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Challenges to Social Cohesion

and a Strategy for Economic Policy Reform

by Dennis J. Snower

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Now, at the end of the 20th century, many OECD countries face serious problems in achieving both prosperity and social cohesion. One important - and sadly neglected - source of these problems are the very policy systems that are meant to address them. I will argue that these policy systems - including taxes and transfers, regulations governing employment, welfare services, and many more - are imparting a serious long-term imbalance to their host countries, by making these countries increasingly vulnerable to economic, social and political shocks. Although these policy systems were originally designed with the express aim to cushion citizens from these shocks and to provide security against a variety of uncertainties, their long-term effect is turning out to be the opposite of what was intended.

This paper examines how and why this has happened and then turns to some important, recent economic developments that are likely to make this problem more serious in the future. Finally, it examines a strategy for economic policy reform that addresses the problem and thereby provides a means for achieving more favorable economic and social outcomes in the years ahead.

1. Policy Systems as a Source of Imbalance in the OECD

The central pillars of the main OECD policy systems - unemployment benefit systems, job security regulations, networks of taxes and transfers, pension systems, health and education systems, and various other groups of welfare state entitlements - were erected in the golden years of the 1950s and 60s, when economic growth was high, the labor force was increasing, unemployment was low, and poverty was falling. In the light of this propitious economic performance, only a small minority of citizens required the support that the welfare states were offering, and even when they did so, the need was often only temporary. Under these circumstances, it was possible for governments to be generous in providing support for the poor, benefits for the unemployed, pensions for the elderly, education for the young, and health care for the sick.

With the upsurge in economic activity, a large group of tax-paying, employed people helped support a relatively small group of unemployed ones; a large group of healthy people provided for a small group of unhealthy and disabled ones. As populations and labor forces grew, a relatively large group of young people financed

the pensions of a relatively small group of retirees. In short, the prevailing economic policy systems were able to provide substantial economic security and protection against poverty as long as little reliance was placed on these systems.

But the services of these systems have been important to most people's well-being even when they were not used. An important reason is that people often get stuck in unfavorable economic and social states unless they receive prompt help in overcoming them. those who become ill may remain unhealthy unless they receive prompt treatment; people who fall into poverty may remain there unless they receive some support to improve their skills and gain appropriate employment; people who become unemployed require prompt incentives to find work again, before they become deskilled, unmotivated, and stigmatized. In these various ways, welfare state policy systems made important contributions to prosperity and social cohesion, even though only a relatively small minority of the population made use of them at any given point in time.

In a sense, the service of these policy systems played a role similar to fire insurance in making a significant contribution to one's peace of mind even when one's house hasn't burnt down. The ability of these policy systems to cushion people from economic uncertainties and to correct glaring market failures in the provision of education, health insurance, unemployment insurance, and pensions doubtlessly played an important role in promoting the postwar prosperity. Public support for education helped raise people's skills; job security legislation helped bond employers to their employees and thereby gave both parties incentives to invest in training; unemployment benefits gave the temporarily unemployed people the means to search for the appropriate jobs, rather than accepting the first position that came along; public health provision helped promote a healthier, and hence more productive, workforce; income redistribution systems and poverty programs helped create more cohesive societies and reduce social polarization along with the associated costs of crime and social tension.

In these many ways, the welfare states amplified the favorable economic and social conditions most OECD countries faced in the early postwar years.

But then, around the mid-1970s, the party came to an end. After the first oil price shock in 1973, trend productivity growth in most market economies fell sharply and, despite subsequent booms and periods of optimism, has not recovered since then.

As result, poverty became a more challenging problem and income redistribution, to meet this problem, became more painful. As the postwar baby boom subsided, population growth slowed, particularly in Europe. This meant that the people of working age were required to support an increasingly larger proportion of older people. In addition, the increasingly generous pensions, which the retirees were unable to bequeath to their children, reduced people's incentive to save, and stimulated consumption at the expense of capital accumulation. Furthermore, the long recessions of the mid-1970s, early 1980s, and early 1990s - interacting with the European nexus of stringent job security provisions and generous unemployment benefits - made European unemployment rates drift inexorably upwards, from an average EC rate of 3.7% in the 1970s, to 9.1% in the 1980s, to around 11% now. Thus unemployment benefits and income support, which were originally designed to tide people over temporary jobless spells, became their mainstay over many years and, in some cases, the basis for an unemployed way of life. In Europe, therefore, the employed tax payers were required to support a growing segment of unemployed claimants.

On account of these developments, welfare state spending rose rapidly as percentage of GNP in Europe and most other OECD areas. This rise in spending, combined with the shrinking tax base, made it necessary to governments to raise taxes and public borrowing. Increasingly, these governments found it difficult to meet their commitments in supporting education, health, disability, housing, unemployment insurance, and pensions. The increasing taxes on employers discouraged job creation, the increasing taxes on employees discouraged job search, the increasing taxes on non-wage incomes and wealth discouraged saving and capital accumulation. Public borrowing put upward pressure on real interest rates, thereby discourage capital accumulation even more.

After about a decade of these developments, it was therefore virtually inevitable therefore that governments in many OECD countries should find themselves confronted by an overwhelming need for retrenchment in the 1980s. The pace and scale of this retrenchment process varied considerably among the OECD countries and was dictated profoundly by voting arithmetic. As result, the process turned out to be highly asymmetric. Since the poor and the unemployed are generally not a large or influential segment of the voting population, it has often been easier for governments to relinquish previous commitments to these groups than to the middle

classes. Thus, in many OECD countries, eligibility criteria for unemployment benefits and income support were tightened, monitoring procedures for the fulfillment of these criteria became more stringent, regulations were relaxed to allow greater scope for temporary, part-time, and self-employment, and the growth of various poverty programs was arrested or rolled back. On the other hand, public spending on pensions and (to a somewhat lesser degree) on education and health has been largely unaffected by the drive towards fiscal austerity. Job security legislation protecting the positions of the established, incumbent employees was also left largely intact.

As result, governments have become progressively less able to protect their citizens from economic uncertainties - just at the time when these uncertainties were growing. A wide variety of forces - including the liberalization of product markets, the expansion of international trade and capital flows, the skill-bias of recent technological advances, and changes in the organization of firms - has led to an increasing dispersion of wages or employment opportunities in many OECD countries. This dispersion has been amplified through the asymmetric course of policy retrenchment since the 1980s. As transfers to the middle classes have remained intact while support for the poor and disadvantaged as fallen away, the distribution of economic outcomes has inevitably widened further. Thus societies have become progressively polarized, between the long-term employed and the long-term unemployed, the high-wage and low-wage earners, or those with abundant and favorable job opportunities and those with few and unfavorable ones. As firms become increasingly vulnerable to market forces, there is a danger that long-term commitments between employers and employees may become increasingly unstuck, thereby reducing the incentives to invest in training. The social polarization threatens the efficiency of market transactions by encouraging crime and necessitating rising expenditures on crime prevention.

2. The “Quicksand Effect”

In retrospect, we can see that just many of the common OECD policy systems amplified the favorable social and economic developments of the 1950s and 60s, so they are also amplifying the unfavorable developments that have occurred since then. I would like to call this the “quicksand effect.” It signifies that, in the long run, the

prevailing policy systems have not provided a firm foundation for supporting people against poverty and uncertainty and promoting prosperity and social cohesion. Rather, the more people need to be supported, the greater are the political and economic pressures on governments to reduce that support. The prevailing policy systems, in other words, are a bit like quicksand: they start giving way as soon as enough weight is placed on them.

Conversely, the less the support is required, the greater are the political pressures to make it more generous. This is the sense in which the prevailing policy systems have created economic and social imbalance over the long run.

3. A General Strategy of Policy Reform

It is important to keep in mind that this imbalance is the product of past policy decisions, which may be revised once the source of the imbalance has been recognized. To find the appropriate guidelines for policy reform, European governments must first understand the need to design policies that are automatic stabilizers in two senses at the same time: When there is an increase in the likelihood of an adverse economic or social contingency - such as the risk of unemployment, illness, poverty, insufficient education and training opportunities, insufficient support for old age - the policies must automatically provide

- more support for the people affected by that contingency, and
- greater economic incentives to overcome the contingency.

To see how this works in a specific instance, consider the implications for this strategy for the reform of unemployment policy. Here the aim is to replace current unemployment policy measures by ones that have the following dual stabilizer function: when unemployment rises, they must automatically provide (i) more support for the unemployed and (ii) greater incentives for employment creation and job search.

Current unemployment benefit systems fulfill the first condition but not the second. When unemployment rises, the government's aggregate unemployment benefit payments increase, providing more support for the unemployed. But incentives for employment creation and job search are reduced: the unemployment benefits discourage the unemployed from seeking jobs, for when an unemployed person finds a job, the unemployment benefits are withdrawn and taxes are imposed; furthermore,

the unemployment benefits put upward pressure on wages and thereby discourage employment. And it is because current unemployment benefit systems do not act as unemployment stabilizers in the second sense, that the quicksand effect arises. Since these systems augment the underlying unemployment problem, they destabilize the government's budget and thereby create political pressures to make these systems less generous.

Reform of current economic policy systems should be aimed at breaking this trade-off between stability of people's incomes and stability of the government budget deficits. Before examining the requisite reform strategy, we turn some important recent developments that may be expected to make the underlying problem worse - and thus the need for reform more urgent - with the passage of time.

4. Challenges to Social Cohesion

Let us now consider three important challenges that will make it increasingly difficult for policy makers to achieve prosperity growth *together with* social cohesion in the decades ahead. Although these challenges are strongly interrelated, we will consider them under the broad headings of (a) globalization and skill-biased technological change, and (ii) changes in the organization of firms.

4a. Globalization and Skill-Biased Technological Change

In recent years it has often been claimed that the gradual erosion of barriers to international trade and foreign direct investment has expanded both the market opportunities and competitive pressures faced by many companies in the OECD, and this has created an increasingly global matrix of business strategies. One important consequence of this development, so the story goes, is that the advanced market economies are achieving an ever more pronounced comparative advantage in the production of commodities that are relatively intensive in skilled labor.[1] This is often

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[1]See, for example, Leamer (1994), Sachs and Schatz (1994), and Wood (1994)

touted as the reason why the demand for skilled labor has risen relative to that for unskilled labor in Europe as well as the United States.[2]

In the US, where wages are comparatively flexible, the response has allegedly been increasing wage dispersion; in many European countries - where wages are compressed through legislation, centralized bargaining, norms, union pressures, and welfare state entitlements - the result has been rising unemployment of unskilled people. In either case, the resulting trend toward greater inequality in income and wealth is seen to pose a major threat to social cohesion in the advanced market economies. It is also viewed as endangering the future prosperity of these countries, as goods requiring low-skill labor inputs are increasingly imported and factories to produce these goods are increasingly shifted to the low-wage economies of the Far East and Central Europe.

This account doubtlessly has some explanatory power, but it does not tell the full story since it doesn't fit all the relevant facts:

- Trade flows are probably still too small a proportion of national product in Europe and the US to account for more than a small percentage of the massive increase in European unemployment and the dramatic fanning out of the American wage distribution over the 1980s.
- A significant amount of trade between the advanced market economies of Europe and the US (on the one hand) and the emerging markets of Asia and the East (on the other) is intra-industry - not inter-industry - trade, even at the three-digit level; and there is little reason of course why intra-industry trade should raise the demand for skilled relative to unskilled labor.
- According to the conventional wisdom,[3] the expansion of international trade induces the unskilled workers to move from the import-competing sectors (where wages are comparatively low and/or unemployment is comparatively high) to the protected sectors. But there appears to have been little movement of this sort in the advanced market economies. Instead of a change in the industry mix - a rise in the use of skilled labor in the sectors producing skill-intensive goods and a fall in the

[2]In accordance with the Stolper-Samuelson theorem, the fall in demand for unskilled workers will spill over from the tradable to the non-tradable sectors.
[3] This view is founded on the Hecksher-Ohlin trade theory of international trade.

use of labor elsewhere - most sectors have increased their ratio of skilled to unskilled labor.

- It is far from clear that the skill level (weighted by population) of the countries trading with Europe and the US has, on average, gone down (on account of, say, the increasing role of China in world trade) or up (on account of the rising skill levels of, say, the Japanese and Korean workforce).

Beyond that, technological change is often deemed to be another explanation for the joint problems of increasing wage dispersion and unemployment in many OECD countries. It is argued that the technological change over the past two decades has been heavily skill-biased - once again, raising the demand for skilled relative to unskilled labor.[4] There is some evidence that firms spending relatively large amounts on R&D tend to pay relatively high wages to their skilled employees[5]. There is also evidence that workers who use computers tend to earn relatively high wages[6].

There is, however, an important sense in which this is not an explanation at all. Economists define technological change as anything that shifts the production function. It is the residual change in output, after all other sources - namely, change in the use of inputs - have been accounted for. Since it is a residual, we simply don't know where is comes from. Thus to say that the rise in the demand for skilled relative to unskilled workers is due to skill-biased technological change virtually like saying that we don't know why this change in relative demand has occurred.

In any case, it is clear that globalization and skill-biased technological change are bound to make many of the current economic policy systems greater sources of imbalance. The reason is that, by widening the distribution of incomes, they widen and deepen citizen's reliance on public support and thereby augment the quicksand effect.

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[4]See, for example, Bound and Johnson (1992) and Mincer (1989, 1991).
[5]For example, Machin (1996).
[6]This is documented in Berman, Bound and Griliches (1993) and Krueger (1993). Krueger claims that computer use on the job can account for 1/3 to 1/2 of the rise in the rate of return to education.

4b. The Organizational Revolution

Another important development, that has been documented extensively in the recent business management and sociological literature[7] but has received hardly any attention from the economics profession,[8] is a constellation of phenomena that I shall call facets of the "organizational revolution". It has the following salient features.

First, in a significant and growing cross-section of companies in the advanced market economies, the command-and-control style of management - where authority flows from the senior executives down through middle management to the workers in the functional departments - is being replaced by a flatter organizational structure, with a large number of teams reporting directly to the central management with few, if any, intermediaries.

In the process, the functional specialization of the traditional firms is being reversed: each of the small teams performs many of the separate tasks that used to be divided among separate departments. The teams are now often organized with reference to particular sets of customers rather than tasks. It is the "integration" of tasks that permits the teams to give customers more individual attention. This development also means that substantial layers of middle management are no longer needed.

Second, there are radical, interrelated changes in the organization of production. In both the manufacturing and service sectors, returns to scale in production are drastically reduced, with the introduction of flexible machine tools and programmable equipment and the use of computer-aided customization of goods and services. Setup and retooling costs have come down, and this permits production in smaller batch sizes, shorter production cycles, smaller delivery lags, and - with the help of computer-aided design - quicker product development.

These changes have enabled producers to adopt ideas such as "lean production" (keeping inventories low) and "just-in-time production" (delivering supplies only when they are required). These are not simply cost-cutting devices. They are also a

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[7]For a survey of the evidence on these developments, see Appelbaum and Bott (1994), Hammer and Champy (1993), Lundgren (1994), Pfeffer (1994), and Wickstrom and Norman (1994).

[8]First attempt to subject these phenomena to economic analysis is made in Lindbeck and Snower (1995a,b), and Snower (1996d). Milgrom and Roberts (1990) examine a subset of these phenomena relevant to manufacturing.

method of decentralizing the production and associated learning process, since they expose bottlenecks where they arise and give the front-line workers the opportunity to overcome them on their own. The new innovations also permit an increasing degree of integration between design, engineering, and manufacturing.

Third, there have been dramatic changes in the nature of products and in seller-customer relations. The new "holistic" companies offer broader product lines in smaller quantities. There is also greater emphasis on product quality and sensitivity to purchasers' requirements: products are developed and improved over progressively shorter periods of time, methods of quality control are becoming steadily more stringent, and more product adjustments are made in response to customer demand. There is also increasing scope for customer participation in the design of new products. These include not only information and repairs, but also prompt processing of orders and individualized marketing.

Fourth, in the new types of business organizations, occupational barriers are beginning to break down, as employees are given multiple responsibilities, often spanning production, development, finance, accounting, administration, training, and customer relations.

The new, smaller, customer-oriented teams require versatility, cognitive and social competence, as well as judgment. What matters is not only the competence in a particular activity of production, organization, development, and marketing, but rather all-round knowledge, potential to acquire multiple skills, and ability to learn how the experience gained from one skill enhances another skill. In this context, traditional occupational distinctions begin to lose their significance and what we mean by "skilled" versus "unskilled" workers becomes radically changed.

The implications of these developments is far-reaching. To begin with, they help explain the rising resistance to centralized wage bargaining relative to firm-level bargaining in many OECD countries. A usual objective of centralized bargaining is "equal pay for equal work", and this it invariably imposes some uniformity of wages across workers for given tasks. But when employees are given multiple responsibilities, spanning various complementary tasks, this practice can become very inefficient, for there is no reason to believe that the productivity of one employee's time at a particular task should be similar to the productivity of another employee's time at that task. For instance, there is no reason that time spent with customers

should affect the productivity of a product designer in the same way as it affects the productivity of a production worker. Thus the restructured firms often have an incentive to offer different workers different wages for the same task. But this is precisely the practice that centralized wage bargaining inhibits. In this way, the restructuring process raises the efficiency costs of centralized bargaining and thus gives employers and employees growing incentives to choose decentralized bargaining arrangements instead. This, however, may be expected to increase wage dispersion in countries where centralized bargaining has compressed the distribution of wages.

Furthermore, insofar as women tend to specialize less in terms of skills than men, these developments help explain some of the narrowing male-female wage differentials and nonemployment differentials. And finally, insofar as people within given occupational, educational, and job tenure groups differ substantially in terms of their versatility as well as the social and cognitive skills necessary for success in holistic organizations, these development also offer a new explanation for the widening wage dispersion *within* these occupational, educational, and job tenure groups.

The organizational revolution magnifies the influence of globalization and skill-biased technological change on the performance of the currently dominant OECD policy systems. Specifically, the organizational revolution makes it more likely that these systems will become a source of economic and social imbalance in the long run. The reason is that, by increasing the dispersion of incomes between versatile and non-versatile workers and between well educated and poorly educated ones, and by making jobs less secure than heretofore, this phenomenon is likely to create greater social reliance unemployment insurance, public support for education and training, and a wide variety of welfare state services. In this process, the existing policy systems run a much increased risk of generating the quicksand effect.

5. Illustrative Reform Proposals

To meet the challenges above, many OECD countries require a fundamental reform of their current policy systems, so as to avoid the pitfall of relying on measures that give way as soon as there is a significant demand for them. As noted, a promising way to do so is to design networks of policies that not only give automatic support to

people facing adverse economic and social contingencies, but also automatically provide greater economic incentives to overcome these contingencies. The following set of complementary policy approaches are a good illustration of how this could be achieved.

5a. The Opt-Out Program

The idea this proposal[9] is simple. Classify everyone in the economy by income, age, sex, marital status, and other major determinants of people's demand for welfare state services, and compute the per capita cost of these services within each group. The proposal is then to give people the option of relinquishing their entitlements to these services in specific areas in return for a rebate amounting to x% of the cost of these services within their particular group. (In practice, the rebate could amount to about 70%.)

If the entitlements accrue at present (as in the case of public education for people with children of school age), the rebate would take the form of a tax reduction. On the other hand, if the entitlements are to accrue in the future (as in the case of pensions for those of working age), the rebate would take the form of a bond, with a maturity commensurate with the time when the entitlements accrue. This option is to be supplemented by compulsory insurance against sickness, disability, and old age.

That would leave (1-x) % of the funds to cover the deadweight loss arising when people who consume a disproportionately small fraction of each type of service take disproportionately large advantage of the opt-out option. By specifying the personal characteristics of each opt-out group sufficiently narrowly, governments could reduce the deadweight loss below x% of the available funds, leaving a surplus to improve the state-provided services.

The motivation is to put the decision between public and private welfare provision into the hands of the consumer. 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 get this decision right. The strength of the advanced market economies has been to put the decision into the

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[9]For a rigorous analysis, see Snower (1996b).

hands of the consumer. The Opt-Out Program puts the division of responsibility over welfare state services into the consumer's hands as well.

It is often argued that allowing people to leave the welfare state system would turn it into a poverty program, and that services for the poor eventually turn into poor services. This argument, however, does not apply to the Opt-Out Program. First, there would be no special incentive for the rich to opt out while the poor stay in. Those affluent people who consume little of these services would thus get a small rebate and have a correspondingly small incentive to opt out. Those making greater claims on these services (such as the middle classes on pensions and education, or the poor on housing and non-contributory benefits) would receive a larger rebate and have a correspondingly larger incentive to opt out. Second, under the Opt-Out Program, the size of the rebate for those who have opted out is tied to the cost of the state-provided services for those who have remained in. Thus those who opt out would have no incentive to vote for a run-down of the state sector.

The Opt-Out Program is equivalent to giving everyone a voucher for specific welfare state services, with the size of the voucher depending on personal characteristics, and with somewhat larger vouchers going to those who do not opt out of the state system. The Program thereby gives people appropriate incentives for choosing between public and private provision of welfare state services. People who opt out will be the ones whose particular needs can be met more adequately through private providers. Given the enormous diversity of needs and the inevitable standardization of publicly provided services, it is inevitable that such people should exist. Consequently, the public and private welfare state systems would exist side by side, each providing services in which they have a comparative advantage. The resulting competition would give both an incentive to become more efficient than they would otherwise be.

In short, the Opt-Out Program is a straightforward way for governments to reduce their spending on the "welfare society" without putting significant segments of the voting population at a disadvantage. The reduction in distortionary tax-and-transfer arrangements should gradually generate enough saving to the government - through taxation of the new private sector welfare provision - to permit improved state provision.

Observe how this program operates as a dual stabilizer and thereby avoids the quicksand effect. It provides not only support against economic and social uncertainties, but also automatically raises the incentives to overcome these uncertainties when the need of support rises. Under the policy regime established by this program, a government that reduces its welfare state services in the face of budgetary pressures would thereby induce more people to opt-out of public sector provision. Since these people would all receive rebates for relinquishing their entitlements to public support, this policy strategy would not ease the government's budgetary problems. In this way, the government would be forced to internalize some important social costs and benefits of its welfare state involvement.

5b. Government Loan Guarantees

This proposal involves a simple, inexpensive way in which the government could help the private sector to provide some important welfare state services more efficiently.

Many of the problems that the welfare state attempts to address have their origins in imperfect capital markets. The problem of unemployment is an example. The hardship from unemployment is due not only to the reduction in people's lifetime income but also to their inability to borrow against their incomes in future periods of employment. The most appropriate way of dealing with this problem is not through government provision of unemployment benefits, but through government loan guarantees.[10]

The reason why the free market generally does not give people the opportunity to borrow against their human capital is that banks usually have trouble collecting the debts from people who change jobs and geographical regions, and thus lending on the basis of human capital would encourage default. The government, however, has a comparative advantage in this area. Unlike banks, it is able to trace people through the tax system and is thus in an advantageous position to make loan guarantees. Once loans on human capital have thereby been made possible, people's unemployment durations would become more efficient since they would now come closer to paying

[10] See Snower (1993).

for the cost of their unemployment as well as receiving the benefits from a judicious job match.

Roughly the same approach is also appropriate to education. The main reason why the free market provides less than the efficient amount of education is that students are generally unable to borrow against their future incomes. Government loan guarantees would help students, particularly poor students, in acquiring a more efficient amount of education, since they would come closer to internalizing both the costs and the benefits from their education.

Loan guarantees for health insurance would also promote efficiency in this market and help bring poor people's opportunities for health cover a step closer to those of the more affluent.

This policy clearly has a dual stabilizer function that helps circumvent the quicksand effect. The loan guarantees would be maximally effective in providing support against unemployment, education, and health care when the public's need for these services was greatest. Since the loan guarantees would stimulate private sector activity, the government's tax revenue from this activity may generally be expected to outweigh its costs of loan default, thereby making the government's budget less, rather than more, sensitive to external shocks.

5c. Support Accounts

This proposal is to replace current public support systems by *support accounts* (SAs). The budgets of the current public support systems - such as unemployment benefit systems, public pension plans, and nationalized health care, and publicly provided education - are often financed out of general taxes. Under the proposal, employed people would be required to make ongoing contributions to their SAs and the balances on these accounts would each individually be used to cover their pension requirements, their health and education needs, and their income support whenever periods of unemployment, illness, or disability lead to financial distress.[11]

The basic idea is to replace the current tax-and-transfer system - whereby general tax revenues are used to finance unemployment benefits, pensions, public

[11]This proposal is similar in spirit to the Central Provident Fund system in Singapore. It bears some resemblance to the reform proposal in Folster (1994). For an analytical study, see Snower (1996c).

health and education - by a system of compulsory private saving. When people become old, unemployed, ill, disabled, or have children of school age, their withdrawals from their SAs would be the substitute for the unemployment benefits, public pensions, etc. they currently receive. Thus their financial support would depend significantly on the accumulated balances in their SAs.

To meet its equity objectives, the government would top up the contributions of individuals in the lowest income groups. In fact, when an individual's SA has been exhausted (i.e. the SA balance falls to zero) and all the permissible transfers among SAs have been exploited, the person would becomes entitled to assistance from the government on precisely the same terms under the current public support systems. Correspondingly, a portion of each employed person's SA contributions, month by month, would be spent on an "assistance charge" to help finance the assistance above.

When people's SA balances are sufficiently high, they could use the surplus funds for any other purposes; and at the end of their working lives, their remaining SA balances in their unemployment accounts could be transferred into their pension schemes. Balances remaining at the end of one's life could be bequeathed to one's successors.

The aim of the proposal is to reduce the major efficiency losses created by the current public support systems without sacrificing their underlying redistributive goals. For example, unlike unemployment benefits, the unemployment SAs would do less to discourage job search, for when an unemployed person finds a job and contributes to his unemployment SA, he is reducing the financial uncertainty associated with future periods of unemployment and creating wealth that he will be able to use later on. Moreover, the pension SAs would do less to discourage saving then public pension plans, since pension SA balances can be bequeathed whereas the public pension plans cannot.

People would be given some discretion over who could manage their SA funds: the government or financial institutions in the private sector. To minimize the danger of bankruptcy, the financial activities of the private-sector SA fund managers would have to be regulated, along lines similar to the regulation of commercial banks.

The process of transition from the current public support systems to ones based on SAs would of course have to be gradual. It takes time for people to accumulate the requisite SA balances. Perhaps the simplest way of organizing the

transition process would be to put new entrants to the labor force under the SA system. The Opt-Out Program would enable people to speed this transition process up, perhaps substantially.

It is easy to see that the SAs would act as automatic stabilizers in both senses above, not only securing people against uncertainties and stabilizing their incomes, but also creating greater incentives to overcome the underlying problem. Consider the effect of unemployment SAs, for example. These would not only provide support when people are unemployed, but also generate greater incentives for employment creation and job search as unemployment rises. The greater is the expected duration of unemployment, the greater would be the incentive for people to avoid periods of unemployment. For the longer a person is unemployed, the lower would be his unemployment SA balance and thus the smaller the funds available to him at a later date. In this way, the unemployed person would internalize many of the social costs generated by his unemployment. And this efficiency gain could be achieved without sacrificing their underlying redistributive goals. Besides, the unemployment SAs are more efficient than unemployment benefits at redistributing income from rich to poor, since unemployment benefits are not targeted at the poor, whereas government unemployment assistance under the USA system is.

Moving from the current public support systems to the SA system could have a profound effect on economic activities. People would have greater incentives to avoid the risks of unemployment, illness and disability. The reason is that under the current public support systems, people receive few financial penalties. For example, people pay no costs for remaining unemployed other than those associated with current income foregone and a possible reduction in prospects of future employment. When an unemployed person finds a job, his unemployment benefits and various welfare state entitlements are withdrawn and taxes are imposed, and this discourages him from job search. The disincentive effect is particularly large for people considering the movement from unemployment into part-time or temporary employment. Under the SA system, by contrast, this disincentive effect would be far less pronounced. The longer a person remains unemployed, the lower will be his SA balance and consequently the smaller the funds available to him at a later date. Here the

unemployed person is largely internalizing the social costs generated by his unemployment.[12] The same principle holds for the health care accounts.

On this account, the SA contributions necessary to finance a particular level of unemployment, health, and disability support (in the form of SA disbursements) will be lower than the taxes necessary to finance the same level of support under the current system of public provision financed through general taxation. In this way, the public stands to gain from a switch from the current public support systems to the SA system.

5d. Conditional Negative Income Taxes

The previous proposals were predominantly concerned with promoting prosperity by making the provision of state services more efficient. We now turn to proposals that are primarily aimed at promoting social cohesion through the redistribution of income. On the whole, most OECD countries conduct such redistribution in exceedingly inefficient ways, needlessly reducing incentives for employment and production and imposing unnecessary burdens on governments' budgets, thereby enhancing the quicksand effect.

This section considers a promising, largely untried, policy alternative: the conditional negative income tax. To put the advantages of this policy into sharp perspective and to illustrate what the negative income tax should be "conditional" on, it is useful to view it as replacing a current redistributive policy, such as the current unemployment benefit system. In this context, the conditions attached to the proposed negative income tax would be analogous to those attached to current unemployment benefits. For instance if, under the current unemployment benefit system, people must provide evidence of serious job search in order to qualify for unemployment benefits, then they must also be required to provide such evidence under the proposed conditional negative income tax system; If unemployment benefits decline with unemployment duration under the current benefit system, then so too must the negative income taxes.

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[12]Some of the disincentive effect remains, of course, through the government unemployment assistance and the associated assistance charge.

The broad argument in favour of this switch from unemployment benefits to negative income taxes is that this policy could meet the equity and efficiency objectives of current unemployment benefit systems more effectively than the unemployment benefit systems themselves. Although conditional negative income taxes would generate the same type of policy inefficiencies as unemployment benefits, the former would tend to do so to a lesser degree than the latter. For example, negative income taxes may be expected to discourage job search, but by less than unemployment benefits, for when a worker finds a job, he loses *all* his unemployment benefits, but only a *fraction* of his negative income taxes.

It is worth noting that a major criticism of the traditional negative income tax schemes - namely, that they make people's material well-being less dependent on employment and thereby discourage employment - obviously doesn't apply to *conditional* negative income taxes, since these taxes are conditional on the same things as current unemployment benefits.

Furthermore, conditional negative income taxes also tend to be more effective than unemployment benefits in overcoming labour market inefficiencies generated by credit constraints (e.g. people being unable to take enough time to find an appropriate job match or unable to acquire the appropriate amount of training on account of credit constraints), since the presence of these constraints is more closely associated with low incomes than with unemployment.

Against this, conditional negative income taxes are by their nature less effective than the economic theorists' socially optimal unemployment insurance schemes in overcoming efficiency problems in the unemployment insurance market (such as the problems of moral hazard and adverse selection). The reason, of course, is that conditional negative income taxes are designed to reduce people's risk of poverty, rather than risk of unemployment. However, the practical significance of comparing conditional negative income taxes with socially optimal unemployment insurance schemes is generally small, since the unemployment benefit systems operative in most OECD countries do not to have much in common with the central features of optimal unemployment insurance. One reason is that most of the existing unemployment insurance schemes either impose ceilings on benefits are a these benefits as flat rates, while optimal unemployment insurance does not have is property. In many European countries, the duration of unemployment benefits is not closely tied to the previous

span of employment, which optimal unemployment insurance would clearly do. Moreover, the relative contributions of employers, employees, and the government to the current unemployment insurance schemes bear little if any relation to the social costs that these agents fail to internalise.

Given that unemployment benefit systems in practice have little in common with the main features of optimal unemployment insurance, the efficiency case for the unemployment benefit systems is considerably weakened. What remains, then, is the equity case; but here - as we have noted - unemployment benefits tends to be less effective than conditional negative income taxes.

Finally, the unemployment benefit system has the well-known advantage that since it is more narrowly targeted than a conditional negative income tax system which provides a similar level of support for the target group, the unemployment benefit system tends to be less expensive. Specifically, the unemployment benefit system requires a lower level of tax revenue to finance a given level of support for its target group than does the conditional negative income tax system. This disadvantage of conditional negative income taxes versus unemployment benefits must be set is the advantages noted above. Should the disadvantage prove to be overwhelming in particular instances, policy makers may wish to target the conditional negative income taxes in the same way as the unemployment benefits are currently targeted.

5d. The Benefit Transfer Program

As rising unemployment represents one of the severest challenges to the achievement of prosperity and social cohesion in many OECD countries for the 21st century, it is of paramount importance to consider how policy inefficiencies and inequities in this area can be undone. The aim of the Benefit Transfer Program[13] (BTP) is simply to redirect the funds that the government currently spends on the unemployed - in the form of unemployment benefits, temporary layoff pay, redundancy subsidies, poverty allowances, and more - so as to give firms an incentive to employ these people.

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[13]For a more detailed analysis, see Snower (1994).

The BTP gives the long-term unemployed people the opportunity to use some of the money that pays for their unemployment support to provide vouchers to firms that hire them. The longer people are unemployed, the greater the vouchers that employers would receive for hiring them. Employers would also be given greater vouchers if they could prove that they were using them entirely to train their new recruits.

If the support for the unemployed comes in the form of unemployment benefits, the BTP would enable the long-term unemployed to transfer a portion of their unemployment benefits into employment vouchers. If, on the other hand, the support was in the form of unemployment SA balances, the BTP would permit the long-term unemployed to offer a fraction of these balances as an inducement to potential employers.

Since the BTP is voluntary, it extends the range of choices open to the unemployed and their potential employers. The unemployed will join only if it is to their advantage. Many could become much better off, since the wages they would be offered could will be significantly higher than their unemployment benefits. At the same time, employers will join only if they find it profitable. Once again, many could well do so, since the vouchers could significantly reduce their labor costs. In short, employees may wind up receiving substantially more than their unemployment support, and many employers may find themselves paying substantially less than the prevailing wages. The difference is the unemployment support that has been transferred to employment vouchers.

The BTP would be an automatic stabilizer in both senses above: As unemployment rises, the aggregate amount of funds available for unemployment support would rise (because more people are drawing on their unemployment benefits or their USA balances) and thus more funds would automatically be available for employment vouchers. Thus, in the process of stabilizing incomes, the program would simultaneously provide incentives for employment creation and job search when they are needed most.

Beyond that, the BTP would clearly not be inflationary, since it would reduce firms' labor costs and since the long-term unemployed have no noticeable effect on wage inflation. It would cost the government nothing, since the money for the employment vouchers would have been spent on unemployment support anyway. By

offering higher vouchers for training, the Program could become the basis for an effective national training initiative. Clearly, firms will spend the vouchers on training only if they intend to retain their recruits after the subsidies have run out. Thus the training for the unemployed would automatically come with the prospect of long-term employment. This is something that the existing government training schemes do not offer. Many existing schemes also run the risk of being ill-suited to people's diverse potential job opportunities, whereas under the BTP firms would naturally provide the training most appropriate to the available jobs. And whereas the existing training schemes are costly to run, the BTP is free.

Finally, the BTP could play a vital role in tackling regional unemployment problems. Regions of high unemployment would become areas containing a high proportion of workers with training vouchers, thereby providing an incentive for companies to move there and provide the appropriate training.

The fall in unemployment would also give some governments the opportunity to expand their tax base by raising the retirement age for both men and women to 70. The cost of social provision to the tax payer has exploded not just because these services have been getting steadily more expensive, but also because many governments artificially depress the number of tax payers through its retirement legislation. Not only do people live longer than they used to, but they also continue to be productive for longer. By putting many elderly people out of work long before they cease being productive, governments increase the number of dependents on the welfare sate and reduce the number providing financial support. Raising the retirement age would keep advanced industrialized countries from hamstringing themselves in this curious way.

6. Concluding Thoughts

The reform proposals above are all part of a single, coherent overall strategy that is meant to promote prosperity and social cohesion by reversing the long-run instability inherent in many of the dominant policy systems in OECD countries. I have argued that such reform is particularly important nowadays, since the OECD faces some rapidly growing challenges to social cohesion in the years ahead: globalization, skill-biased technological change, changes in the organization of firms, and lagging

productivity growth in the welfare state sector. What these developments have in common is that, as we have seen, they all tend to yield greater dispersion of wages and of employment opportunities within the advanced market economies of the OECD, so that a given amount of economic prosperity can be achieved only through social polarization and loss of social cohesion. Thereby these developments imply a progressively growing need for a social safety net and for insurance against economic uncertainties - a growing need, in other words, for welfare state services. But as productivity growth in the welfare state sector continues to trail behind average productivity, the cost of welfare state services will continue to rise, and the growing need for these services will become ever more difficult to satisfy. If the prevailing policy systems are progressively dismantled, then these systems will, over the long run, amplify unfavorable economic and social shocks and thereby impart an imbalance to their host countries.

Furthermore, I have suggested that, to avoid this “quicksand effect”, the OECD requires a new generation of policy systems that have a “dual stabilizer” role: when adverse economic or social contingencies arise, these systems must automatically provide both support for those affected *and* greater economic incentives to overcome these contingencies. The four reform proposals above - the Opt-Out program, the government loan guarantees, the Support Accounts, and the Benefit Transfer Program, - are illustrative of this fundamental reform strategy. They all serve to give individuals greater responsibility and greater choice in the provision of public goods. In addition, they all provide people with greater incentives to avoid wasting resources in the production and distribution of these goods.

They rest on the realization that some of the major market failures in OECD countries are the outcome of existing public policies, since these policies often distort individuals’ incentives to achieve their economic goals efficiently. And the reform proposals aim to readjust these incentives by helping individuals internalize the main costs and benefits of their activities. Although the need for social cohesion makes a total internalization of these costs and benefits socially undesirable, it is clear that many of the prevailing redistributive policies are needlessly inefficient. The reform proposals above point to a strategy for achieving our redistributive goals at minimal efficiency cost. They may thereby provide a vital opportunity of achieving prosperity together with social cohesion in the 21st century.

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