SOCIAL WELFARE'S TWIN DILEMMAS

"Universalism vs. Targeting"
and
"Support vs. Dependency"

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All across the developed world, uneasiness is growing about the continuing rise in government social welfare spending and the dependent behavior that it seems to encourage. As a result, many social policy experts and national governments are reassessing their social welfare programs. Essentially, they are asking two related questions: (1) Should the growth in total social welfare spending be constrained by moving from universal programs to more targeted ones? and (2) Should behavioral dependency be discouraged by placing limits or conditions on government support?

Most developed countries have already adopted some combination of measures to target benefits and discourage dependency, often after considerable political controversy. Some of these measures seem to have at least slowed spending growth, if only temporarily. But the changes adopted so far have been relatively modest compared to what is needed to avoid massive future deficits—as the coming decades see populations age and other social needs burgeon.

For the foreseeable future, therefore, developed countries should expect a continuing political debate over the size and shape of social welfare programs. As the foregoing suggests, two dichotomous choices will dominate: (1) Universalism vs. Targeting, and (2) Support vs. Dependency.

Because these questions offer equally valued but irreconcilable options, this paper calls them "twin dilemmas." As a trade-off between two valid principles, they epitomize the dictionary definition of a dilemma: "a situation involving a choice between equally unsatisfactory alternatives."[1]

This paper argues that nations must make a choice—between the two contradictory poles of each question. If they make a decision to target program benefits further, they will be abandoning the principle of universalism, and if they impose behavioral incentives or sanctions to discourage dependency, they will be denying support to some of those in need.

Making the best choices, under these circumstances, will be a challenge to experts, politicians and, ultimately, voters. For, the competing values in each choice raise fundamental questions about a polity's responsibility to its less-advantaged citizens. Reasonable people, of course, can disagree about the appropriate balance, which will vary over time and depend on the program and the national culture.

Although this paper concentrates on developed countries, the issues discussed are also important to developing ones. If the latter are to avoid facing the same politically difficult budgetary cuts in the future, now is the time to apply the lessons learned by developed nations. In other words, developing countries should learn from the experience (some would say the mistakes) of the developed world.

Past Spending Increases

At the beginning of the last century, government spending in what would become today's industrial countries accounted for less than one-tenth of national income. In the next 90 years, it rose to almost half of national income. As Clive Crook writes in *The Economist*, "Decade by

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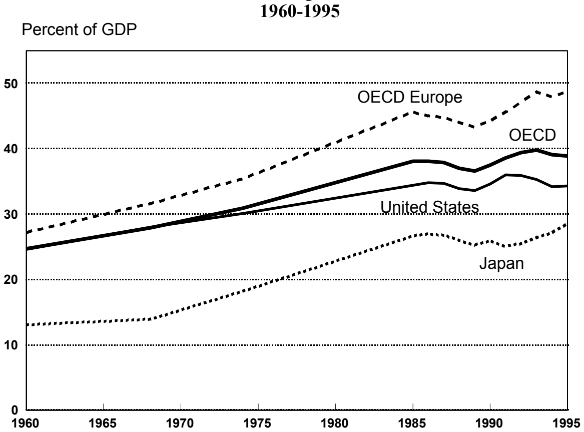
[1]*The Random House Dictionary of the English Language* (New York: Random House, 1973), 403. The logical term dilemma is defined as: If A, then B; if C, then D. A choice must be made between A or C, therefore resulting in consequences B or D.

decade, the change in the government's share of the economy moved in one direction only: up. During war it went up; during peace it went up."[2]

Since the end of World War II, the bulk of these spending increases have been for social welfare programs. As an Organisation for Economic Co-operation and Development (OECD) report comments, "The driving forces behind higher government spending and taxes were mainly social expenditures, particularly unemployment benefits, old-age pensions, disability benefits and health-care expenditure."[3]

Chart 1 portrays this rise in *total government spending*, measured as a percentage of Gross Domestic Product (GDP), from 1960 to 1995.[4] In this period, for example, expenditures[5] rose across all OECD countries from about 25 percent of GDP to almost 40 percent of GDP. They rose higher in the European OECD countries, from about 27 percent to almost 50 percent of GDP. Government spending in Japan followed the same trend. Between 1960 and 1985, expenditures as a percentage of GDP more than doubled. By 1985, they reached 26.6 percent of GDP, and have only risen 1.9 percentage points since then.

Chart 1
Current Expenditures
1960-1995



Source: Organization for Economic Co-operation and Development, "Historical Statistics," 1997, table 6.4.

In the United States, expenditures did not rise as much as in Europe and Japan. U.S. expenditures as a percentage of GDP increased by approximately 10 percentage points between 1960 and 1985, and have remained fairly constant since that time. Many might interpret this lack of growth as a sign that the United States did not substantially increase its social spending during this period. While it is true that spending increased more sharply in many European countries, a major reason that U.S. expenditures did not increase is that savings from reduced military spending were used to finance social welfare programs. As Chart 2 illustrates, in 1968, combined defense and social welfare (called "human resources") spending amounted to 16.7 percent of GDP, 9.7 percent and 7.0 percent, respectively. By 1996,

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[2]Clive Crook, "The Future of the State," *The Economist* (September 20, 1997): 7.

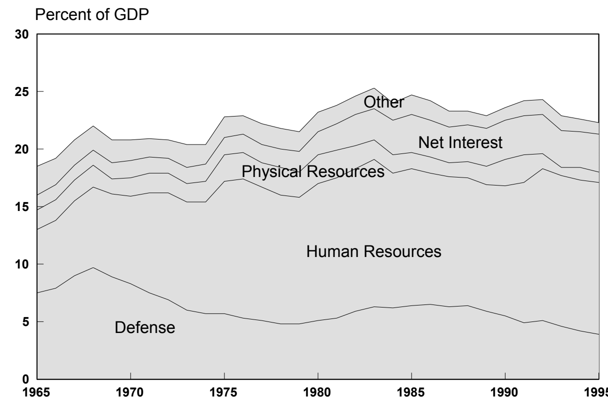
[3]Willi Leibfritz, John Thornton, Alexandra Bibbee, "Taxation and Economic Performance" (Economics Department Working Paper no. 176, Organisation for Economic Co-operation and Development, Paris, 1997), 13.

[4]Unless otherwise specified, all data concerning expenditures, revenues, and deficits are derived from Organisation for Economic Co-operation and Development, *Historical Statistics: 1960–1995* (Paris: Organisation for Economic Co-operation and Development, 1997).

[5]Expenditures include current disbursements for all government levels combined. For the United States, for example, federal, state, and local level spending is incorporated. Current disbursements mainly include final consumption expenditures, interest on the public debt, subsidies and social security transfers to households.

the total of the two had grown only six tenths of 1 percent, to 16.8 percent of GDP.[6] But the proportions had more than reversed. Defense expenditures had declined to 3.6 percent of GDP, while social welfare had increased to 13.2 percent. In other words, a 30-year decline in military expenditures (as a proportion of GDP), uneven though it was, enabled the United States to double social welfare expenditures without increasing the proportion of GDP allocated to the two together.[7]

Chart 2
U.S. Federal Expenditures
1965-1995, by Category



Source: U.S. Office of Management and Budget, "Historical Tables," Fiscal Year 1997.
Note: Human Resources includes Social Security, Medicare and other health, income security, education, training, and social services.

Recent Cutbacks

Since the mid-1980s, spending increases have slowed considerably and in many countries have all but ceased. After rising 13 percentage points between 1960 and 1985, expenditures across all OECD countries plateaued for the next decade—hovering between 38 and 39 percent of GDP during this period. (See Chart 1.) In OECD Europe, expenditures continued to rise—but at about half the rate of the preceding decade, and they fluctuated more than elsewhere, in part because of changing economic conditions. (By 1995, expenditures were only 3.1 percentage points higher than in 1985, whereas they had climbed about 7 percentage points in the previous decade.)

One major reason expenditures have plateaued is the fact that many countries have trimmed their social welfare programs. This is not the place to provide a detailed account of recent developments in each country; even a brief country-by-country summary of developments could fill a small volume.[8] Instead, let me outline the broad programmatic trends—with the understanding that the process is far from uniform. Some countries have made substantial cuts, at least in the projected growth of programs, while others have done much less.

- *Old-age pensions*. Some countries have increased the age of retirement and years of work necessary for a full pension, changed the benefit formula and cost of living adjustments to lower the value of pensions, and even means tested the entitlement. For example, France, in 1993, raised the contribution period for a full pension from 37.5 to 40 years, and as a result the retirement age for a full pension rose from 60 to 65. In addition, early

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[6]U.S. Office of Management and Budget, *Historical Tables* (Washington, DC: Government Printing Office, 1997), Table 3.1.

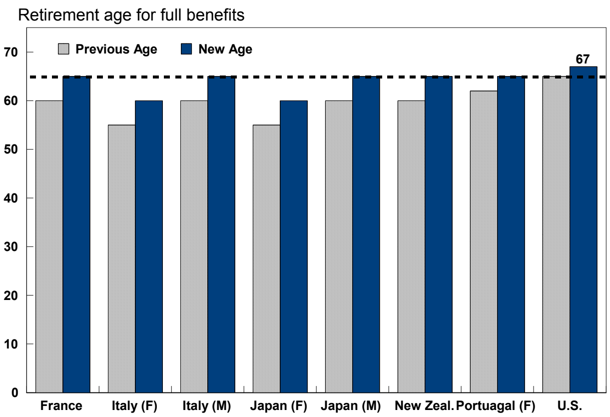
[7]Some might see this as some sort of long-term "peace dividend," but it actually reflects the fact that, during the Cold War, the U.S. economy was growing much faster than the Soviet Union's so that it could reduce the proportion of its national economy spent on the military.

[8]See generally, Neil Gilbert, *Transformation of the Welfare State: The Silent Surrender of Public Responsibility* (Oxford: Oxford University Press, 2002).

retirement was abolished, and the value of pensions was lowered by basing them on the average of a worker's best 25 years of earnings instead of the best 10.[9]

Chart 3

Pensionable Ages



Source: Internal Social Security Review, February 1996, table 1.

- *Health care*. Some countries have capped health department budgets, rationed the use of high cost services, limited the number of hospital beds, established price schedules, and redefined "core" services. Italy, for example, has tried to control expenditures on medications by restricting what used to be the free provision of drugs. Since 1993, Italy has required that non-prescription medications be paid in full by the individual, regardless of age. Medications for non-life-threatening illnesses are free only to children under age 10 and adults over 60; everyone else must pay 50 percent of their cost. Only "essential," or life-saving, medications remain free.[10]

- *Unemployment*. Some countries have time-limited benefits, lowered the value of benefits, increased the required contribution period for eligibility, increased waiting periods, and required recipients to engage in activities (such as education or job training) while unemployed. In 1993, Denmark, for example, time-limited unemployment benefits to five years (there had been no limit), raised the minimum age to qualify for benefits, ended the possibility of extending benefits by participating in a job training program, and conditioned unemployment benefits, after two years, on participation in education and training programs.[11]

- *Disability and sickness insurance*. Some countries have tightened eligibility requirements, time-limited benefits, periodically reviewed the status of recipients, and lowered the value of benefits. The most well-known reforms have been in the Netherlands, and are discussed below. Other countries, however, have also reined in their sickness and disability programs. In 1990, Sweden, for example, lowered the level of compensation after one year out of the labor market from 90 percent to 70 percent of the recipient's past wage, made employers financially responsible for one month of sick pay, narrowed the conditions for receiving sickness benefits to medical reasons only and dropped coverage for work-related injuries, and abolished early retirement for labor market reasons.[12]

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[9]"France: Priority for Employment," *International Social Security Review* 2, no. 2 (1996): 125–126.

[10]"The Reform of Health Systems: Equity, Efficiency and Quality of Care," *International Social Security Review* 49, no. 2 (1996): 81.

[11]Agnete Gersing, "Structural Unemployment in Denmark" (Economics Department Working Paper, no. 183, Organisation for Economic Co-operation and Development, Paris, 1995), 16–17.

[12]Hans Svensson and Jan-Åke Brorsson,"Sweden: Sickness and Work Injury Insurance: A Summary of Developments," *International Social Security Review* 50, no. 1 (1997):76–78.

- *Education*. As increasing proportions of their populations attend colleges and universities, some countries have reduced spending per student or abandoned the tradition of free tuition. In July, 1997, Britain's new Labour government announced the end of universal free higher education. Instead, students will pay up to $1,690 a year (depending on family income) toward their tuition.[13] (Only 30 percent of students, those from the poorest backgrounds, will be exempt from tuition fees.)[14] In addition, government grants to help pay for living expenses are now more highly means tested.[15]

- *Child care*. Some countries have cut subsidies for child care, means tested benefits, or limited cost increases. In Sweden, for example, the number of children per caretaker in day care centers rose from an average of 12–15 children to 16.5 children, with some up to 24 children. At the same time, the charges that parents pay "have risen steeply in recent years and can differ widely from one municipality to another."[16]

- *Welfare (or one-parent benefit programs)*. Some countries have cut payments to single mothers, imposed time limits and work requirements, and taken other steps to encourage work and discourage additional births. In 1996, the U.S. government imposed a two-year time limit on the receipt of benefits before recipients are expected to work as well as a five-year lifetime limit on benefits. (There is a question, however, about whether the individual states will actually impose these time limits or use their own funds to avoid them.) In addition, to receive benefits, teenage mothers are now required to live in the home of a parent or guardian.[17]

One can argue about the significance of these programmatic cuts, of course. Many are small, leading some observers to conclude that only marginal changes are being made. But it seems more realistic to see these cuts, regardless of their actual size, as harbingers of much larger changes that are likely to come.

A Tax Ceiling

In order to determine whether the current leveling off of expenditures is a temporary pause in the growth of government social welfare programs or something more permanent, its causes must be understood. Roger Freeman of the Hoover Institution argues: "It is now evident that the trend toward increased governmental spending for domestic purposes slowed substantially during the second half of the 1970s. This was due less to the intents of our political

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[13]Peter David, "Inside the Knowledge Factory," *The Economist* (October 4, 1997):11.

[14]United Kingdom Department of Education and Employment, available from: http://www.coi.gov.uk/coi/depts/GDE/coi3445d.ok.

[15]Telephone interview between Jennifer Ehrle, The American Enterprise Institute, and John Russell, Embassy of the United Kingdom of Great Britain and Northern Ireland, November 21, 1997.

[16]The Swedish Institute, "Fact Sheets on Sweden: Child Care," (August 1996), 2.

[17]Mark Greenberg and Steve Savner, *A Detailed Summary of Key Provisions of the Temporary Assistance for Needy Families Block Grant of H.R. 3734*, (Center for Law and Social Policy, Washington, DC, August 1996).

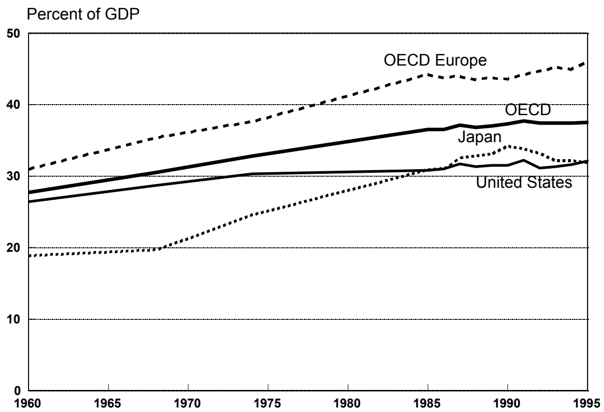
leaders than to lack of money."[18] The basis of his conclusion is apparent in the recent history of tax rates.

Between 1960 and 1985, taxation in most countries did not keep pace with spending increases. Across all OECD countries, taxes only rose by 8.8 percentage points of GDP, even as spending rose by 13.4 percentage points. (See Chart 4.) As a result, many countries experienced large deficits. (See Chart 5.) After 1985, taxes as a percentage of GDP grew by only about 1 percentage point across OECD nations, as did spending.

Chart 4

Tax Revenues

1960-1995



Source: Organization for Economic Co-operation and Development, "Historical Statistics," 1997, table 6.6.

Although taxes in OECD Europe rose much higher and faster than elsewhere, they also did not keep pace with expenditures. In the OECD-European countries, between 1960 and 1985, the tax rate climbed by about 13 percentage points, from 31 percent to 44 percent of GDP—but spending increased about 18.5 percentage points. Tax increases slowed after 1985. Between 1985 and 1995, the increase in tax rates compared to the preceding 25 years declined by 65 percent—rising only 1.8 percentage points, to 46 percent of GDP.

Taxes in the United States plateaued in the 1970s at about 30 percent of GDP, roughly where they remain today. As explained above, this is partly because coincident reductions in defense spending (as a percentage of GDP) were used to help finance major expansions of social welfare spending until the mid-1980s, when defense spending and deficits both rose.

Japan, like Europe, reached a tax plateau in 1985. Between 1960 and 1985, taxes as a percentage of GDP grew by 12 percentage points, to 30.8 percent of GDP. In the next 10 years, taxes rose only 1.2 percentage points, hovering between 30.8 and 32 percent of GDP.

I interpret this plateauing of taxes to mean that, throughout this period, most OECD governments were unable to raise taxes enough to fund higher expenditures. Put simply, political realities limited the proportion of national income that could be taxed from one group and then transferred to another group (or back to taxpayers). Here is how Nobel laureate in economics Milton Friedman put it:

> As a political matter, I believe that in the long run the level of taxes comes closer to determining the level of spending than the other way around. Occasionally, as in World War II, a special emergency produces a willingness to raise taxes and spending is the moving force. But once the new level of taxes is in place, it tends to become permanent, or nearly so, and thereafter spending is determined in large part by how much the revenue structure will raise.[19]

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[18] Roger A. Freeman, *A Preview and Summary of The Wayward Welfare State* (Stanford, CA: Hoover Institution Press, 1981), 103.

[19] Milton Friedman, *An Economist's Protest* (Glen Ridge, NJ: Thomas Horton and Company, 1972), 68.

Many economists would say that this political "tax ceiling" reflects an underlying reality: Government programs inevitably distort supply and demand. While some level of government spending is essential, most government tax and transfer systems are, from an economic point of view, inherently inefficient. At some point, additional spending results in diminishing returns and, eventually, burdens the overall national economy.

For example, when OECD staff simulated various macroeconomic scenarios for the period 1993 to 2000, they concluded that bringing national budgets closer into balance through higher taxes would be more costly in terms of GDP, inflation, and unemployment than it would be through expenditure cuts. As they explained, "tax increases tend to increase inflation and hence produce negative effects on real wealth, private demand and on government's debt servicing costs."[20]

Such inefficiencies are more difficult for individual nations to accept because of the globalization of the economy. As international trade has become a larger component of most national economies, and as capital and even labor have become more mobile, nations in competition with each other seek to lower the costs of their products and services by lowering taxes and public spending.

An added pressure on many European countries has come from the fiscal-policy standards of the Maestricht Treaty on the European monetary union (which limit outstanding debt to 60 percent of GDP and annual budget deficits to 3 percent of GDP in order to constrain inflation, interest, and exchange rates).[21] For example, in 1992, Italy adopted strict budgets, abolished its inflationary wage indexation system, and reduced social welfare benefits, including pensions and health care. As a result, between 1993 and 1995, spending dropped from 53.2 percent to 49.5 percent of GDP. Other countries also cut spending. Sweden, in the same period, reduced government spending from 67.4 percent to 64 percent of GDP, and the Netherlands cut spending from 55.6 percent to 52.1 percent of GDP.

I am not arguing that the OECD countries have actually reached their economic or political "tax ceilings." Nor will I even hazard a guess about the actual level of such ceilings. They are undoubtedly well below 90 percent of GDP, but whether they are at 40 percent, 50 percent, 60 percent of GDP, or even higher, is beyond my powers of estimation. And they surely vary from nation to nation and from one time to another, depending on various economic, social, and cultural factors. My only point is that there are ceilings—and, for now at least, the governments in many developed nations seem to think they have reached theirs.

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[20]Willi Leibfritz, Deborah Receiver, and Paul van den Njord, "Fiscal Policy, Government Debt, and Economic Performance" (Economics Department Working Paper, no. 144, Organisation for Economic Co-operation and Development, Paris, 1994), 20.

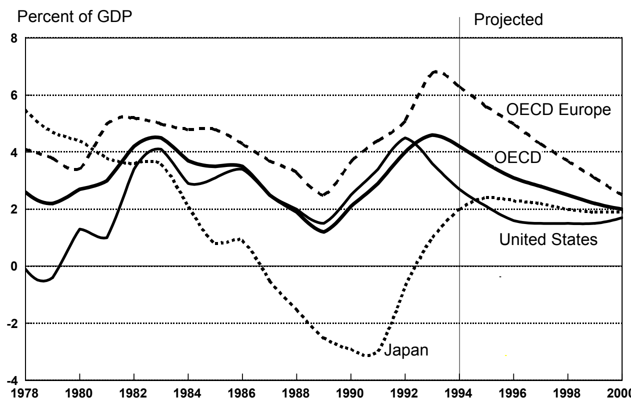
[21]"In order to qualify for membership of EMU, the Treaty requires Member States to aim for certain targets for their budget deficits, public debt, inflation, and interest rates and exchange rates. Since inflation, interest and exchange rates are crucially influenced by the size of budget deficits, special surveillance procedures are applied by the Council and the Commission. . . . Under the `excessive deficit' procedure, as it is known, the focus is on a country's total outstanding public debt as a percentage of its gross domestic product (GDP) and on its budget deficit as a percentage of GDP. The targets laid down in a protocol to the Treaty are 60 percent of GDP for outstanding debt and 3 percent for the annual budget deficit." Web Site of the European Union, Economic and monetary policy, available from: http://europa.eu.int/pol/emu/en/info.htm#epc.

Let me be quite direct: While voters may still desire generous social welfare programs, they have much less appetite for the higher taxes needed to pay for them.[22]

Long-Term Deficits

This long-running mismatch between spending and taxation has been reflected, of course, in the recent budget deficits of developed countries. But as Chart 5 suggests, the combination of the program cuts described above, small tax increases, and, of course, economic growth have led to declining deficits.[23] As a result, an immediate budget crisis may have been averted. For OECD countries, the OECD estimates that deficits will decline from 3.6 percent of GDP in 1995 to 2 percent of GDP in 2000. For European OECD countries, the estimated deficit declines from 5.6 percent to 2.5 percent of GDP; in the United States, from 2.1 percent to 1.7 percent of GDP; and in Japan, from 2 percent to 1.9 percent of GDP.[24]

Chart 5
Deficits
1978-2000, Actual and Projected



Source: Organization for Economic Co-operation and Development, Working Paper no. 144, table A1 and table 4.

But this short-term deficit relief is only the quiet before the storm. Long-term projections—which assume no fundamental changes in policy or economic conditions but take into account the aging of the population—are much grimmer. To put it bluntly, the "greying" of the populations in most developed countries will make current deficits look tame.

Median ages are increasing in developed countries—because of longer life expectancies, lower birth rates, the disproportionate size of the now-aging, post-war baby boom generation, and, for many European countries, the lack of substantial immigration. As a result, in the next decades, the proportion of the population collecting old-age pensions will grow substantially, placing an added burden on national budgets because, in most countries, these are *unfunded* governmental obligations (that is, they will have to be paid for with future taxes).

Assuming that present trends and policies continue, by 2050, pension expenditures as a percentage of GDP will almost double in many OECD countries. As Table 1 indicates, most countries will face pension obligations of around 15 percent of GDP; some will reach almost 20 percent. Only Austria, Iceland, Ireland, the United Kingdom, and the United States will have

[22]Here is how Freeman put the point in regard to the United States: "Public opinion polls favor a reduction in the size of government but reveal little enthusiasm for drastic cuts in specific domestic services and benefits except possibly in public assistance. That makes a flattening of governmental growth tendencies likely to continue but keeps prospects of major reductions in doubt." Freeman, *A Preview and Summary of The Wayward Welfare State*, 104.

[23]Leibfritz, Receiver, and van den Njord, OECD Working Paper, no. 144.

[24]Leibfritz, Receiver, and van den Njord, OECD Working Paper, no. 144, Table 4.

pension responsibilities amounting to less than 10 percent of their GDPs. In Japan, expenditures for pensions are expected to increase by 150 percent.

Table 1
Past and Projected Spending on Old-Age Pensions (as a percent of GDP)

Country	1995	2050
Austria	8.8	14.9
Belgium	10.4	15.1
Denmark	6.8	11.5
Finland	10.1	17.7
France	10.6	14.4
Germany	11.1	17.5
Iceland	2.5	5.2
Ireland	3.6	3.0
Italy	13.3	20.3
Japan	6.6	16.5
Netherlands	6.0	11.4
Norway	5.2	11.5
Portugal	7.1	16.5
Spain	10.0	19.1
Sweden	11.8	11.2
U.K.	4.5	4.1
U.S.	4.1	7.0

Source: Willi Leibfritz, Deborah Roseveare, Douglas Fore, and Eckhard Wurzel, "Populations, Pension Systems and Government Budgets: Simulations for 20 OECD Countries" (Economics Department Working Paper No. 168, Organisation for Economic Co-operation and Development, Paris, 1996), Table 3.

Note: These projections are given in 1994 prices and assume current government expenditure and revenue policies continue. The projections also assume all economies have returned to their medium-term growth path and that there is no cyclical unemployment. Medium-term economic growth is determined by the projected growth of the working-age population and an assumed labor productivity growth rate of 1 ½ percent yer year, with participation rates remaining constant. Data from national sources were used to model contribution and benefit rates, taking into account differences in retirement ages and eligibility criteria.

Public expenditures on health will also rise as populations age. By 2030, it is estimated that many OECD countries will see their public spending on health increase by more than 20 percent, and by as much as 45 percent in the United States. (See Table 2.)[25]

As in Europe, the aging U.S. population will result in escalating pension (Social Security) and health (Medicare) expenditures. Social Security is estimated to grow from 5 percent of GDP in 2005 to 6 percent in 2020 and to 7 percent in 2040. Even under conservative assumptions, Medicare is predicted to grow more rapidly: From 4 percent of GDP in 2005 to 6 percent in 2020 and 8 percent in 2040.[26]

Table 2
Public Spending on Health (as a percent of GDP)

Country	2000	2030
France	6.9	8.5
Germany	6.1	7.5
Italy	6.3	8.0
Japan	5.1	6.2
U.K.	5.8	7.0
U.S.	6.4	9.3

Source: Leibfritz, Roseveare, Fore, and Wurzel, OECD Working Paper No. 156, Table 3.

Note: Projections are based on OECD estimates of demographic changes and the assumption that per capita spending on health increases at the same rate as productivity (1.5 percent per year).

In almost all OECD countries, these projected increases in public expenditures on pensions and health care will lead to unprecedented peace-time deficits. As American economist Herbert Stein warns about the U.S. budget, "As we look ahead 20 years or so, we see a period in which, as things are now set up, we are going to have, not federal surpluses, but enormous deficits, this time because of an aging population's increased drain on Social Security and Medicare."[27]

The OECD estimates future deficits using four different assumptions.[28] For simplicity, I will use its first scenario, in

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[25]Willi Leibfritz, Deborah Receiver, Douglas Fore and Eckhard Wurzel, "Ageing Populations, Pension Systems and Government Budgets: How Do They Affect Saving?" (Economics Department Working Paper, no. 156, Organisation for Economic Co-operation and Development, Paris, 1995), Table 3.

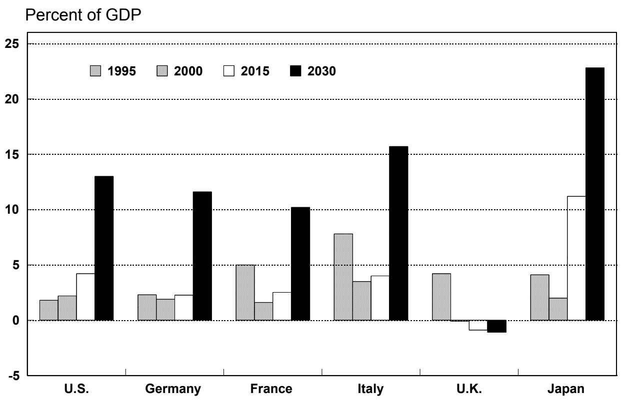
[26]Congressional Budget Office, "The Long Term Budget Outlook," in *Long-Term Budgetary Pressures and Policy Options* (Washington, DC: Congressional Budget Office, 1997), Table 5.

[27]Herbert Stein, "Washington's Coffers Are About to Overflow: How Should Conservatives React," comment, *The American Enterprise* 8 (Nov/Dec. 1997), 59.

[28]The four alternative assumptions are: (1) real interest rates after the year 2000 stay constant for "old" debt that accumulated through 2000 while the interest on "new" debt incurred after 2001 is the average of the interest rates in the major seven nations; (2) real interest rates and growth rates remain constant between 2000 and 2030; (3) interest rates on "old" debt slowly approach rates on "new" debt until there is no difference; and (4) the same assumptions as alternative (3) except country-specific interest rates are used

which interest rates remain constant. Under this assumption, the German deficit in 2030 will be 11.6 percent of GDP, the French deficit will be 10.2 percent of GDP, the Italian deficit will be 15.7 percent of GDP, and the Japanese deficit will be 22.8 percent of GDP. The United Kingdom is expected to have a slight surplus equal to 1.1 percent of GDP, in large part because of the Thatcher-era privatization of its pension system. But already some are expressing concerns that the private system will need a public bailout. (See Chart 6.)[29]

Chart 6
Projected Deficits
1995-2030



Source: Organization for Economic Co-operation and Development, Working Paper no. 156, table 5.
Note: Assumes interest rates remain constant.

The United States also faces massive, long-term deficits. The U.S. Congressional Budget Office (CBO) estimates that the U.S. budget will be in balance by the year 2002 and then begin to rise after 2007. Like the OECD, the CBO uses various assumptions to estimate budget deficits.[30] Using the assumption that discretionary spending grows at the rate of inflation and that national debt affects the growth of the economy, the CBO predicts that the deficit will grow from 2 percent of GDP in 2005 to 3 percent in 2010, double to 6 percent in 2020, double again to 12 percent in 2030, and reach 31 percent of GDP in 2040. (Using other policy and economic assumptions, the CBO developed projections as low as 2 percent, 3 percent, 5 percent, 8 percent, 11 percent of GDP, respectively.)

These projections, of course, are based on current conditions and policies. It is always possible that GDP will grow faster than predicted, thereby providing a bigger pie to divide.[31] That would certainly be the best solution, although, if the economists are correct, it would require a sharp departure from the current policies of many countries. (Western European immigration[32] and farm policies are only the most prominent examples.)

In any event, in the absence of unprecedented growth, taming these long-term deficits will require some combination of tax increases and spending cuts (and, one hopes, faster

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rather than average market interest rates. Leibfritz, Receiver, Fore and Wurzel, OECD Working Paper, no. 156, 16–17.

[29]Leibfritz, Receiver, Fore and Wurzel, OECD Working Paper, no. 156, Table 5.

[30]Analysts at CBO estimate spending growth in two ways: (1) based on inflation and (2) based on economic growth. Using these two assumptions, they simulate budget shortfalls without economic feedbacks, such as how the debt affects the economy, and with such feedbacks. Congressional Budget Office, *Long-Term Budgetary Pressures and Policy Options*, section 3.

[31]Note that I am not asserting that social welfare programs cannot be afforded because of economic weakness. Despite the current pressures of national budgets, the developed world is richer than ever before. The problem is that its appetite for social spending has simply increased even faster than national wealth.

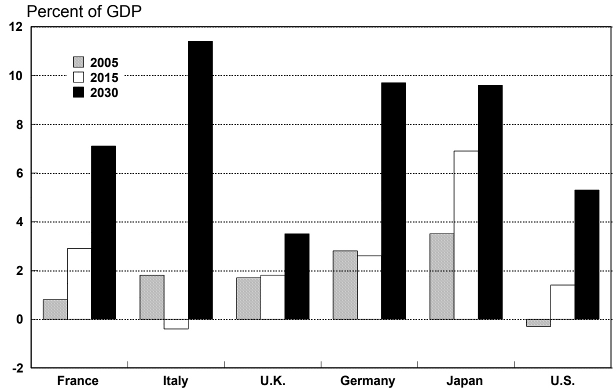
[32]In the United States, the costs associated with the aging population and the falling birth rate have been partially offset by millions of younger, working-age immigrants. Most European nations have strict immigration policies, however, and thus cannot rely on the availability of a large pool of new workers.

economic growth). For simplicity, I address taxes and spending separately, although a change in one area reduces the need to take action in the other.

How much *additional taxation* would be needed? The OECD has estimated the level of additional taxation that would be needed to keep net national debt at current levels: Germany's taxes would have to increase by 2.8 percent of GDP in 2005, and by 9.7 percent in 2030. In France, taxes would have to rise by 0.8 and 7.1 percent, respectively; in Italy, by 1.8 and 11.4 percent; in Japan, by 3.5 and 9.6 percent; in the United Kingdom by 1.7 and 3.5 percent, and in the United States, by -0.3 and 5.3 percent. (See Chart 7.) In a separate analysis using somewhat different assumptions, the CBO estimated that, to keep the U.S. budget balanced, federal taxes (as distinct from state and local ones) would have to rise from 21 percent of GDP in 1996 to about 27 percent in 2050.[33]

Chart 7

Increase in Tax Required to Keep Net Debt Constant



Source: Organization for Economic Co-operation and Development, Working Paper no. 168, table 6.

How likely are tax increases of this magnitude? Robert Greenstein, executive director of the Center on Budget and Policy Priorities, speaking on the United States situation, concludes that "costly proposals for new universal social programs will probably have to be accompanied by tax increases. While some tax increases may be possible, there are likely to be political limits to how large they can be."[34]

In the absence of such large tax increases, sharp *spending cuts* would be needed to avert these looming deficits. Consider pension expenditures: OECD economists simulated alternative scenarios to adapt the previously cited baseline projections to reflect some of the policy issues being discussed in member countries. A later retirement scenario, which gradually raises retirement age to 70, could largely offset the demographic pressure on pension expenditures in most countries. A cost-containment scenario, such as limiting pension expenditure to the rate of GDP growth after 2015, would also reduce budget pressures, but not as much. A means-testing scenario, such as limiting pensions to those with lower incomes after 2010, would also reduce expenditures. A wage-indexation scenario, such as tying all pensions payments to wages, would exacerbated cost pressures by an average of 2 to 3 percentage points of GDP.

OECD economists acknowledge that such reforms may seem extreme, but they illustrate "the scale of pension reform that would be needed to get significant fiscal results."[35] Actually, the problem is even larger than these projections suggest. A host of unmet (or emerging) social

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[33]Congressional Budget Office, *Long-Term Budgetary Pressures and Policy Options*, section 3.

[34]Robert Greenstein, "Universal and Targeted Approaches to Relieving Poverty: An Alternative View," in *The Urban Underclass,* eds. Christopher Jencks and Paul Peterson, (Washington DC: The Brookings Institution, 1991), 453.

[35]Receiver, Leibfritz, Fore and Wurzel, OECD Working Paper, no. 168, 7.

needs face developed countries. Meeting them—through the expansion of current programs or the creation of new ones—would take spending far beyond these current projections.

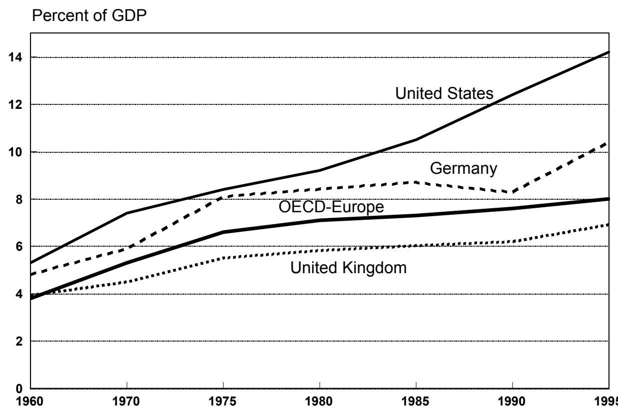
Unmet Needs

The aging of the population is only the most measurable future claim on the modern social welfare state. Maturing, post-industrial societies have a host of other social welfare needs created by various social, economic, and technological changes. Let me list some of the most prominent examples:

- *Health care* costs will probably rise much higher than the projections mentioned above, which are based on only the aging of populations. Advances in medical technology will be more expensive than current treatments and there will be increased expectations of access to them.

  As Chart 8 shows, health care costs (public and private combined) have already increased considerably in the U.S. and many European nations. Between 1960 and 1992, total expenditures on health as a proportion of GDP increased from 5.3 percent to 14 percent in the United States, from 3 percent to 7 percent in Japan, from 4.8 percent to 8.7 percent in Germany, and from 4 percent to 7 percent in the United Kingdom. For OECD Europe as a whole, health expenditures as a percentage of GDP increased 110 percent during those years, from 3.8 percent to 8 percent.[36]

Chart 8
Total Expenditures on Health Care
1960-1995



Source: Organization for Economic Co-operation and Development, Working Paper no. 149, table 6, and *OECD Health Data 97.*

- *Long-term care* for the elderly, including nursing home care, is sure to increase with the rising percentage of people over 75 years of age in most countries. The continued atomization of society and family breakdown will add to the demand for publicly provided care.

- *Child care* costs will increase as more mothers of young children work outside of the home, and as parents and program advocates push for "higher quality" care.

- *Education and training* costs will rise as the technology-driven economies of most developed nations demand more educated workers. This will include expanded access to higher education as well as to career retraining, as citizens of all ages seek to continue

[36]Howard Oxley and Maitland MacFarlan, "Health Care Reform: Controlling Spending and Increasing Efficiency," (Economics Department Working Paper, no. 149, Organisation for Economic Co-operation and Development, Paris, 1994), Table 1.

their education through college, and as older workers in declining industries seek new skills for the new economy.

- *Income maintenance and social support programs* will have to expand to meet what most experts believe will be a continued increase in out-of-wedlock births among young and disadvantaged populations. Young, single mothers with low levels of education simply do not have the earnings capacity needed to support a family.

  In the United States, for example, one-third of all births were nonmarital in 1995, compared to 5 percent in 1960. The proportion of teenage births that were out of wedlock increased from about 15 percent to 75 percent during those same years.[37] In the 15 European Community nations, the proportion of nonmarital births rose from 5.1 percent in 1960 to 23.4 percent in 1995, a 143 percent increase.[38] (See Table 3.)

Table 3
Nonmarital Births
(as a percent of all births)

	1960	1995
Austria	13.0	27.4
Denmark	7.8	46.5
France	6.1	37.2
Germany	7.6	16.1
Ireland	1.6	22.7
Italy	2.4	8.1
Netherlands	1.4	15.5
Portugal	9.5	18.7
Spain	2.3	10.8
Sweden	11.3	53.0
U.K.	5.2	33.6
U.S.	5.3	32.2
EU 15	5.1	23.4

Source: U.S. Department of Health and Human Services, *Report to Congress on Out-of-Wedlock Childbearing,* Table I-3; Ventura, et al., *Monthly Vital Statistics Report,* Table 14; Eurostat, *Demographic Statistics,* Table E-4.

I have not attempted to quantify the financing needed for these programmatic expansions, but I hope the bottom line is clear: Post-industrial societies face enormous social welfare needs—some of which are only dimly perceived in official projections.

How will governments meet these burgeoning needs? Barring an unprecedented growth in GDP (perhaps fueled by a lowering of the barriers to immigration) or an unlikely decline in the hostility toward higher levels of taxation, government revenues will not be sufficient to preserve the universal nature of current social welfare programs, let alone to meet the new needs described above. Put more strongly, if universal programs continue unchanged, they will hollow out the modern social welfare state.

Even today, additional spending is needed in each of the areas listed above. But because current, quasi-universal programs have a monopoly on spending, most countries have under-invested in meeting these other needs. As the American economist Isabel Sawhill cautions:

> Consider what has happened since the early 1960s. Social insurance programs have expanded dramatically. Indeed, social security and medicare have been responsible for all of the increase in [U.S.] federal spending as a proportion of GNP [Gross National Product] since that time. Because of public resistance to paying higher overall taxes, this expansion has necessitated a lowering of income taxes to accommodate higher payroll taxes and has put tremendous downward pressure on discretionary [nonentitlement] programs, including programs for the poor. We shouldn't ignore this substitution effect in

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[37]U.S. Department of Health and Human Services, *Report to Congress on Out-of-Wedlock Childbearing*, (Washington, DC: Government Printing Office, 1995), Table I-3; Stephanie Ventura, et al., "Advance Report of Final Natality Statistics: 1995," *National Center for Health Statistics Monthly Vital Statistics Report* 45, no. 1 supp, (June 10, 1997), Table 14.

[38]Eurostat, *Demographic Statistics: 1997* (Luxembourg: European Communities, 1997), Table E-4.

arguing for universal programs. Their trickle down benefits have to be balanced against their costs in crowding out other efforts.[39]

Analogous to the "crowding out" Sawhill describes is what is happening to funding for tertiary education in many OECD countries. Over the last decade, the percentage of 18- to 21-year-olds enrolling in colleges and universities has almost doubled in several European nations. For example, between 1985 and 1995, in Great Britain the proportion rose from about 15 percent to over 30 percent; in Norway, from 9 percent to 18 percent; in France, from about 20 percent to 35 percent; and in Spain, from 15 percent to 25 percent. U.S. enrollment remained fairly constant during this time, at around 35 percent.[40]

Even when countries find it difficult to pay the costs of these increased enrollments, they hesitate to abandon their long-standing commitments to free higher education. This often results in a reduction of per student spending. "In a forthcoming survey of higher education in ten rich countries, the OECD reports the growth in demand has caused deteriorating staff-student ratios, overcrowding, and great unevenness in the quality of teaching and learning."[41]

Great Britain provides an apt example. Even as public spending on higher education increased by 45 percent in the past 20 years, spending per student fell by 40 percent, because enrollments were also rising sharply.[42] This is why, as described above, Britain's Labour government announced the end of free higher education in July, 1997. In November, 1997, German university students engaged in strikes and demonstrations against what *The Washington Post* called "sharp spending cuts" and "overcrowded classes." According to the *Post*, "In some places students outnumber professors by 600 to 1."[43]

In this context, cutting back on universal programs is not about ignoring social needs, nor is it about saving taxpayers' money. Rather, it is about making funds available to increase spending on the most needful recipients of existing programs, to support new social programs, or simply to maintain current levels of support for existing programs as the number of recipients grows. In other words, it is about the allocation of limited resources *within the family of social welfare programs*.

Universalism vs. Targeting

When universal programs were first established, they were a much more attractive response to social welfare needs than they are now. They were less expensive than now, because benefits tended to be smaller and were provided to fewer recipients (the programs often having been phased in over many years or even decades). They were also less regressive, because the middle class was not nearly as large a proportion of most national populations as it is now. Thus,

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[39]Quoted in Robert Greenstein, "Universal and Targeted Approaches to Relieving Poverty: An Alternative View," 457–458.

[40]Peter David, "Inside the Knowledge Factory," 4, 11.

[41]Ibid, 11–12.

[42]Ibid, 11.

[43]William Drozdiak, "German Students Take to the Streets," *The Washington Post*, November 27, 1997, A39.

it was natural to promote universal programs on the grounds that they built social solidarity, avoided the stigmatization of recipients, had lower administrative costs than many other types of programs, and secured the support of large numbers of voters for government aid programs.[44]

Now, universal programs are not only generating intense budgetary shortfalls, they can also be extremely regressive. They often provide vast sums of aid to the middle class when the unmet needs of the disadvantaged are much more compelling. Why, then, have universal programs had such staying power?

First of all, universal approaches still command great moral authority. With good cause, they are seen by many as hard-won gains in the fight for social justice—in the form of universal pensions, medical care, and unemployment benefits—that must be defended at all costs. This sentiment is fed by the proponents of targeting when they seem to show little concern for those left out of targeted programs. Moreover, the temporary decline in national deficits has undoubtedly led to a degree of complacency. Somehow, many seem to think, if we muddle along, with an adjustment here and an adjustment there, the problem will go away. But, as I have tried to show, much more fundamental change will be necessary if countries are to afford their social welfare systems.

But by far the most important factor preventing reform has been the existence of large, politically powerful recipient groups. Roger Freeman explains:

> Social programs build their own clientele groups which organize for political effectiveness and fight to the utmost to keep the money flowing at an undiminished, and if possible increased, pace.[45]

This phenomenon is explained by public choice theory: A group that receives a particular, identified benefit is more likely to organize politically for its continuation than is the general public, which only dimly perceives its interest in the matter.[46] As an OECD report describes:

> Many entitlements have acquired the status of property rights, and withdrawing them may meet resistance because the costs of cutting programs will tend to be obvious and fall on particular groups while the benefits of reduced taxes or lower interest rates are spread among many.[47]

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[44]William Julius Wilson argues, "An important consideration in assessing public programs targeted at particular groups (whether these groups are defined in terms of race, ethnicity, or class) is the degree of political support those programs receive, especially when the national economy is in a period of little growth, no growth, or decline. Under such economic conditions, the more the public programs are perceived by members of the wider society as benefiting only certain groups, the less support those programs receive." Quite simply, Wilson states, "income-tested programs are much less likely to be introduced or to receive continuing support in a stagnant economy." William Julius Wilson, *The Truly Disadvantaged*, (Chicago: The University of Chicago Press, 1987), 118, 124.

[45]Freeman, *A Preview and Summary of "The Wayward Welfare State*," 103.

[46]See, e.g., James M. Buchanan, *Public Finance in Democratic Process: Fiscal Institutions and Individual Choice* (Chapel Hill: University of North Carolina Press, 1987).

[47]Leibfritz, Receiver, and van den Njord, OECD Working Paper, no. 144, 21.

Program advocates and social welfare experts, by failing to educate the public about the fiscal realities of universalism, also deserve some of the blame (or credit) for the failure to reform social welfare programs. In fact, they have participated in something of a political shell game. Despite the welfare-like, redistributive character of many universal programs, in the United States they have sold voters on the idea that benefits are earned, rather than being a form of government assistance. As Robert Greenstein argues in explaining the popularity of the American pension system: "One reason social security enjoys such strong political support is that most Americans also regard these benefits as earned rather than as a handout."[48]

This should be a warning to developing countries: Once the middle class becomes used to receiving benefits under a particular program, most governments have found it exceedingly difficult to make even marginal reductions in the program. As Jonathan Rauch, an American essayist, colorfully describes: "Government can't grow much because voters resist raising taxes (and elites resist deficits), but it can't shrink much because client groups surround every program with barbed wire and machine gun nests."[49]

Only the overwhelming realities sketched above have begun to change this political dynamic. Projections of unsustainable growth for universal programs—combined with the host of new social needs that must be addressed—have undercut both the moral authority and political strength of universal programs. Let me explain.

Universal unemployment, pension, and medical programs were the first kids on the block, so to speak, and thus faced little competition from *other social welfare programs*. For many decades, their proponents had no moral obligation to consider the funding available for other programs that might represent greater social needs. But now, as I have tried to show, these dinosaurs of the twentieth century welfare state no longer compete solely with military programs, for example, but with other social welfare programs[50]—such as enhanced medical care, long-term care, child care, expanded education and training, and growing income maintenance and social support programs for single mothers. (Given this reality, instead of building social solidarity, universal programs could soon be the cause of social division.)

The argument in favor of targeted benefits, then, is quite simple: They cost less, thus leaving funds available for other, more pressing, social purposes. Despite the clear economic need to rein in spending on universal programs, however, targeted programs pose serious ethical and, therefore, policy concerns. Targeting is a blunt policy instrument prone to over- and under-inclusion. There are no bright lines for deciding who needs aid—and who does not. Politics often determine "who gets what."[51] Furthermore, the alternative—case-by-case decision making—is

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[48]Robert Greenstein, "Universal and Targeted Approaches to Relieving Poverty: An Alternative View," 446.

[49]Jonathan Rauch, "Days of Apathy," response, *The American Enterprise* 8 (Nov/Dec. 1997): 26.

[50]Leibfritz, Thornton, and Bibbee state: "The driving forces behind higher government spending and taxes were mainly social expenditures, particularly unemployment benefits, old-age pensions, disability benefits and health-care expenditure. Public-sector wage bills and interest payments on government debt also increased in many countries. By contrast, government expenditure for infrastructure investment, education and research and development (R&D), often thought to be growth-enhancing, declined as a percent of GDP in many countries." Leibfritz, Thornton, and Bibbee, OECD Working Paper, no. 176, 13.

[51]Harold D. Lasswell, *Politics: Who Gets What, When & How,* (New York: Meridian Books, 1958).

unreliable, vests too much discretion in the hands of bureaucrats, and can be prohibitively expensive.

Consider eligibility for old-age pensions as an example. Some countries are in the process of raising the age at which benefits are available, often from 60 to 65, and with calls to raise them further. The argument for doing so is that retirement ages need to be raised to reflect the longer life expectancies and better health of the elderly. From a budgetary point of view, this reform is long overdue. But what may be a reasonable retirement age for white-collar workers may be very late for blue-collar workers—especially those still expected to perform manual labor. Chart 3 illustrates both the recent increases in retirement age, and the disparity among countries that reflects the subjectivity of establishing a "national" retirement age.

Income is another common method of targeting. But it, too, is an imperfect measure. People with no income or less income than others are not necessarily poor—consider retirees, students, and people just starting a new business. Conversely, people may appear to be financially comfortable, but actually have greater needs—consider those with large families, unusual medical needs, or no spouse to help support the family.

Thus, targeted programs are inevitably plagued by what statisticians call type I and type II errors:[52] They leave out many who need aid—even as they include many who do not. No matter how carefully developed and applied, targeted programs inevitably hurt some "innocent" people. The conservative social critic Charles Murray put it strongly, but accurately: "Any objective rule that defines eligibility for a social transfer program will irrationally exclude some persons."[53] But the more eligibility is broadened to cover the outliers, so to speak, the more likely it is that the program will include vast numbers of recipients with relatively little need for aid. Hence, the policy dilemma.

Further complicating the process is that decision making must take place on two dimensions. Not only must policymakers determine the relative needs of different recipients of one particular program, they must also weigh the needs of recipients (or potential recipients) of other social welfare programs who must be helped from the same finite budget.

It does not help that targeting is often an intensely political process. Too often in the United States, it seems, the elderly win this competition for funds—not because they are the most needful, but because they can dominate the ballot box.

[52]"A type I error is made if the null hypothesis is rejected when the null hypothesis is true. A type II error is made if the null hypothesis is accepted when the alternative hypothesis is true." William Mendenhall, Dennis Wackerly and Richard Scheaffer, *Mathematical Statistics with Applications*, 4th ed. (Boston: PWS-KENT Publishing Company, 1990), 430. (These errors are sometimes also called "false positives" and "false negatives.") The "null hypothesis" is, "The assumption that any observed difference between two samples of a statistical population is purely accidental and not due to systematic cause," *Webster's Third New International Dictionary* (Springfield, MA: G. & C. Merriam Company, 1971). In this case, the null hypothesis would hold that the person does not require aid.

[53]Charles Murray, *Losing Ground* (New York: BasicBooks, 1984), 211.

Support vs. Dependency

Targeted benefits are meant for those who need them most. Programs to combat poverty, for example, are aimed toward the “truly needy,” to use a U.S. term. But what if the availability of the aid, itself, leads people to adopt the very behavior the aid is meant to ameliorate?

Here is the problem: When aid is based on a condition or behavior, and people are able to alter their condition or behavior to conform to the criteria for program eligibility, the aid tends to encourage the very problems that it is meant to alleviate.[54] As an OECD report warns, “dependency traps are an unintended outcome of most social security systems.”[55]

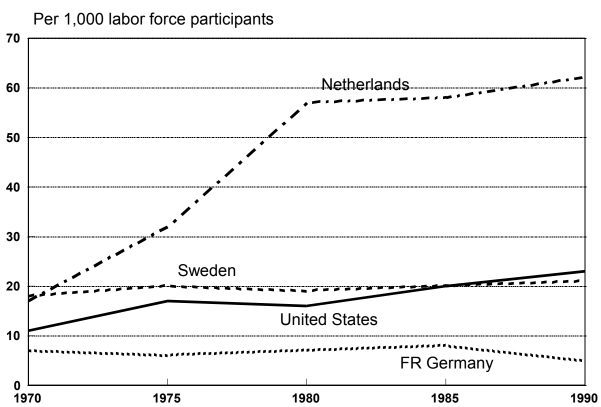
If the payoff is great enough, many potential recipients respond to the incentives imbedded in social welfare programs (such as disability and unemployment) by not working, lowering their (reported) income, or changing their marital status or living arrangements. In some respects, the danger of changed behavior has worsened as community and institutional bonds have weakened. A community of strong families, for example, is less likely to respond to the financial incentives for couples to divorce—or not marry in the first place.

Probably the most well-known example of government-bred dependency concerns disability payments in the Netherlands, the so-called “Dutch disease.” Between 1970 and 1990, the percentage of workers receiving disability payments rose from 5.5 percent to 15.2 percent, an almost two-fold increase. For those aged 15 to 44, the percentage rose from 1.7 percent to 6.2 percent, 2.6 times higher. Of 5.5 million Dutch workers in 1994, over 900,000 were receiving disability benefits.[56] According to an OECD report,

> As the number rose, the average age of beneficiaries declined, and the proportion who qualified on the basis of psychological hardship expanded from 21 percent to 27 percent. . . . When other welfare spending is included, every 100 employed Dutch people supported 86 recipients on social aid.[57]

As Chart 9 shows, in 1990 the proportion of Dutch workers aged 15 to 44 on

Chart 9
Disability Recipients Ages 15-44
1970-1990



Source: Philip R. deJong, "Social Policy and the Labor Market," *International Studies in Social Security*, 1997, table 3.3.1.

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[54]Charles Murray calls this one of the Laws of Social Programs: “Any social transfer increases the net value of being in the condition that prompted the transfer.” Murray, *Losing Ground*, 212.

[55]Organisation for Economic Co-operation and Development, *Shaping Structural Change: The Role of Women*, (Paris: OECD, 1991), 27. Reported in: Neil Gilbert, *Welfare Justice* (New Haven, CT: Yale University Press, 1995), 77.

[56]“Netherlands: Serious Steps to Resolve Longstanding Problems,” *International Social Security Review* 29, no. 2 (1996): 25.

[57]Organisation for Economic Co-operation and Development, *Economic Surveys: The Netherlands*, (Paris: OECD, 1991), 27. Reported in: Gilbert, *Welfare Justice*, 70.

disability was about three times higher than in other OECD-Europe countries. In that year, Prime Minister Lubbers, referring to this rise in disability claims, called the Netherlands a "sick" country.[58] Lubbers "stressed the need for radical change of the Dutch culture with respect to work absenteeism and disability claims, and declared that he would resign if the number of disability beneficiaries grew beyond one million."[59]

The consensus seems to be that Dutch disability benefits were simply too generous and too easily obtained. The replacement benefit was high (70 percent of the last gross wage), and was not time limited. Coverage did not depend on work history.[60] A worker on disability did not have to take a job that was not commensurate with his training and work history.[61] Disability assessments were not made by physicians, so that, according to Hans Aliens, "employees used to determine . . . whether they were ill or not without involvement of a doctor."[62] He added, "While other countries re-examined people on their illness and reintegrated them in the labor process, benefits in the Netherlands would only end at retirement or death."[63] In some respects, the disability program had become a form of early retirement.

Starting in 1993, the government began to take steps to "cure" the Dutch Disease. Under the Reduction in Claims for Disability Benefits Act, for example, the government put "more of the financial costs on the employer and the employee."[64] It required employers to "pay a penalty to a separate fund for each of their employees who enters the disability rolls . . . The fund gives a bonus to each firm that employs a disability beneficiary for at least a year."[65] Work no longer has to be on a par with the recipient's training. A disabled worker must now accept any "work that can actually be undertaken, regardless of levels of education, skill, former occupation and labor-market conditions."[66] Self-diagnosis of disabilities is no longer allowed. The legislation "stipulates that the association between the disorder and the work incapacity must be direct and established objectively."[67] For workers under age 50, disability benefits are now contingent upon the worker's age and previous employment.[68] Benefits are no longer unlimited in duration. After three years, their status is reviewed.[69]

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[58]Leo Parts and Philip de Long, "The Dutch Disability Program and How it Grew," in *Curing the Dutch Disease*, Eds. Leo Parts, Richard Burkhauser and Philip de Long, (Aldershot, UK: Avebury, 1996), 61.

[59]Ibid, 61.

[60]Ibid, 23.

[61]Ibid, 23.

[62]Hans Aliens, "To Rigorously Combat the Dutch Disease," *Social Security World* (1997): 17.

[63]Ibid, 17.

[64]"Netherlands," *International Social Security Review*, 28.

[65]Parts and de Long, *Curing the Dutch Disease*, 63.

[66]"Netherlands," *International Social Security Review*, 26.

[67]Ibid, 27.

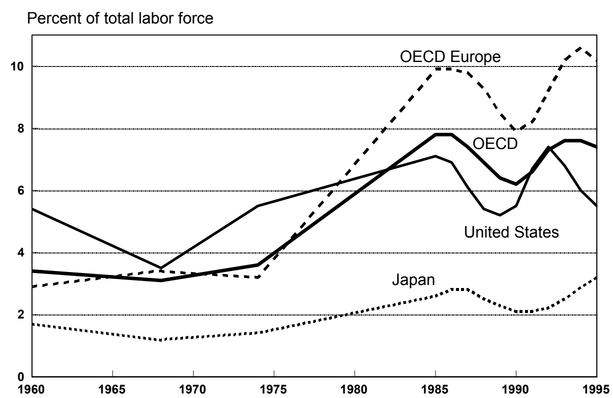
[68]Ibid, 27.

[69]Parts and de Long, *Curing the Dutch Disease*, 61.

According to the Dutch Social Security Supervisory Board, these programmatic changes have reduced the number of disability-benefit recipients. The Board found that "47 percent of all the reviewed beneficiaries thus far have either lost their benefits entirely or had them lowered. . . . [The decrease in the volume of . . . benefit claims can be almost entirely attributed to the new legislation in general."[70] Moreover, a study by the Central Bureau of Statistics found that "sickness absence rates for business have dropped from 6.7 percent in 1993 to 5.5 percent in 1994, a decrease of almost 19 percent."[71]

Other countries' disability programs seem to contain similar work disincentives. But because their programs were not nearly as generous, the concomitant behavioral changes have apparently not been nearly as dramatic. The United States, for example, has a much more modest program.[72] Nevertheless, since the late 1950s, the average age of an American male disability recipient has dropped by 10 years. In 1957, the average male receiving disability insurance was 59.4 years old; in 1995 he was 49.7 years old. And whereas only about 3 percent of recipients in 1960 were in their 30s, by 1995, 15.5 percent were—a five-fold increase.[73]

Chart 10
Unemployment
1960-1995



Source: Organization for Economic Co-operation and Development, "Historical Statistics," 1997, table 2.15.

For most countries, unemployment benefits pose the greatest danger of work disincentives. As an OECD report notes, "There is broad consensus that unemployment rates across time and countries are related to the generosity of income support available to the unemployed."[74] This has been a particular problem in OECD Europe, where unemployment rates have been in the double digits twice since 1985, compared to a U.S. rate that is about 40 percent lower. (See Chart 10.)

Most economists believe, for example, that a major reason why the U.S. unemployment rate is so much lower than that of OECD Europe is that its unemployment

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[70]"Netherlands," *International Social Security Review*, 28.

[71]Ibid, 30.

[72]To qualify for Disability Insurance benefits, an individual must have worked—the amount depending on age. A worker in his 30s, for example, must have worked for five years. A state agency determines disability by assessing whether the individual is engaged in substantial gainful activity (SEA), which is usually determined by income. If a person is engaging in SEA, he is not considered disabled. If he is not engaged in SEA, then the severity of his disability is explored. If it meets a published medical listing, and will last for at least one year, benefits are granted. Regulations passed in 1980 require that disability beneficiaries be reexamined every three years. The Disability Benefits Reform Act of 1984 identified a number of medical improvements that would result in the termination of benefits. Social Security Administration, *Social Security Disability Benefits*, SSA Publication No. 05-10029 (May 1996); U.S. Congress, House, Committee on Ways and Means, 104th Congress, 2nd Session, *1996 Green Book* (November 1996) . 40–41.

[73]Social Security Administration, *Social Security Disability Benefits*, Table 5.D4.

[74]Organisation for Economic Co-operation and Development, *Implementing the OECD Jobs Strategy: Member Countries' Experience* (Paris: OECD, May 1997), 27.

benefits are sharply limited. (There are, of course, other reasons, such as the high cost of labor in Europe.) U.S. benefits replace no more than 50 to 70 percent of the unemployed worker's pretax wage, depending on the state, with state-determined caps ranging from roughly between $200 and $400 per week. More importantly, benefits are fiercely time limited: An unemployed worker can receive 26 weeks of benefits and, if needed, an additional 13 weeks under the Extended Benefit Program, for a maximum of 39 weeks of benefits. After that time, the only benefits uniformly available are food stamps, which are coupons redeemable for foodstuffs that range in average value from $119 for one person to $397 for a family of four. In addition, short-term welfare benefits may be available.

A number of research studies have concluded that unemployment benefit recipients do in fact respond to incentives. In summarizing several studies that estimated the impact of replacement wages and time limits on reemployment, Paul Decker of Mathematica Policy Research (MPR) notes, "Although the exact magnitude of the response is uncertain, the lengthening in average unemployment spells is likely to be in the range of 0.5 weeks to 1.5 weeks for every 10 percentage-point increase in replacement rates."[75] He also found that the potential increase in the duration of unemployment insurance benefits lengthened recipiency. One recent study suggested that a one week increase in benefit duration prolonged recipiency by 0.1 to 0.5 weeks.[76] Although these individual impacts may not seem large, multiply an additional week of unemployment by the total number of unemployed in a country and the resulting loss of economic activity becomes significant.

There is a clear tradeoff here. As Gary Burtless of the Brookings Institution describes, "the percentage of working-age adults who EITHER earn low wages OR are jobless is a little higher in France than in the U.S.A. For example, among 15-64 year-old men, the percentages are 38% in France versus 35% in the U.S.A. In France, the percentage of working-age people who are jobless is higher; in the U.S.A., the percentage of working-age folks who earn low wages is higher. But the sum of these two percentages is higher in France than the U.S."[77]

With the U.S. example before them—and with what a 1994 OECD Jobs Study called "unacceptably high rates of structural unemployment"[78]—many European countries have recently trimmed various aspects of their unemployment systems.[79] Three countries have time-limited benefits (Belgium, Denmark, United Kingdom). An equal number have reduced the value of benefits (Germany, Ireland, Switzerland). Many nations have also made it more difficult to get unemployment benefits by tightening eligibility requirements (by, for example, increasing the required contribution period, raising the minimum age, and excluding those who voluntarily quit

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[75]Paul Decker, "Work Incentives and Disincentives," in *Unemployment Insurance in the United States: Analysis of Policy Issues*, eds. Christopher O'Leary and Stephen Wander, (Kalamazoo, MI: Upjohn Institute, 1997), 296.

[76]Ibid, 297.

[77]Wiemer Salverda, Brian Nolan, Bertrand Maitre and Peter Mühlau, *Benchmarking Low-Wage and High-Wage Employment in Europe and the United States: A Study of New European DATANET and National Data for France, Germany, the Netherlands, the United Kingdom and the United States* (Amsterdam: Institute voor Arbeids Studies, 2001).

[78]Organisation for Economic Co-operation and Development, *Implementing the OECD Jobs Strategy: Member Countries' Experience*, 26.

[79]Ibid, 28.

jobs.) Countries have also made benefits conditional on working on government projects or participating in job-related activities.[80]

Lessening the work disincentive effects of various income support and social welfare programs, thus, has become a priority in many developed countries. As Neil Gilbert of the University of California describes in his book *Welfare Justice*:

> By the mid 1990s quiet satisfaction had turned to manifest discontent with conventional welfare arrangements. In Europe the Organization for Economic Cooperation and Development (OECD) advocated a shift from "passive" welfare policies that undermined initiative to "active" policies that would reinforce the work ethic.[81]

This brings me to the second dilemma in this paper's title: If incentives or disincentives (that is, sanctions) are to succeed in discouraging dependency, they must "bite." But if they really bite, they will harm the recipients and potential recipients who cannot change their behavior.[82] Even mandatory work programs will leave some behind—because some people will refuse or be unable to fulfill the program's requirements.[83] Charles Murray acknowledges this reality: "The less likely it is that the unwanted behavior will change voluntarily, the more likely it is that a program to induce change will cause net harm."[84]

The U.S. unemployment insurance system exemplifies the dilemma of time-limiting benefits. While many unemployed workers respond to the time limit and find work, many do not. According to a 1990 MPR study, 63 percent of unemployment benefit recipients found work by week 25. As the 26 week limit approached (the legal cutoff at the time of the study), the proportion of recipients leaving unemployment for work rose rapidly. According to Walter Corson and Mark Dynarski, authors of the MPR report, "In the context of theoretical models of job search, it has been noted that the reemployment probability should be greater in the time interval shortly before or after unemployment benefits are exhausted. One reason for the expected increase is that the exhaustion of benefits gives rise to a sharp reduction in well-being while unemployed, which induces workers to return to work more quickly by searching more actively or by accepting job offers that may have been unacceptable while they were still receiving benefits."[85] Among workers who had exhausted their benefits, the probability of reemployment was highest one to two weeks after their last check (9 percent), and fell to 4

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[80]"Developments and Trends in Social Security 1993-1995: Broadcasted Retrenchment Developments," *International Social Security Review* 49, no. 2 (1996), Table 1.

[81]Gilbert, *Welfare Justice*, ix.

[82]This is why Digby Anderson titled the book he edited *This Will Hurt* (New York: National Review, 1995).

[83]LaDonna Pavetti of the Urban Institute estimates that 35 percent of all AFDC recipients will exceed the five year time limit on welfare. About two-thirds of women with less than nine years of education are predicted to exceed the limit, as are 45 percent with no recent work experience, 43 percent of never-married women, and 43 percent with three or more children. U.S. Congress, *1996 Green Book*, Table 8-48.

[84]Murray, *Losing Ground*, 216.

[85]Walter Corson and Mark Dynarski, *A Study of Unemployment Insurance Recipients and Exhaustless: Findings from a National Survey* (Washington, DC : U.S. Department of Labor, 1990), 60.

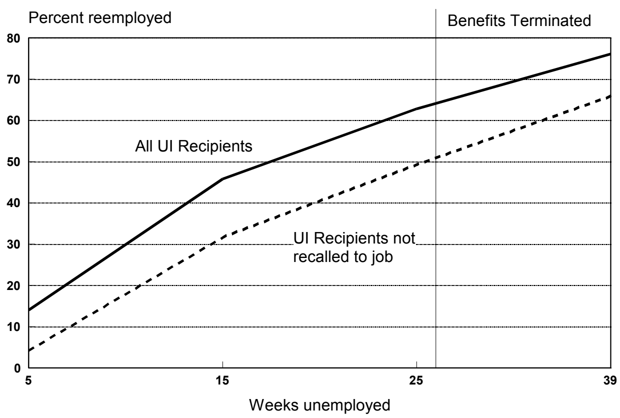
percent around the fourth week. The authors concluded, "The reemployment probability declines sharply after that point (between 2 and 3 percent), as theoretical models predict."[86]

Thus, time-limited unemployment benefits seem to encourage workers to find jobs earlier than they might otherwise. But a substantial proportion of workers will inevitably be hurt, either because they cannot find jobs or they are forced to take lower-paying jobs as time runs out.

Chart 11

Leaving Unemployment for Work

U.S. Recipients Subject to Time Limit



Source: Mathematica Policy Research, 1990.
Note: UI benefits exhausted at 26 weeks.

Chart 11 illustrates the problem in unambiguous terms. About 37 percent of unemployment benefit recipients did not have a job at the 26 week cutoff point. Corson and Dynarski's work indicates that the majority—75 percent—were still jobless one month after receiving their final payment, and 60 percent were so after two months.[87]

Corson and Dynarski compared the characteristics of beneficiaries who found work with those who exhausted their benefits. They found that, in general, those who did not find work were more likely to be black, Hispanic, women, older workers, and workers in weak labor markets. Some workers could not find work because of the nature of their jobs; they were, for example, more likely to be displaced workers or in seasonal industries.

The distribution of exhaustees was also bimodal: Workers without a high school diploma and those with a college degree were both more likely to exhaust benefits than high school graduates and those with some college. High school dropouts, according to the authors, have difficulty finding jobs because of their low skills; college graduates because they take time to find an appropriate job. Unemployed women with a working spouse were also more likely to exhaust their benefits, presumably because the income of a second worker enabled them to be more choosy about a new job.

Perhaps the biggest determinant of benefit exhaustion was whether the worker expected to be recalled to his previous job. Corson and Dynarski found that workers who expected to be recalled were the least likely group to exhaust benefits. The probability of exhausting benefits was 12 percent for those who expected to be recalled, compared to 35 percent for those who did not. The authors concluded, "Having a definite recall date thus reduced the probability of exhaustion by approximately 65 percent, after other differences among workers are controlled for."[88]

[86]Ibid, 68–69.

[87]The MPR study was published in 1990. Even though the United States is currently experiencing low unemployment rates, in Fiscal Year 1995, 2.1 million recipients, or 35 percent of those receiving benefits between March 1994 and March 1995, exhausted their benefits. U.S. Congress, *1996 Green Book*, 342.

[88]Corson and Dynarski, *A Study of Unemployment Insurance Recipients and Exhaustless: Findings from a National Survey*, 33.

Some would respond to the foregoing by arguing that some type of screening process should be developed to exempt, from the harshness of the aid cut off, those who cannot alter their behavior. Unfortunately, there is no evidence that reliable screening procedures can be developed. As we have seen, even disability programs, which presumably deal with more measurable conditions than "employability," are fraught with problems of over- and under-inclusion.

Others have suggested some sort of residual or reduced aid or a voucher for those who exhaust their benefits. (In the United States, as noted above, after unemployment benefits run out, the family is still eligible for food stamps and may also be eligible for limited welfare payments.) But, again, for the dependent behavior to be discouraged, the recipient must feel the consequences. Thus, the benefits must be somehow restricted and perhaps stigmatized.

Despite our fervent wishes to the contrary, the same unbending equation holds true across a host of social programs: For disincentives (or sanctions) to discourage dependency, people who do not respond to them must suffer financially.

This reality is not easy to accept. Few of us want to see our fellow citizens suffer, even if they have acted irresponsibly, and even if the discipline of a work requirement or a time limit would improve the lives of many others. But this is an unavoidable tradeoff. Better policies might result if all sides recognized this truth and dealt with it in as straightforward a manner as possible. Only in this way, for example, will the need for a "safety net" be apparent.

One of the disheartening failures in the U.S. welfare reform debate was the failure of the Right and the Left to engage on this key issue: Some recipients would be unable to meet the new responsibilities being imposed on them and would have to be sanctioned—even to the point of losing all their benefits. The Right did not want to discuss this possibility because it might undermine the validity of its "tough love" approach. The Left did not want to discuss this possibility because the poor might seem less "deserving."

Conclusion

Here is my argument in a nutshell: Both targeting and anti-dependency measures are almost assuredly essential to the future of the modern social welfare state. Indeed, without such measures, it is difficult to see how political support for social welfare programs will not continue to weaken. Nevertheless, they both require ethical, social, and political tradeoffs of the highest order.

Hence, in the coming years, social welfare policy making will increasingly involve (1) choosing between competing needs to decide who gets what benefits, and (2) deciding how to limit the tendency of government aid to create dependency. This paper has called the two questions underlying such decisions—universalism versus targeting and support versus dependency—twin dilemmas because they share parallel elements: a desire to provide income and social support to the disadvantaged (or less affluent), the need to limit aid in order to control costs and to reduce dependency, and the inevitable errors of over- and under-inclusion.

This decision-making process will have to be repeated many times over in the years to come, as needs, resources, attitudes, and political forces shift. In fact, it is likely to dominate social welfare planning for the foreseeable future. To an important extent, decision making can be assisted by objective cost/benefit analysis. And, indeed, economists are working on theories (and econometric models) for maximizing the economic efficiency of targeted social policies and for discouraging behavioral dependency.[89] In the end, however, most issues will be decided by the political process, and that is why it is so important that there be greater candor in the policy debate.

If developed countries, and developing ones, are to achieve anything like a reasonable accommodation between these conflicting principles, both sides of the debate need to be more forthcoming about the inevitable drawbacks of their respective approaches. Those seeking to protect current programs should acknowledge that, short of massive economic growth, looming budget deficits and high rates of dependency threaten to undermine social welfare programs in general. And those on the other side should acknowledge the difficulties of targeting and the need to have program incentives (or sanctions) that hurt those who do not respond to them—as well as some sort of social safety net.

Such candor could lead to vastly better policies than we have now. But it will require a high degree of responsibility on the part of political and intellectual elites—something, alas, in short supply these days. I see no other way, however, to address the fundamental ethical and social issues both dilemmas raise—and, therefore, no other way for modern welfare states to move to the next stage of their evolution.

[89]Economist George A. Akerlof at the University of California has described the social welfare policy debate as a two way tradeoff between welfare support and marginal rates of taxation, and a three-way tradeoff between these two variables and tagging. Akerlof sets up equations to model these tradeoffs, and concludes from his economic analysis that there exists an optimum point at which the amount redistributed from skilled to unskilled workers is maximized—subject to the constraint that any greater redistribution would cause skilled workers to switch from difficult to easy jobs (work disincentive). Akerlof would say the key to optimizing redistributive policy is to develop a tax scheme which maximizes the utility for three groups: the unskilled targeted, the unskilled uncarpeted, and the skilled. George A. Akerlof, *An Economic Theorist's Book of Tales*, (New York: Cambridge University Press, 1984), 45–68.