly of personal care that is difficult to rationalize to any large extent.

The choice between insurance and tax financing is associated more or less with the same problems as health care in general. But the possibilities of allowing freedom of choice, for instance via voucher systems, are much greater. This holds, in particular, for simple household service for the elderly in their homes – shopping, cooking, cleaning, companionship etc. When medical requirements are modest, vouchers may also be useful in the case of institutionalised old-age care. Still, as in the case of medical care in general, greater freedom of choice than today is certainly also feasible in the case of more intensive medical services. But since elderly patients have substantial difficulties in making themselves heard, there is a particularly strong case for supervision of services provided. Presumably, these needs increase if entry of service providers is opened up.

V. Concluding Remarks

Social policies, and hence welfare-state arrangements, may to a large extent be seen as rational responses to market failures, myopic or free-riding behaviour of individuals and redistributional ambitions (based on self-interest as well as altruism) of the general public. But such arrangements also suffer from a number of limitations and weaknesses, such as (i) financial instability in response to shocks; (ii) undesirable behavioural adjustments in response to the arrangements themselves; and (iii) only limited adjustments of these arrangements to contemporary changes in socio-economic conditions. Entrenched special interests and complications in party politics have, however, made it difficult to remove these deficiencies.

So far, financial instability has mainly been dealt with by marginal, *ad hoc* modifications of existing welfare-state arrangements. Indeed, such adjustments will always be necessary. It may also be useful, however, to incorporate automatic adjustment mechanisms into certain social arrangements to bring about faster, and perhaps also less politically controversial, adjustments. So far, such reforms have been introduced mainly in pension systems, often in the context of shifts from defined benefit (DB) to defined contribution (DC) systems. In some countries, such reforms have taken the form of shifts to fully funded, actuarially fair systems, in other countries of transformations of existing paygo systems to so called Notional Defined Contribution (NDC) systems, which I earlier characterized as ”quasi-actuarial”.

Undesirable behavioural adjustments have been particularly observed in the labour market. This has, for instance, been reflected in difficulties to reconcile job protection for insiders with good employment prospects for low-skilled workers. Schematically speaking, the United Kingdom (like the United States) has emphasised the latter aspect, at the expense of job protection and distributional concerns – although such concerns have been taken into account to some extent by “in-work benefits” to the working poor. Countries on the European continent have instead emphasized job protection, at the expense of a pronounced insider-outsider divide in the labour market. Southern Europe may be characterized broadly in the same way, although with more low-skilled jobs in informal sectors, and with more intergenerational income sharing within families. The Nordic countries differ from countries on the continent mainly by greater government provision of household services, in particular, in the case of childcare and old-age care, which has contributed to high female labour force participation. Indeed, with the high tax burden that prevails in these countries, it is financially hazardous to have one spouse stay at home to take care of children.

In all European countries, it has turned out to be particularly difficult to deal with moral hazard and benefit cheating – for instance, in the case of unemployment benefits, the support of single mothers, sick-leave insurance and early retirement for asserted health reasons. Such problems are bound to be particularly serious if social norms in favour of work, and hence against living on benefits, recede over time when the number of beneficiaries increases, for instance, as a result of smaller economic incentives for work or a rise in the number of beneficiaries after unemployment-creating macroeconomic shocks. This implies that the welfare state may wind up in a vicious circle if weaker economic incentives for work gradually make living on benefits more socially acceptable. To finance the higher costs of welfare-state arrangements, politicians may have to raise taxes further, which makes work even less rewarding as compared to living on benefits, with even smaller incentives for work and possibly also a further weakening of work norms, etc.

The welfare state has basically been a *national* project. How, then, will increased international economic integration affect the European social models? Some observers have predicted a “race to the bottom” of both the social-assistance level and the redistributional ambitions of the tax system. So far, however, there is not much evidence of such a race (Bertola *et.al.*, 2001). It could, of course, become a serious problem in the future, for instance, if national labour markets become much more internationally integrated than today, so that low-skill individuals move to countries with relatively strong income protection and redistributional ambitions, while highly skilled individuals move in the opposite direction. Clearly, such tendencies are likely to be accentuated in connection with the geographical enlargement of the EU to countries with relatively low per capita income.

A common minimum level of social assistance for all countries may not be a feasible solution to this problem as long as average income differs dramatically between the countries in the western and eastern parts of the future EU. An alternative, discussed by Sinn (2000), would be to opt for different social-assistance levels within a nation, depending on the country of origin of the individual. But would such a set-up be politically feasible?

The policies that are most likely to encounter a “race to the bottom” are corporate taxes and individual capital income taxes. We may perhaps also expect taxes on personal income and consumer goods to converge. When looking at this issue, it is, however, important to consider the entire “package” of benefits and taxes for highly taxed groups, rather than their marginal tax rates alone. Moreover, experience from the United States indicates that such tax rates may differ by several percentage points among neighbouring states without serious problems. For obvious reasons, larger differences than within the United States may certainly survive within Europe.

Clearly, increased mobility of labour also raises the issue of the transferability of entitlements – in principle, in a similar way as the transferability of occupational pensions among firms and industries within countries. Presumably, this problem is easier to solve in the case of contribution-based systems with individual accounts than in benefit-based systems (without such accounts). It would, therefore, seem that the internationalisation process favours quasi-actuarial and actuarially fair systems with individual accounts, as compared to traditional defined benefit systems.

International complications may also arise in the case of tax-financed social services. Will the government in nation *A* be willing to pay for its citizens’ health care in country *B*? If so, one possibility would be international agreements about the rights of the authorities in country B to bill the authorities in country A, and *vice versa*, with clearing mechanisms among national governments. Indeed, it is not unlikely that the legal authorities of the EU will grant individuals in member countries the right to receive social services in all EU countries, with a legislated duty of the individual’s home country to pay.

Standardisation of welfare-state arrangements in different countries is sometimes suggested as a method of dealing with international complications such as these. But there are also good reasons to avoid this route. It would seem that welfare-state arrangements often function best when they are anchored in domestic traditions and social and political structures. Another reason is that standardization would make decentralized experimentation more difficult. There is also value in the possibility for individuals to choose in which “policy regime” to live, including welfare-state arrangements and taxes. Voting with one’s feet is an important complement to voting at the ballot box.

Moreover, the explosive development of information and communication technology, ICT, is likely to contribute to better informed decisions than in earlier generations (Lindbeck and Wikström, 2002); the number of sites on the Internet where such information is provided is growing rapidly. ICT has also potentially important consequences for the administration of national and international welfare-state arrangements. For instance, international clearing mechanisms for the payment of social-security benefits and the financing of social services can be simplified.

ICT also lowers the costs of operating systems with individual accounts, which favours quasi-actuarial and actuarially fair pension systems as compared to traditional defined benefit systems. ICT also opens up new channels for citizens to influence types and quality of public-sector services. The ordinary political process, i.e., the ballot box, is a blunt method for influencing types and quality of services provided by specific public-sector institutions, such as a certain school or a child-care centre. The reason, of course, is that electoral campaigns deal with packages of policy issues, often dominated by national politics. ICT offers new ways for citizens not only to acquire better information from public-sector agencies but also to communicate interactively with specific public-sector service institutions, including providers of social services. In fact, in some cases, ICT has great potential for *delivering* services via the Net; important examples are education and health care.

In particular, ICT strengthens an individual citizen’s “voice”, when many people simultaneously express their views via the Net. This development is especially important in the public sector, since the exit option is so weak. Of course, the voice option would become much more powerful if there were also exit opportunities in the form of alternative suppliers, for instance, via voucher systems. There is no reason to assume that exit opportunities, and hence freedom of choice and competition, are less important and useful in the case of social services than in the case of other products.

So my simple punch line is that there are huge needs, and vast possibilities, to improve the performance of European socials models – in terms of employment, benefit programs and social services. The question is whether politicians are willing and able to grasp these opportunities, which often requires both courage and skill in coalition building.

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