Orszag, Jonathan Michael; Snower, Dennis J.

Book Part

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Suggested citation: Orszag, Jonathan Michael; Snower, Dennis J. (1998) : Expanding the welfare system : a proposal for reform, In: Europäische Kommission / Generaldirektion Wirtschaft und Finanzen (Ed.): The welfare state in Europe, ISBN 92-828-2118-8, Off. for Off. Publ. of the Europ. Communities, Luxembourg, pp. 101-117, http://hdl.handle.net/10419/2093

EXPANDING THE WELFARE SYSTEM:

A Proposal for Reform

by J. Michael Orszag and Dennis J. Snower

Authors:
Michael Orszag, Department of Economics, Birkbeck College, University of London, 7-15 Gresse Street, London W1P 1PA, UK. Tel: (44 171) 631 6427; e-mail: MOrszag@economics.bbk.ac.uk
Dennis J. Snower, Department of Economics, Birkbeck College, University of London, 7-15 Gresse Street, London W1P 1PA, UK; and CEPR. Tel: (44 171) 631 6408; e-mail: DSnower@economics.bbk.ac.uk

Abstract: The proposal involves the establishment of "welfare accounts" for every person in a country. There are to be four accounts: a *retirement account* (covering pensions), an *unemployment account* (covering unemployment support), a *human capital account* (covering education and training), and a *health account* (covering insurance against sickness and disability). Instead of the current welfare state systems - where welfare services are financed predominantly out of general taxes - people would make ongoing, mandatory contributions to each of these welfare accounts. The balances in these accounts would cover people's major welfare needs. The government is to set mandatory minimum contribution rates and maximum withdrawal rates from the accounts. The government is to have two budgetary systems: one in which non-welfare expenditures are financed through the existing array of taxes, and another system in which the public-sector expenditures on welfare services are financed through payments from people's welfare accounts. The government would be able to redistribute income across people's welfare accounts, but these redistributions would be constrained to be of the balanced-budget variety: total (economy-wide) taxes on each of the welfare accounts would be equal to total transfers into each of accounts. The public and private sectors would provide welfare services on an equal footing, setting prices for these services and competing with one another for the custom of the welfare account holders. We argue that moving from the current welfare state systems to a welfare account system may be expected to play a substantial role in reducing unemployment, encouraging labour force participation, promoting skills, reducing governments' budgetary pressures, cushioning people against economic risks, ensuring efficient provision of health and education services, providing social safety nets and redistributing incomes more efficiently.

Key Words: Welfare state, redistribution, social insurance, unemployment, health, education and training, pensions, sickness and disability, welfare accounts, competition.

JEL Classifications: E61, E62, E64, H11, H23, H24, H41, H42, H51, H52, H53, H54, H61, I11, I22, I28, I38, J68

Acknowledgement: We are indebted to Ron Smith for his perceptive comments.

1. Introduction

Since the early 1980s the welfare states of most European countries have come under increasing strain. All the main traditional functions of the welfare state--social insurance, redistribution from rich to poor, life cycle transfers, and the provision of social services such as health and education--are gradually being called into question, implicitly or explicitly. Many of the welfare state reforms implemented in Europe over the past one and a half decades have involved rolling back welfare provisio n. This has largely been the outcome of a top-down, dirigiste policy strategy, initiated by governments in response to their political, financial, and institutional pressures, rather than the outcome of a public movement in favour of diminished welfare state services. On the whole, the reforms have tended to occur in the wake of fiscal crises and have been justified primarily by governments' inability to finance welfare provision on a previously envisaged scale.

The welfare state is therefore at a cross-roads. Budgetary pressures are continuing to induce European governments to retreat from welfare state provision and finance, while economic and social pressures (skill-biased technological change, globalisation, crime, drug-abuse, educational under-achievement) are continuing to swell the demand for welfare services. This dilemma is a major source of disagreement between right-and left-wing parties throughout Europe.

What has made this dilemma a matter of ideological conflict is the widespread perception that policy-makers must choose between two disagreeable options on the welfare state: (i) a "flexible" economy with low rates of taxes and transfers, large disparities in incomes, and limited welfare state provision; and (ii) an "inflexible" economy with significant tax-and-transfer distortions, a relatively compressed distribution of incomes, and relatively generous welfare state. According to this view, a "flexible" economy is characterised by comparatively low unemployment and high efficiency, but also by economic inequality and little protection against economic and social risks; whereas the "inflexible" economy provides reasonable minimal standards of security against the risks of unemployment, infirmity, illness, and poverty, but it is also bedevilled by economic inefficiencies and high unemployment. Thus policy makers often see themselves as having to choose between inequality and unemployment, between efficiency and fairness, and between economic growth and social cohesion.

We argue that this view rests on a myth, for it takes the current institutional setting of the welfare state as given, and thus blinds us to the institutional changes that could promote efficiency without harming our equity objectives. It is important to expose the myth and thereby enable policy makers to focus on with the urgent business of fundamental welfare policy reform.

The trick is to recognise that much of the welfare policy is *responsible for* the disagreeable choice between efficiency and equity. The current system of unemployment benefits and taxes is a good example. When unemployed people find jobs, their unemployment benefits are removed and taxes are imposed. Not surprisingly, this policy discourages the unemployed from seeking work. Within this system, a policy of restricting the benefits will reduce unemployment and create more inequality. But what usually gets overlooked is that this unemployment-inequality trade-off is largely the *outcome* of the tax-benefit system. If we changed the system, we could alleviate the disagreeable trade-off.

This paper presents a proposal for reforming the provision and finance of welfare services--interpreted broadly to include social insurance, social services, redistribution, and life-cycle transfers. Our aim is to outline a set of complementary institutional changes that would permit an expansion of the welfare system while at the same time promoting economic activity.

Our proposal is based on the view that it is misleading to address the public policy concern over welfare issues exclusively through an analysis of the appropriate domain of the "welfare state." The reason is that the state is only one possible source of welfare services. Many of them can be carried out by firms, households, and other organisations as well. European countries differ dramatically in their division of labour in this respect. For example, many of the welfare activities shouldered by the government in Sweden are conducted by households and firms in France and Switzerland. The size of a government's welfare state spending may thus bear little relation to the level of welfare services provided in the economy. For this reason, it appears desirable to shift attention away from the "welfare state" to the "welfare system." Expanding the welfare system does not necessarily mean expanding the welfare state.

But reforming the welfare system involves much more than deciding on the appropriate division of labour between the government and private-sector agents in providing and financing welfare services. This division of labour depends on the complementarities between the government and the private-sector agents and these complementarities, in turn, depend on the institutional structure within which welfare provision is provided. The government can influence the "rules of the economic game" determining the degree to which market activity pursues public purposes. This applies as much to the provision of welfare services as it does to preserving the environment, protecting worker health and safety, and encouraging competition. The degree to which the private sector can participate in the provision and finance of the welfare system depends on the degree to which the gains from such activity are economically appropriable. Fundamental welfare state reform must involve the development of institutions that yield a socially desirable degree of appropriability.

The remainder of this paper is organised as follows. Section 2 gives an overview of the sources of the welfare state crisis. On this basis, Section 3 summarises the objectives of our reform proposal. Section 4 presents the proposal itself. Section 5 considers some important implications of the proposal. Section 6 concludes.

2. Sources of the Welfare State Crisis

The main institutions of the welfare state--the redistributive systems of taxes and transfers, the pension provisions, the state-run health and education institutions, the job security regulations, the unemployment benefit systems, and various other welfare entitlements--were developed primarily in the 1950s and 60s, when most European countries enjoyed high rates of economic growth, substantial growth of their labour forces, relatively low unemployment rates, and high rates of male labour force participation. Under these circumstances it was relatively easy to provide social insurance, since only a small minority of citizens required unemployment benefits, incapacity payments, and other welfare support. The robust rates of economic growth made it comparatively easy for governments to redistribute income through the tax system and to provide a wide range of social services.

Finally, the relatively rapid growth of the labour force facilitated the payment of generous pensions on a Pay As You Go basis.

Productivity, Unemployment, Labour Force Participation, and Ageing

After the mid-1970s, however, productivity growth fell significantly in Europe as elsewhere. As result, the redistribution of incomes became more painful, bringing the interests of the affluent and the poor into more visible conflict. In the two decades that followed, Europe's labour markets became increasingly segmented, as the employment opportunities of unskilled workers fell significantly behind those of their skilled counterparts. In the aftermath of two oil price shocks and various interest rate and exchange rate shocks, EC unemployment climbed remorselessly, from an average rate of 3.7% in the 1970s, to 9.1% in the 1980s, to around 11% currently.

Over the same period, EC labour force participation fell steadily. As the number of people requiring welfare state support rose relative to the number of those supporting them, there was a steady rise in the level of taxes and transfers necessary to maintain a particular distribution of incomes. Thereby the cost of social cohesion in Europe rose. This development was reinforced by the progressive breakdown of the traditional family (creating a class of single parents facing unemployment or low-paying, insecure jobs) and the ageing of the European population (which augmented the fall in the labour force participation rate and increased the demand for health services).

These various changes have served to make the costs of the European welfare states rise substantially faster than GNP. Since the lion's share of European welfare services has traditionally been financed and provided by the state, government budgets came under progressively increasing pressure, leading governments towards an intensifying search for ways to reduce their welfare commitments.

This drive came at a time when expansions in international trade and growing capital mobility made it increasingly difficult for governments to tax multinational corporations and capital gains. Advances in information technologies made it difficult to the burgeoning communication and information-based services; and increased mobility of professionals made it easier for skilled labour to escape the tax net. In a world in which unskilled labour is left as perhaps the most immobile factor of production, there is a temptation for governments to make this population group - which is in growing need of welfare support - to bear an increasing share of the overall tax burden.

Inefficiency in Welfare Provision

The debate over the need to roll back the welfare state came at a time of increased awareness concerning the limitations of the state in providing public services. With the collapse of communism in Eastern Europe and the former Soviet Union, the inefficiencies of public enterprises received widespread attention. This recognition, together with rising European tax burdens, led to widespread calls for government accountability and an increasing interest in the appropriate degrees of decentralisation of public services. The growing concern for regional and local autonomy and for the principle of subsidiarity is also related to this development.

The efficiency problem in public enterprises often arises for much the same reasons as it does in some large private enterprises: Eliminating waste is difficult and expensive. Unless organisations face severe competitive pressures, it is often in their best interests to be wasteful. Large parts of the European welfare states are government monopolies, facing no competition whatsoever. Under these circumstances, inefficiencies are inevitable. No number of quantitative targets and administrative controls are capable of dealing with this problem, since the services are highly heterogeneous, the public's needs are difficult to assess, and the activities of the suppliers are difficult to monitor. This is the lesson from the performance of centrally planned economies the world over. As long as the welfare states are run along central planning lines, their inefficiency will remain a fact of life.

This inefficiency is usually magnified by the "soft" budget constraints of the welfare state. Unemployment benefits, pensions, national health, and public education are commonly financed through general taxes, and thus the government bodies providing these services often face no sharp, objective standards whereby the costs of these services are brought into relation with the associated benefits. The soft budget constraints also serve as an entry barrier discouraging private-sector provision of welfare services. As long as it is possible for the government to use its tax-levying power to finance welfare services, it can always drive private providers out of business; and the private providers, knowing this, do not seek to enter. Under these circumstances it is also impossible to induce the private-sector financial services industry to contribute to the financing of the welfare system.

The soft budget constraints help explain why the prices of welfare services tend to be gravely distorted. In the face of massive cross-subsidisation among the different domains of the welfare system, there is little incentive - even in the absence of distributional considerations - to make people's financial contributions to the system reflect the costs of the services provided.[1] To overcome this problem, it is not sufficient to introduce "quasi-markets" in the welfare system and prices for welfare services (as, for example, the UK Conservative government did for health provision in the late 1980s and early 1990s). Provided that the government can use its tax receipts to finance the provision of these services, it can keep the prices of state services artificially low.

The Blurring of Boundaries

Yet another source of the welfare crisis is the absence of clear boundaries between the various welfare state domains. The welfare state provides a variety of disparate services - social insurance, social services, redistribution and life-cycle transfers - that have traditionally been seen as the government's responsibility since they were allegedly undeliverable through the market mechanism. These services addressed a diversity of social needs, and there has been no compelling economic or social reason for grouping them together, other than their apparent susceptibility to market failures. However the existing market failures in the provision and finance of welfare services are often the outcome of institutions that prevent the private sector from contributing profitably in this area.

Furthermore, the fiscal practice of grouping "welfare state" activities served to blur the divisions among the different welfare services. For example, unemployment insurance clearly fulfils a quite different functions from income redistribution, but unemployment benefit systems are usually designed to achieve redistributional objectives. This blurring of

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[1] This is the case even in the UK, where major efforts have been made to promote market pricing of welfare services. For example, the marginal cost of participation in the UK Social Security system (for those who can afford it) is less than 2% of the Lower Earnings Limit of about £60 per week. This is less than one sixth of what the UK Conservative Party proposed in 1997 to refund to individuals as contributions to a Chilean-style fully funded state pension.

boundaries has made welfare services particularly susceptible to political pressures. When European governments attempt to roll back the welfare state, they are often guided by the interests of the dominant voting constituencies. Thus the services most prone to cut-backs have been those that benefit the poor and the disadvantaged (who have relatively little electoral clout), while services focusing mainly on middle class (such as pensions and education) have remained relatively unscathed. As result, the European welfare states have shown a tendency to turn into what Lindbeck (1988) has called "transfer states," where much of the tax revenue comes from those who are comfortably off and many of the services go to these people as well. In some countries, unemployment benefit systems and incapacity benefit systems have been changed with a view to lessening their redistributive impact and improving labour market incentives and, as result, the social insurance aspect of these systems has suffered as well. In this way, the blurring of boundaries within the welfare state has robbed governments of policy instruments where by the different types of welfare services may be adjusted in response to the public's different types of needs.

Finally, it is wrong to think that the carousel of taxes and transfers among middle-class groups has little economic impact, just because it gives middle-class people about as much as it takes from them. On the contrary, each tax and transfer places a wedge between people's services and rewards and thereby distorts their incentives to work, invest, and save. This development has raised the cost of running the welfare state and reduced its effectiveness in providing social insurance and in redistributing income.

The Increasing Demand for Welfare Services

Despite European governments' efforts to cut back their welfare state spending, there are good reasons to believe that, over the past two decades, the need for welfare services in Europe has grown at a rate unprecedented for the post-war period. The case for redistributing income - based on the widespread European conviction that social safety nets and compressed distributions of income are important for the preservation of social cohesion - has been strengthened by the growing danger of unemployment and the increasing disparity between the job opportunities of skilled and unskilled workers. The rising youth unemployment, the increasing duration of the unemployment spells of older workers, and the falling average retirement age witnessed in many European countries, must have all served to increase the need for life cycle transfers. The decline of the extended family has reduced access to informal family-level insurance which was an important cushion against unforeseen economic shocks and life-cycle transfers thirty years ago.

The gradual rise in European living standards must have brought with it a steadily increasing demand for public services such as health and education and all forms of social insurance. After all, these welfare services are not inferior goods; the demand for them rises as people's income and wealth increases.[2] For this reason, welfare programs remain broadly popular in Europe, despite their high costs.[3]

At the same time, the rising risks of unemployment and job loss--and particularly the concentration of these risks at particular times (recessions) and on particular people (the unskilled, disadvantaged, poorly educated segments of the European population)--made it steadily more difficult for financial institutions in the private sector to meet the growing needs for social insurance and life cycle transfers. Thus, given the current institutional framework, Europeans have become steadily more dependent on the State for welfare provision.

In sum, the crisis of the welfare state reflects a supply-side failure combined with a growing demand for welfare services. The sources of the crisis - government budgetary problems, rising unemployment, falling labour force participation, ageing of the population, the inefficiencies in providing and financing welfare services, soft budget constraints, and the blurring of boundaries between the different domains of the welfare state - suggest the objectives of our reform proposal.

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[2] There are many illustrations of this relation. For example, Using a sample of 92 countries, the World Bank (1994) finds a strongly positive relationship of pension spending as a percentage of *GDP* (*PS*) and income per capita (*YCAP*) measured in dollars: $PS = 0.66708 + 0.000519\ YCAP$.

[3] This appears to be the case even in the UK which, in the period of Conservative rule (1979-1997) has undertaken particularly stringent measures to roll back welfare services. For example, individuals in the British Household Panel Survey (BHPS) are asked a number of attitudinal questions and they do not indicate either a lack of support for the welfare state or any major recent changes in attitudes. When asked whether they agreed with the statement that: ``All health care should be available free of charge to everyone regardless of their ability to pay", 81.3% of respondents in the 1995-96 wave agreed or strongly agreed as compared with 84.6% in 1991. When asked whether: ``It is the government's

3. Aims of the Proposal

Our proposal has the following objectives.

It aims to increase consumer choice regarding the magnitude and composition of welfare services.

The only way to ensure that welfare services meet the diverse and changing needs of the population is to give people decision-making power over which services to consume and to enable their decisions to guide the provision of these services. The failure of central planning to bring living standards in Eastern Europe and the former Soviet Union into line with those in advanced market economies indicates how important it is to give consumers such decision-making power. The current European welfare states, on the whole, are organised predominantly along the central planning paradigm: Governments usually decide how much to spend on health and education, how much to tax and transfer, how to structure pension provisions and employment regulations, and so on. Although the governments are elected by the citizens, local and national elections are about a lot more than welfare state policy and thus they are a very blunt instrument for determining such policy. The consumers usually have no mechanism whereby they can signal to their governments how to adjust the magnitude and composition of welfare services, taking all the relevant costs and benefits into account. Our proposal is meant to give them such a mechanism.

The proposal seeks to minimise the inefficiencies associated with redistribution by separating the redistributive mechanism from the provision and finance of other welfare state services.

Redistributing income invariably means distorting people's incentives to produce and work and thereby introducing inefficiencies into the market mechanism. For, in purely individualistic terms, redistribution means rewarding some people for something they have

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responsibility to provide a job for everyone who wants one," in 1991 48.7% of respondents not earned in the economic system and depriving others of what they have earned. Within a cohesive society, however, such an individualistic frame of reference is inadequate by itself. There is a widespread belief in Europe that the provision of social safety nets and the avoidance of extreme income inequalities is an important social goal. But there are many ways of pursuing this goal, it is important to choose the policy strategy that minimises the associated inefficiencies.

In the current European welfare systems, incomes are redistributed in a wide variety of ways: through the tax system, pension system and the unemployment benefit system, and frequently also through the housing, the health, and education systems. This institutional structure is needlessly wasteful: distributing money from the employed to the unemployed, from the healthy to the sick, from the privately educated to the publicly educated, and so on, is an inefficient way of distributing money from the rich to the poor, because the rich are not invariably employed, healthy, and privately educated and the poor are not invariably in the opposite camp. Beyond that, this institutional structure makes the redistributive mechanism vulnerable to political pressures such a budgetary difficulties or organisational changes in the pension, unemployment, housing, health, and education systems. Our proposal attempts to avoid this danger by separating the redistributive mechanism from the provision and finance of other welfare services.

The proposal aims to induce the private sector to contribute to the provision and finance of welfare services.

If the need for welfare services is rising with the passage of time whereas the ability of governments to provide these services is shrinking, it is desirable to explore whether the private sector can be enlisted to bridge the gap. There are certain welfare activities - such as redistribution of income - that will presumably remain dependent on government, although charities may be induced to play a significant role. But there are other activities - such as various forms of social insurance, social services, and life-cycle transfers - where the private sector could become usefully involved, provided that the institutional setting is appropriate.

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strongly agreed and in 1995-96 this percentage had risen to 51.0%.

Many branches of European welfare states are constructed in such a way as to make private benefit from welfare provision impossible. The challenge is to alter the institutional structure of the welfare system so as to enable the private sector to derive rewards from involvement in the welfare system. Our proposal seeks to achieve this objective.

The proposal is meant to promote competition between the public and private sectors in the provision and finance of welfare services.

The proposal does not aim to replace the public sector by the private sector in particular areas of welfare activity. Nor does it seek to establish "spheres of influence" for the public and private sector's welfare activities. On the contrary, it aims to make the welfare system "contestable," i.e. to give both the public and private sectors the ability to enter the market for welfare services. The consumers are then in a position to choose who they wish to provide and finance their welfare needs. Whenever a single agent - whether in the public or the private sector - has a monopoly on the provision or finance of any particular service, there are few incentives to avoid waste. But when it is possible for other competitors to enter the market, the incentives are greater, for then an inefficient supplier may be driven out of business. Competition between the public and private sectors may be particularly desirable with regard to welfare services such as health, education, and pensions, since the two sectors have different strengths and weaknesses in these areas. For example, a major advantage of the government in the provision of education services is that it can trace people through the tax system and thereby can avoid monitoring costs and default risks often faced by private enterprises. The private-sector enterprises, on the other hand, often find it easier to provide more highly diversified products than the public sector, e.g. schools for children with special needs and abilities or training programs for firms with idiosyncratic requirements.

The proposal is self-financing.

In the current economic and political climate, welfare reform proposals that are not self-financing usually stand little chance of adoption. Beyond that, the self-financing criterion puts an important discipline on reform proposals. If resources under the current system are wasted, then a policy that eliminates the waste should be able to do so without additional expenditure of resources. Consequently the self-financing criterion is a way of ensuring that any particular welfare reform does indeed improve efficiency. Our proposal attempts to satisfy this criterion.

4. The Proposal

The Establishment of Welfare Accounts

The proposal involves the establishment of "welfare accounts" for every person in a country. There would be four accounts: a *retirement account* (covering pensions), an *unemployment account* (covering unemployment support),[4] a *human capital account* (covering education and training), and a *health account* (covering insurance against sickness and disability). Instead of the current welfare state systems - where welfare services are financed predominantly out of general taxes - people would make ongoing, mandatory contributions to each of these welfare accounts. The balances in these accounts would cover people's major welfare needs.

This reform would replace the current tax-and-transfer system by a system of compulsory saving. When people retire, they would make withdrawals from their retirement accounts. When they become unemployed, they would make withdrawals from their unemployment account instead of claiming unemployment benefits. When they acquire skills, they could draw on their human capital account instead of receiving government grants, subsidies, and loans for education and training. If they are ill or disabled, they could draw on their health account.

Mandatory Contribution and Withdrawal Rates

An important potential problem that the government faces with a welfare account system is moral hazard: If individuals know that their government will care for them in old age, sickness, disability, and poverty regardless of the size of their account balances, they will have an incentive to make insufficient contributions to their accounts and excessive withdrawals from them. Consequently, the government must set mandatory minimum contribution rates and mandatory maximum withdrawal rates. These rates would be set in an actuarially fair manner (using a prospective benefits method such as the actuarial attained age or entry age method), so that for each of the accounts, nation-wide, the discounted value of the associated aggregate benefits equals the discounted value of the aggregate contributions.

The mandatory contribution rates would depend on income and age.

Withdrawals from the welfare accounts would be regulated by the following simple rules. People who reach pensionable age or those become unemployed, ill, or disabled would be entitled to withdraw fixed maximum amounts per month. Like the contribution rates, the withdrawal rates would depend on income and age.

The Provision of Welfare Services

As noted, the private sector gains the incentive to contribute significantly to the welfare system only if the institutional structure of this system makes it impossible for the government to use the tax-and-transfer system to drive the private providers out of business. In order to establish the requisite institutional structure, the proposal in effect insulates the welfare system from the rest of the government's budgetary process. Specifically, the government would have two budgetary systems: one in which non-welfare expenditures (on defence, transport, environmental protection, and so on) are financed through the existing array of taxes (income taxes, VAT, capital gains taxes, and so on), and another system in which the public-sector expenditures on welfare services are financed through payments from people's welfare accounts.

The government would be able to redistribute income across people's welfare accounts, but these redistributions would be constrained to be of the balanced-budget variety: total (economy-wide) taxes on each of the welfare accounts would be equal to total transfers into each of accounts. Thereby our proposal meets one of the central challenges of welfare reform, namely, to enable the government to redistribute income from the rich to the poor without thereby enabling it to use the tax-and-transfer system to finance its welfare provision and thereby discourage private-sector provision. With regard to the health accounts, for example, these would balance for the economy as a whole, and thus the

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[4] Orszag and Snower (1997) examine the labor market implications of unemployment accounts.

government could not use its tax receipts to fund public health and consequently drive down the prices of public health services, thereby keeping private providers from entering the health industry.

Rather, welfare services would be financed solely from what people choose to spend on these services out of their welfare accounts. Consequently, the government would have no incentive to manipulate the contribution rates and withdrawal rates of the welfare accounts in order to ease fiscal pressures outside the welfare state (e.g. to use tax receipts from welfare accounts to finance spending on defence).

The public and private sectors would provide welfare services on an equal footing, setting prices for these services and competing with one another for the custom of the welfare account holders. For instance, with regard to health services, people's health accounts would pay for their health insurance and they could then *choose* the provider of their health services, whether public or private.

In order to prevent the private sector from "cream-skimming" (providing services only to those who are unlikely to receive large payouts and leaving the others to the public sector), private-sector pricing of insurance services would need to be regulated. As in the case of many existing private insurance systems, private providers could be required to make their prices of welfare services dependent only on a small subset of characteristics, such as age and income, and to ignore all others.

The resulting competition between the public and private sectors in the provision of welfare services would encourage efficiency in welfare provision in both sectors.

Income Redistribution and Social Safety Nets

In order to moderate the distortions associated with income redistribution and the provision of social safety nets, the proposal involves redistributing income across people's accounts along the lines of a "conditional negative income tax." People's mandatory contributions to each of their welfare accounts would rise with their incomes. The lowest income groups would receive transfers from the government into each of their welfare accounts. These transfers would pay all or a portion of these people's mandatory account contributions. The greater the levels of income, the lower the transfers. Eventually, at higher income levels, the transfers would give way to taxes. The conditions attached to the transfers for low-income groups would be analogous to those attached to current unemployment benefits. For instance, if the current unemployment benefit system specifies that people must provide evidence of genuine job search in order to qualify for unemployment benefits, then they must also be required to provide such evidence in order to receive the proposed transfers.

Each welfare account would have a specified minimum balance, depending on age and income. If a person's balance in one account fell beneath the specified minimum, he or she would be required to replenish that account with excess funds from the other accounts. If the balances on all accounts fell beneath the specified minima, the government would make specified deposits into these accounts from the mandatory contributions of those who are better off.

This redistributional mechanism would give rise to substantially less distortions than the present welfare systems. For example, with regard to the unemployment account, the conditional negative income tax mechanism would discourage job search, but by substantially less than unemployment benefits do, for when a person finds a job, he loses *all* his unemployment benefits, but only a *fraction* of his negative income taxes. Moreover, since the transfers under the negative income tax system would be *conditional* on proving willingness to accept work (except in cases of disability, illness, or other accepted personal circumstances), they would provide incentives for people to engage in productive activity. Finally, the proposed redistributional mechanism would be more efficient than the current systems at redistributing income from rich to poor, since unemployment benefits, training schemes, and other welfare entitlements are not targeted exclusively at the poor, whereas the transfers under the conditional negative income tax system would be.

Voluntary Contributions and Transfers among Welfare Accounts

People could voluntarily contribute more than the specified minimum amounts to their accounts. Indeed, they would be encouraged to do so: while their *contributions* would be taxed or subsidised in accordance with the conditional negative income tax scheme, *withdrawals and capital income* from their accounts would be taxed at preferential rates (or possibly not taxed at all). Since funds in the welfare accounts would thus have tax benefits relative to ordinary savings, individuals may choose to save more in their welfare accounts than the mandatory minimum amounts.

Employers would be encouraged to contribute to their employees' accounts at the same preferential rates as the employees. The account balances would be fully portable across employers.

If people's balances in a particular account exceeded a specified limit, they could be transferred to other welfare accounts. For example, a person with excess funds in the health account could transfer these to the human capital account to purchase training. At the end of their working lives, the remaining balances in their unemployment and human capital accounts could be transferred into their retirement account.

Furthermore, excess funds (above the mandatory limit) could be withdrawn entirely from the accounts, but doing so would involve a tax penalties commensurate with the tax advantages of contributing to the accounts.

Recruitment and Training Vouchers

In order to provide additional incentives for employment and production, the government would supplement the welfare accounts of long-term unemployed people who purchase government-issued employment vouchers. Specifically, the government would provide subsidies for the long-term unemployed to use their unemployment account withdrawals to purchase "recruitment vouchers" for firms that hire them. Firms receiving the vouchers would be reimbursed by the government through the tax system. The government would also subsidise the long-term unemployed for making withdrawals from their human capital account to provide training vouchers for firms that employ them and send them on nationally accredited training programs.[5]

The size of each person's voucher would depend on his wages earned over next one or two years of subsequent employment, and the firm could claim the voucher at the end of that period. The recruitment vouchers would reduce firms' cost of employing the long-term unemployed; the training vouchers would reduce the cost of training them. The size of the vouchers would be set so that they could be financed through the tax revenues from

[5] A detailed analysis of employment vouchers is given in Orszag and Snower (1996) and Snower (1994, 1996).

people's first two years of subsequent employment and through the abolition of in-work benefits.

The creation of such vouchers would enable the private sector to contribute to the welfare system in the areas of unemployment and training. For instance, the long-term unemployed could hand their vouchers to private-sector employment agencies - public or private - who could split the proceeds of the vouchers with the employers. Since the size of the vouchers would depend on future wages, the employment agencies would have the incentive not just to place their unemployed clients, but to find the highest-paying jobs for them. Moreover, since the agencies would receive voucher payments regardless of whether a worker trained in one firm is "poached" by another firm, the agencies would not face what economists have called the "poaching externality" (whereby firms have insufficient incentives to train their employees, for once the training has been undertaken, the employees may be poached and thus some of the gains from training would accrue to the poaching firms). Under these circumstances, the employment agencies would have greater incentives to seek training for unemployed people than individual employers would have.

Furthermore, the agencies could raise private funding for fighting unemployment by issuing "voucher-backed equities and securities." These financial instruments would be backed by the revenues of the employment agencies, derived from the unemployment and training vouchers which, in turn, are derived from the future contributions of workers to their unemployment accounts and human capital accounts.

Along the same lines, the government could supplement the retirement accounts of pensioners who purchase recruitment vouchers. These vouchers could be financed through the pensions foregone, and the size of these vouchers would depend on the size of the pensions.

The Transition from the Welfare State to the Welfare Account System

To make the transition from the current welfare state systems to the welfare account system fiscally viable, the accounts could initially be run on a Pay-As-You-Go basis. In this respect, the welfare accounts would be similar to savings accounts at commercial banks under a fractional reserve banking system (in which banks are required to hold only a fraction of their deposits in the form of liquid assets). Just as savings account holders in a fractional reserve banking system can make withdrawals from these accounts whenever they need (within a specified framework of rules) even though most of their money (at any given point in time) is used for other purposes, so welfare account holders would be permitted to make withdrawals from their accounts in accordance with the specified rules, even though, at any point in time, the some of the balances in one set of accounts may be used to finance the benefits derived from another set of accounts.

With the passage of time, the welfare accounts could eventually be turned into fully funded systems. This transition could proceed at quite different rates for different accounts, depending on the government's fiscal pressures. For example, it may be easier for a government to move speedily towards a fully funded system of unemployment accounts (where the inter-generational transfers are comparatively small), but to delay this transition for the retirement accounts until demographic trends turn favourable.

Furthermore, the transition to a fully funded system of retirement accounts could be eased through a reform of the timing of taxes. Currently most pensions provide tax relief on contributions rather than on payments; but reversing the direction of tax relief - so that taxes are paid at the time of contribution rather than time of withdrawal - would shift tax revenues from the future to the present, to match the shift of benefits from the future to the present in the transition from a Pay-As-You-Go system to a fully funded one.

Once the transition towards fully funded systems is under way, people could be given discretion over who manages the funded portions of their accounts. The government and private-sector financial institutions could both do so. To guard against bankruptcy, the financial activities of the latter institutions would be regulated, along line similar to the regulation of commercial banks.

5. Implications

Moving from the current welfare state systems to a welfare account system may be expected to play a substantial role in reducing unemployment, encouraging labour force participation, promoting skills, reducing governments' budgetary pressures, cushioning people against economic risks, ensuring efficient provision of health and education services, providing social safety nets and redistributing incomes more efficiently.

Effects on Economic Incentives

Adopting the welfare account system would improve incentives for productive activity as well as for the efficient use and provision of welfare services. For example, moving from unemployment benefits to unemployment accounts would give people greater incentives to avoid long periods of unemployment. For the longer people remain unemployed, the lower will be their unemployment account balances and consequently the smaller the funds available to them later on. Thus the unemployment accounts generate more employment than unempbyment benefits, for a given amount of income redistribution. By implication, the unemployment account contributions necessary to finance a given level of unemployment support would be lower than the taxes necessary to finance the same level of unemployment benefits.

Effects on Economic Efficiency

In general, the welfare accounts would help people to internalise both the benefits and the costs of welfare provision., and thereby discourage them from using welfare services wastefully. For instance, people would have little incentive to use health services wastefully, since the more health services they purchase, the lower will be their health account balances. The same holds for education and training. The human capital accounts would be better suited than the current education and training programmes to ensure people's lifetime employability, since the accounts could be accessed whenever employees and their employers found it maximally worthwhile. Nor would people have an incentive to use pensions wastefully, since they would have the opportunity of finding employment by using their pension withdrawals to purchase recruitment vouchers.

Since both the public and private sectors would be able to provide social services (such as health services, education and training), life-cycle transfer services (such as pensions), and social insurance (such as unemployment and disability insurance), these markets would become contestable and thereby promote the efficient provision of these services.

Encouraging Investment

The welfare account funds invested by the financial sector would stimulate investment. Indeed these funds could become a key component of EU investment: since the funds would characteristically have liabilities with relatively long durations, these funds could be used to finance long-term investments crucial for maintaining economic growth and competitiveness.

Encouraging Private-Sector Finance of the Welfare System

Once the government and the private sector are competing on an equal footing in providing welfare services, it becomes possible to enlist the support of the financial services industry to provide the requisite finance. In the previous section, we indicated how the creation of recruitment and training vouchers could induce employment agencies to use voucher-backed equities and securities. Permitting the private sector to compete with the public sector in the provision of health, education, and pension services would similarly induce the financial industry to issue equities, securities, and other financial instruments to help finance the welfare system.

Under the above-mentioned circumstances, the financial industry would also have an incentive to contribute to the provision of insurance against major economic risks such as unemployment and fluctuations in human capital. A major reason why reason the private sector has no role in this area under the present system is moral hazard: if people could guarantee their incomes regardless of whether they are employed and regardless of whether they are trained, they would have little incentive to seek jobs and acquire skills. Insurance companies, knowing this, refuse to provide income insurance. However, adverse events - such as earthquakes, fire, theft, and so on - that are objectively monitorable and beyond the control of individual economic agents, are not associated with moral hazard and thus can be insured against. Another source of moral hazard under the present system originates from government behaviour. When the government can finance unemployment benefits and public training programs through general taxes, it is always in a position to drive private providers of unemployment and human capital insurance out of business.

But if the government is constrained to keep each set of welfare accounts in economy-wide balance and to compete with the private sector in promoting employment and training, it is possible to create liquid claims - securities and options - whose values depend on aggregate unemployment and aggregate productivity. Since these aggregates are beyond the control of individual agents, they are not subject to moral hazard, and the claims on the aggregates can be used as a source of unemployment and human capital insurance. (See Shiller (1993) for details of how to insure against macroeconomic fluctuations.) In this way, the private sector can become involved in expanding the welfare system in tandem of with people's expanding needs.

6. Conclusions

The proposal for welfare state reform is related in spirit to the Central Provident Fund system in Singapore and the defined-contribution pensions schemes that have been implemented in Chile and Australia. The account framework is consonant with the policy proposal of Folster (1996). The major innovation in our proposal, however, lies in its use of welfare accounts to (i) encourage the private sector to contribute to the provision and finance of welfare services, (ii) increase consumer choice regarding the magnitude and composition of these services, (iii) make the provision of social safety nets and the redistribution of income less inefficient and less vulnerable to political pressures, and (iv) to promote competition between the public and private sectors in the welfare system.

A common objection to personalised accounts is that these are allegedly tied to a fully funded system, but any rapid transition to such a system from a Pay-As-You-Go system may be impossible in most European countries. We have argued, however, that welfare accounts are compatible with a Pay-As-You-Go system, and thus the issue of the feasibility of transition may be decoupled from the issue of whether welfare accounts are socially desirable.

While people are generally resentful of their tax burden and often demeaned by the existing unemployment benefits and training programmes, they would be more willing to contribute to personalised accounts for their own purposes. The accounts would give people more freedom to meet their diverse individual needs. It would give them greater latitude to respond to changing job opportunities, finance periods of job search, acquire skills, and provide for retirement. And all this could be done without creating greater inequality or increasing government expenditure.

Since the adoption of the welfare account system would stimulate employment and productivity, both employers and employees stand to gain from the switch to accounts. Retired people would gain through their ability to use their accounts balances to augment their pensions. And the government would gain, since the removal of the distortions from unemployment benefit system would promote new economic activity and thereby generate increased tax revenue.

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