

**COSTS OF NON-SOCIAL POLICY: TOWARDS AN ECONOMIC
FRAMEWORK OF QUALITY SOCIAL POLICIES – AND THE
COSTS OF NOT HAVING THEM**

Report for the Employment and Social Affairs DG

FINAL REPORT

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Executive summary

The present report is a contribution to the comprehensive efforts by the European Commission to demonstrate that social policies are to be seen as a productive factor and not as a hindrance to economic activity. No attempt has been made at this stage to quantify the overall economic cost and benefits of different social policy regimes. However, a considerable volume of specific evidence is available on different aspects of the question, and has been drawn together in this report. The report assembles and reviews the diverse research and analytical work that is available concerning the costs and benefits of social policies. It proposes a general economic framework in which to view social policy as a productive factor while establishing that there are economic and social costs to not having social policies of adequate quality.

One must recognise that in industrialised countries, the State takes an important position as an economic actor. In particular, the State has taken responsibility for redistribution policies. This is due to the fact that the market is not able to set up some insurance markets such as, for example, minimum income protection systems for the poor or health and unemployment insurance. Market failures and informational problems are responsible for this. Social policy deals with these market imperfections before they appear. One of the obvious costs of non-social policy is poverty. Beyond this redistribution function, social policy also has a positive impact on the economy in terms of allocation (it contributes to the flexibility of the labour market and the quality of the labour force) and stabilisation (it acts as an automatic stabiliser). The arguments are developed in this report.

The debate on these functions of the welfare state is commonly taking place against the background of the alleged trade-off between economic efficiency and equity. Starting from this alleged trade-off we show that from a theoretical as well as empirical point of view this trade-off emanates from a short sighted understanding of economic mechanisms. More equity can go hand in hand with more efficiency. In other words, a generous level of social protection does not necessarily lead to lower economic achievements. On the contrary, social policies based on investments in human and social capital are conducive to higher economic efficiency for they improve productivity and the quality of the labour force. Social policy is therefore a productive factor, even though its costs are generally visible in the short term while its benefits are often only apparent in the long term.

Résumé

Le présent rapport est une contribution aux efforts intensifs de la Commission européenne à démontrer que les politiques sociales ne sont pas à envisager uniquement en terme de facteur coût ou en terme d'entrave à l'activité économique. Jusqu'à présent, aucune tentative n'a été entreprise pour quantifier de manière globale les coûts et bénéfices des différents régimes de politique sociale. Cependant, un large volume de recherches spécifiques sur divers aspects de la question est disponible. Le rapport réunit et discute les recherches et travaux analytiques disponibles concernant les coûts et bénéfices des politiques sociales. Il propose un cadre économique global permettant d'envisager les politiques sociales comme facteur productif tout en démontrant les coûts économiques et sociaux liés à l'absence de telles politiques.

Il faut bien reconnaître que dans les pays industrialisés l'État prend une position importante en tant qu'acteur économique. En particulier, l'État a largement pris en charge la fonction redistributive. Cela est dû au fait que le marché n'est pas en mesure de mettre sur pied un certain nombre de mécanismes d'assurance, c'est le cas par exemple des mécanismes de protection du minimum vital pour les pauvres et des assurances chômage ou de maladie. Les défaillances du marché et les problèmes d'information en sont les raisons. Les politiques sociales traitent ces imperfections de marché avant qu'elles ne se manifestent. Dès lors, une des conséquences liées à l'absence de politiques sociales est la pauvreté. Au delà de cette fonction redistributive, les politiques sociales ont également une fonction allocative (elles contribuent à la flexibilité du marché du travail et la qualité de la main d'œuvre) ainsi qu'une fonction stabilisatrice (en tant que stabilisateur automatique). Les arguments sont développés dans ce rapport.

Le débat quant à ces fonctions de l'État-providence a communément lieu sur fond d'un prétendu compromis entre efficacité économique et équité sociale. Nous prenons ce prétendu compromis comme point de départ et montrons qu'aussi bien d'un point de vue théorique qu'empirique, il n'y a pas nécessairement d'arbitrage entre efficacité économique et équité sociale. En d'autres termes, un niveau généreux de protection sociale n'est pas nécessairement implémenté au détriment des prestations économiques d'un pays. Au contraire, les politiques sociales basées sur l'investissement en ressources humaines et capital social, peuvent même stimuler l'efficacité économique car cela promeut la productivité et augmente la qualité du facteur travail. La politique sociale peut par conséquent être perçue comme un facteur productif, même si les coûts immédiats ne laissent souvent apparaître des bénéfices qu'à long terme.

1 Introduction

A great deal has changed since 1957 in Europe, when the Benelux countries, France, Germany and Italy started negotiations concerning the creation of a common market. What started with the gradual opening of labour and commodity markets was extended, in the 1980s, by opening the capital market and the market for services. It was also enlarged to include more countries. Alongside of the six original Member States, Spain, Portugal, Greece, Great Britain, Ireland, Denmark, Sweden, Finland and Austria joined in, and more countries from Central and Eastern Europe are expected to join the Union in the near future. Aside from broad economic goals defined in terms of economic growth, rising productivity and participation rates, the Amsterdam Treaty also includes a number of social objectives. These are laid down in articles 2 and 136 of the Treaty, where the improvement of employment, the constant improvement of living and employment conditions, a high level of social protection, social dialogue, the development of human capital to ensure a lasting high level of employment and combatting social exclusion are declared to be among the basic goals of the EU.

In response to including the fight against exclusion as one of the EU policy objectives in articles 136 and 137 of the Amsterdam Treaty, the Lisbon European Council has agreed to take decisive steps to combat poverty. According to the Council the goal for the Union is “to become the most competitive and dynamic knowledge-based economy in the world, capable of sustained economic growth with more and better jobs and greater social cohesion” (European Council, 2000a). The European summit, held in Nice in December 2000, resulted in the Council requesting the Member States to draft action plans against poverty and social exclusion, much in the spirit of the national action plans in the area of employment policy (European Council, 2000b). This recent move towards the monitoring of social exclusion and the explicit formulation of National Action Plans for Inclusion (European Commission, 2002a) demonstrates the desire, at European level, to flank the EMU with a social dimension. The challenge for EU Member States is to be able to achieve high economic and productivity growth while at the same time minimising so-called social failures such as unemployment, poverty and social exclusion (see European Commission, 2000). This is perceived as a challenge because the objective of attaining better social outcomes could be counter to that of high economic performance. Or, to put it another way, social policy is often believed to thwart economic and employment policy. However, as will be shown in this report, this is far from necessarily true.

The debate on the economic relevance of social protection was launched by the conference on ‘Social policy and economic performance’ that was organised under the Dutch EU-presidency in 1997. This triggered a comprehensive effort by the European Commission – especially its Employment and Social Affairs DG – to show that social policy is not by definition and primarily an impediment to economic performance, but rather a productive factor.¹ The debate was then continued and the idea of ‘social quality’ was introduced in EU discourse and the Social Policy Agenda (European Commission, 2000).² The Commission has now turned its attention to the costs of non-social policy. It is against this background that this report has to be seen. In this report, we draw on the available theoretical and empirical economic literature in order to present a general framework in which to view and to assess the productive impact of social policy. We develop an economic argumentation supporting the idea that

¹ See Berghman et al. (1998).

² Beck et al. (1997).

social policy has both positive social and economic returns, and that not having – or having insufficient – social policy leads to a cost in terms of reduced social and economic efficiency.

The report is structured as follows. In Section 2, we briefly discuss the role distribution between the market and the welfare state. Section 3 elaborates on the social costs of non-social policy, while Section 4 discusses the economic costs of non-social policy. In Section 5, we introduce and discuss an innovative approach to social policy which could be termed ‘quality social policy’. Section 6 presents the main conclusions.

2 The mutual roles of the market and the welfare state

2.1 Brief historical perspective

The end of the last century was marked by rapid economic growth in the EU, which resulted in job creation and decreased unemployment. Real GDP growth rate averaged 2.6 percent per year in the 1994-2001 period. Total employment rose by 6.6 percent between 1995 and 2000 while, at the same time, unemployment fell from 10.7 to 8.2 percent (European Commission, 2002a). This sustained economic activity has reduced the rate of long-term unemployment, however, youth unemployment rates and the poverty rate are still high. Estimations by Eurostat show that, in 1996, about 17 percent of all EU individuals lived in poor households (Eurostat, 2001). In the EU, a total of more than sixty million individuals were poor in that year, half of whom had been living in poverty for longer than three years. This last point illustrates that economic performance does not automatically lead to social success. Social policy is an important link for the realisation of social objectives. However, in the neo-classical economic literature, the welfare state – legislation, taxation and benefits to the promotion of individual welfare – has been under attack for its alleged negative effects on economic performance.³ In fact, the mutual role of public authorities in the market economy has been discussed by many economists.

Since Adam Smith, the guiding principle in micro-economic theory is that of the pursuit of self-interest. Smith (1976) demonstrated how the pursuit of private interest leads to the public good in an unregulated economy. The pursuit of self-interest is a major human characteristic. Just as David Hume and John Locke thought of individual interest as a solution to failing morale, in Smith’s opinion it would be useless to try to alter this tendency and would be more fruitful to concentrate on developing supportive institutional structures that account for this propensity such that the pursuit of self-interest would ultimately lead to the common good. According to Smith, the market is the obvious institutional setting to provide for that. An ‘invisible hand’ ensures that when individuals pursue their own interests, the common good is automatically realised. Agents, by pursuing their own interests, will lead markets to an equilibrium situation par excellence. A second argument for small government springs from the belief that capital formation is the engine of economic growth. Hence, according to the argument, government spending for unproductive labour that requires levying taxes, inhibits economic growth because of its negative impact on capital formation. It follows that, for economists, the subsidiary relationship between the State and the market is simple: what the market can achieve should be left to

³ In particular, institutional aspects – such as the minimum wage – have been criticised as having an adverse effect on employment. On the basis of extensive analysis of the situation in the USA, Card and Krueger (1995) show rather the opposite and document the economic benefits of the minimum wage.

the market. A higher, all-enveloping level – such as the State – should carry out activities that cannot be performed efficiently by the market, or that should not be performed by it because of the nature of these activities. In other words public authorities are to take action when market failures arise. Markets fail to achieve an efficient outcome when competition is imperfect, when information is incomplete, when there are public goods to be produced, when production induces externalities, or when the markets face uncertainty. Equity considerations can also call for government intervention.

2.2 Efficiency versus equity

In welfare economics, justifications for government intervention take the free market situation as the point of departure. According to the first theorem of welfare economics, if markets are competitive, information is perfect and there is a full set of markets, then, if a competitive equilibrium exists it is Pareto efficient.⁴ The presumption here is that in the optimal situation, government intervention is not necessary on efficiency grounds. Starting from the usual assumption in neo-classical economics that market allocation is efficient, the State is a subsidiary of the market: activities that can be performed efficiently by the market should be left to the market. In other words, subsidiarity implies that the burden of the proof lies with the defenders of centralisation.

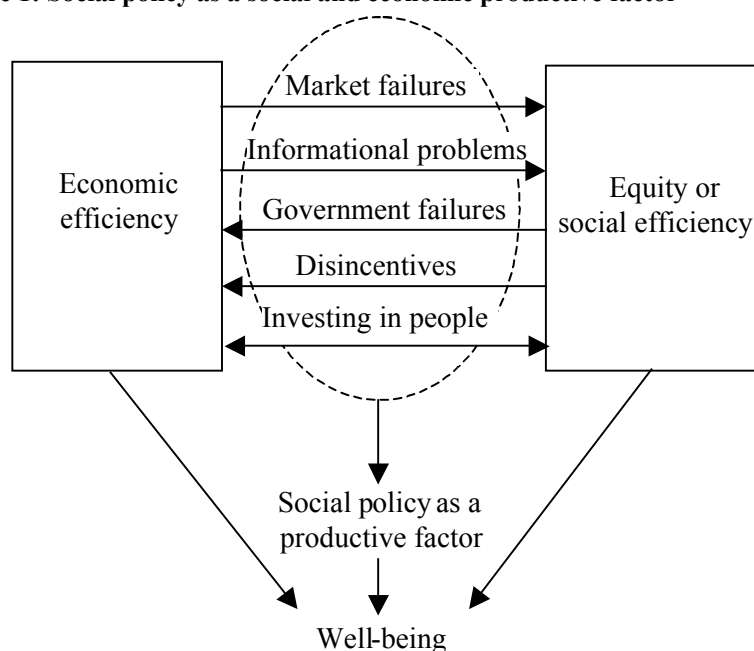
In economic discourse, the discussion on social policy and the redistribution function of the welfare state is generally framed around the concepts of equity and efficiency. From a theoretical point of view, there appears to be a trade-off between the two. In Okun's terms, "the conflict between equality and efficiency is inescapable" (Okun, 1975: 120). Okun – among many others – has stressed the "leaky bucket" character of transfer programmes. To put it briefly, the reasons for this leaky bucket effect of social protection are the administrative costs, the negative effect on work effort and on saving and investment behaviour, and the effect on attitudes.

However, the relationship between equity and efficiency is a complex one. As we will see in the following, the underlying assumptions for an efficient equilibrium in the above statement are not always met so that corrective mechanisms by the State have to be considered. In fact, in advanced economies, the State is generally present in the production process, either as employer, subsidiser or rules setter (legislator). This involvement of the State is particularly true when it comes to the distribution of resources and the analysis of well-being. Eventually, the optimal role distribution between the various actors – i.e. the market and the welfare state – is indeed primarily a question of economic efficiency. However, concern for equity or social efficiency (i.e. the attainment of an optimal social outcome) also matters. The interrelation or synergy between efficiency and equity will determine the framework of this report. We will undertake to show that social policy – as opposed to the impediment of economic efficiency through disincentive effects – can also be viewed as a productive factor. Due to the constraints of time and space, we will not discuss the full details of the theoretical arguments here and will only present the core of the arguments, supporting them, where possible, with empirical evidence.⁵

⁴ Atkinson & Stiglitz (1980: 343) formulate the theorem as such: "If households and firms act perfectly competitively, taking prices as parametric, there is a full set of markets, and there is perfect information, *then* a competitive equilibrium, if it exists, is Pareto-efficient."

⁵ For a thorough analysis of the arguments supporting the welfare state, we refer the reader to Atkinson and Stiglitz (1980), Barr (1987, 1989, 1992) and Stiglitz (1988).

Figure 1: Social policy as a social and economic productive factor



Social policy as a productive factor can be interpreted as promoting growth or, more broadly, as promoting quality of life. Productivity, in the sense of promoting growth implies that growth in income per capita is the key policy aim. This option rejects the quality of life approach as being ill defined and impractical (MacGillivray et al., 1996: 16). Viewing productivity as promoting quality of life emphasises the shortcomings of crude economic indicators such as GDP growth rate. It also concentrates on evaluating the contribution of social policy on an alternative set of indicators of quality of life (such as human development). The important thing is to realise the double dimension of social policy. It has a consumption (e.g. redistribution) and an investment component (education and training, health care, occupational safety and health). On the one hand, the consumption aspect might be conducive to labour disincentives and government failures. On the other hand, the existence of market failures and informational problems call for public mechanisms of insurance and redistribution, and hence more emphasis on social efficiency (see Figure 1). The consumption and in particular the investment component of social policy can allow government policy to combine economic and social efficiency. In the following sections, we will present evidence that social policy is a productive factor in ‘quality of life’ terms and will show that it is productive in ‘promotion of growth’ terms. It must, however, be realised that although the costs of social policy are generally immediately visible, the benefits are more difficult to identify and quantify. The reason is that much of these benefits are long term.

The theoretical arguments for the existence of a benefit system can be articulated according to the three classical economic functions of government intervention: allocation, stabilisation and redistribution (Musgrave, 1959). Although the most important role of the welfare state is to redistribute resources, it also has an allocation and stabilisation function. Considering economic and social efficiency solely in the light of this assumed trade-off is therefore a simplification of reality. Economic and social performance are interrelated in such a way that the potential for win-win situations is high. Higher social efficiency does not necessarily imply loss of economic efficiency. Le Grand (1990) even

argued that the trade-off is an elusive one.⁶ Aside from its obvious function in terms of redistribution, social policy also has an allocation and stabilisation function. More precisely, social protection is not only profitable from the point of view of equity or social efficiency, it can also be a productive factor since it promotes economic efficiency. Both aspects are conducive to improving the standard of living, one of the basic goals of the EU.

We will discuss the arguments along two lines. The first is the equity or social efficiency line and the second relates to economic efficiency (see Figure 1). Concern for equity is the primary reason for the redistribution function of the social protection systems (Section 0). However, efficiency considerations can also be relevant. The redistribution, allocation and stabilisation function of social protection is justified for efficiency reasons (Section 4). This implies that, irrespective of one's own view on equity, there is an efficiency argument favouring the welfare state.

2.3 Welfare state design

How social policy works in terms of social and economic efficiency depends on the way the welfare state is designed. There are choices to be made as to how to organise welfare arrangements and the degree of State intervention. Welfare state arrangements do not stand alone and can be fitted into the stylised models discussed below. Although these models are a simplification of reality – for they do not account for the full diversity of the institutional set-up, policy design and functioning of the welfare states – they are a useful tool in discussing international comparisons. At some points below, Esping-Andersen's typology of welfare regimes (Esping-Andersen, 1990) will be used to investigate the effect of welfare state design on economic and social efficiency. This typology distinguishes among the liberal, the corporatist and the social democratic types of welfare regime. We have added another type – the southern regime – to these types, in response to commonly made criticism to the original typology (see e.g. Ferrera, 1996). These regime types represent a particular institutional framework, a particular type of policy intervention and set of policy tools. Although they differ as to the structure of the tax/benefit system we will mostly concentrate on the benefit side.

The regime types vary as to who is primary responsible for the individual's welfare, which also reflects cultural difference between regimes: the individual him/herself, through the workings of the market as in the liberal regime; the family, as in the southern regime type; social groups or the corporation, as in the corporatist regime; or the State, as in the social democratic regime. In reality, no country fits perfectly into one of these types, nor are they stable features of a country's socio-economic policy over time. Nevertheless, such a typology is scientifically found to be valuable and is widely used.

One major challenge to policy makers is how to achieve the three objectives of high level of employment, a high level of equality and a balanced budget all at the same time. The social democratic approach tends to give more weight to achieving a high employment level and a high level of equality whereas the corporatist matches a high level of equality and a balanced budget. The liberal approach is one where the focus is on a balanced budget and a high employment level. In Section 5, we argue that the investment approach to social policy allows one to match these three objectives at the same time.

⁶ The core of his argument is that efficiency is not one of the primary objectives of the social welfare function. Efficiency is nothing but a rule determining whether or not – given a production frontier – the realisation of the objectives is optimal.

3 Equity argument for social policy: the social cost of non-social policy

3.1 Social justice

Although the market produces wealth well, it distributes it unequally. The distribution of income and wealth resulting from the market process might not correspond to the prevailing concept of equity in society – i.e. the ideas on equity and redistribution the voters in a particular country have at a particular point in time. According to the second theorem of welfare economics, redistribution could be achieved in a non-distortionary way through lump-sum taxes and transfers such that efficiency is not diminished. Lump-sum taxes and transfers are, however, difficult to devise in real world economics, so a trade-off is believed to exist between efficiency and equity (Okun, 1975). In practice, the State might wish to redistribute income, wealth and other human resources so that it is in accordance with society's concern for equity. This is indeed a major role of the welfare state.

One of the problems with standard micro-economic theory is that it leaves no room for the notion of minimum necessary standard. For Adam Smith, one's subsistence would depend on his wages, which he referred to as the natural price of labour. This natural wage should be enough for the labourer to support himself and his family. For those unable to generate enough income to secure a decent living for themselves, he believed that the innate moral sentiment of others would induce spontaneous private charity (Smith, 1974). This is referred to as altruism.

As illustrated in Appendix 1, one of the shortcomings of the standard neo-classical model is that it cannot cope with poverty because the model fails to recognise the notion of minimum subsistence level. Although market outcomes are efficient, Pareto efficiency is not a distributional principle. As such, market mechanisms potentially lead to unequal outcomes and even poverty. Nineteenth century liberals thought of poverty as a short-term problem. They believed that spontaneous processes, through the labour market, would provide one with the opportunity to improve one's own situation. However, poverty appears to be more persistent than it was thought to be. Minimum wage regulations and the welfare state are instruments that make it possible to correct such inequitable market outcomes. The welfare state, however, is often seen as a financial burden leading to inefficiency.

Nonetheless, the question whether the State has any role at all to play in the field of income distribution and poverty relief is a highly normative one on the edge of political and economic theory. While Pareto efficiency is a rather broadly accepted allocation criterion in economics, there is no broadly accepted distributional rule. One's considerations concerning social justice will, to a large extent, determine how one values inequality and redistribution. Within the standard utilitarian framework, the ultimate aim is the maximisation of the sum total utility. Because individuals are generally assumed to have different marginal utility, the distribution of utilities is not an issue.⁷ However, there is one exception where equality enters the welfarist framework: concern for equality can be understood from the point of view of cardinalist welfare criteria. If everyone has the same utility function that is increasing in income and concave then, with a given total income, welfare would be maximised if everyone receives the same income. However, this is a special case. Utilitarians do not reject all forms of State redistribution altogether, but they are aware of its limitations due to the distortive effect of taxation which is linked to the problem of incentives (see below). This is where the alleged trade-off between economic efficiency and equity comes from.

⁷ Some doubt that the distribution of utilities should be of any concern (Sen, 1992).

Libertarians are much more categorical. They see public welfare provision as paternalistic and eroding personal freedom. Therefore, Robert Nozick advocated a minimal State “limited to the narrow functions of protection against force, theft, fraud, enforcement of contracts, and so on, is justified; that any more extensive state will violate persons’ rights not to be forced to do certain things, and is unjustified.” (Nozick, 1974: ix). His view of justice is based on the moral value of rights and entitlements. Any social outcome, including income distribution, is just as long as it is arrived at through a fair exercise of rights and entitlements. It follows that the sole possible role for the State is to see to the proper use of these rights and entitlements. There is, according to his view, no role for the State to play in the policy field of redistribution. Any form of welfare state is unacceptable because it is a violation of individual liberties. The relief of destitution through private charities is, to him, the only legitimate way to redistribute income.

Friedrich Hayek and Milton Friedman are more moderate, although, they also have a minimalist view of the welfare state. For them, taxation might be legitimate for the limited provision of some public goods and for the relief of poverty up to a (low) level of subsistence. Although Hayek and Friedman see an ‘institutional’ welfare state as a coercive agency resulting in inefficiencies, they see a ‘residual’ welfare state as appropriate to relieve destitution and provide certain public goods.

Hayek expected all people to build up money reserves for themselves in order to cover their needs during adverse economic times. He believed private insurance markets would develop in the face of these prospective market opportunities. The State would only have to ensure the development of those insurance companies. Welfare provision by the public authorities is inefficient because it is flawed. It provides for a standard level of welfare to everyone, irrespective of needs and preferences. Moreover, a large social welfare organisation at the national level is an impediment to the creation of other private welfare organisations, also those that, potentially, could offer a higher level of welfare. He also argued that the combination of increasing social security contributions and inflation would eventually lead to more poverty. This, Hayek argued, is because politicians promise adequate levels of social provisions which necessitate, among other things, higher social security contributions.

John Rawls’s liberal view on social justice allows us to visualise the welfare state as an ex-ante insurance mechanism. Rawls (1971) believes that when individuals are placed behind a veil of ignorance – when they know nothing about their socio-economic background and future capabilities – they will agree on a social contract satisfying a set of distributive principles. To put it shortly, the principles hold that primary goods (which include economic goods but also opportunities, skills, liberty and self-respect) are to be distributed equally, unless another distribution is to the greatest benefit of the most disadvantaged. Redistributive policies that improve the position of the least well-off, therefore, constitute an improvement. In other words, the need for social insurance can be understood from the insurance motive. People are willing to redistribute resources towards the needy since there is a chance that they will find themselves in a similar situation at some time in the future. This well-understood self-interest can, therefore, account for the existence of social insurance schemes. Also, altruistic feelings and the public good feature of the income distribution are some of the other reasons for redistribution.

3.2 Altruism and attitudes towards redistribution

Within the utilitarian framework, concern for other people’s well-being can result in altruistic behaviour when utility functions are interdependent. When such value judgements enter the utility function, social cohesion and redistribution increase not only the total welfare, but also the individual

welfare level. Suppose that both the rich's and the poor's income enter the rich's utility function. In that case, there is an income externality of the poor's income on the utility level of the rich and redistribution from the rich to the poor will be rational as long as the rich's utility increase of additional income to the poor exceeds the disutility of their diminished income.⁸

There is indeed evidence that altruistic behaviour is part of human nature (Hoffman, 1981) and that it can play an important role in explaining economic behaviour (Frank, 1987, Becker, 1981, Titmuss, 1971, Arrow, 1972). The above implies that voluntary redistribution without intervention of the State is a possibility. However, a number of problems arise from private redistribution, through, for example voluntary club formation. First, redistribution by voluntary clubs would, most probably, not be on a sufficiently large scale. Secondly, some risks are simply not insurable on the market, i.e. unemployment because of moral hazard, adverse selection and the interdependence of risks (see below). Thirdly, unless there is club formation with effective control on the club members and enforceability of the social contract, the private solution will be marred by the free-rider problem. Finally, lack of co-ordination among private entities might result in undesirable competition among the clubs and, hence, under provision of welfare (see e.g. Lejour, 1995). Hence, as is the case with other public goods, the market is not expected to produce the Pareto-optimal amount of redistribution. It is the welfare state that is better equipped to cope with these difficulties. Note, however, that the welfare state is more than simply the expression of some altruistic concern. The welfare state is a requirement of social justice.

Human dignity is an accepted value⁹. In as far as the market economy does not secure human dignity, it will have to be preserved by other means (such as the welfare state). The income distribution obtained through the workings of the market might not be the one that maximises the social welfare function. In other words, the social preference for equity might be different than the one produced by the market. Research by the Dutch Social and Cultural Planning Office shows that in 1997, 64 percent of the Dutch population found income differences too large. 68 Percent find that income differences should be (much) smaller (SCP, 1998: 12). In the early 1990s, these percentages were 50 and 56, respectively. In another study, it appears that, in 1995, a small majority of the Dutch population (strongly) agrees that public authorities should promote income equality (52 percent) and increase taxation on higher incomes (52 percent; SCP, 1996: 488). Similarly, using the International Social Survey Program data, Svallfors (1997) shows that 60 percent or more of the population in Norway, Germany and Austria sees it as the responsibility of the government to reduce income differences between the rich and the poor (see Table 1; first panel). The US (38 percent) and Australia (43 percent) can be found at the other extreme. As far as work opportunities are concerned, the popular support for the State is strongest in European countries. Overseeing the results from attitude survey data for a number of EU countries and candidate countries, Taylor-Gooby (2002) concludes that there is a strong degree of support for the welfare state, even in countries with low levels of spending on social protection. The majority of people is supportive of redistribution (see Table 1; second panel). He, however, concludes that there is no clear pattern of difference between the various welfare regime types.

⁸ This interdependence of utility can also justify the use of a relative poverty threshold.

⁹ See for instance Article 1 of the Charter of Fundamental Rights: "Human dignity is inviolable. It must be respected and protected."

Table 1: Attitudes towards redistribution in a number of nations. Percentages agreeing with certain propositions

	It is the government's responsibility to reduce differences	the government should provide for everyone who wants one	People with high income should pay a larger share of necessary country's prosperity	Large differences are necessary for the country's prosperity
Sweden	53.7	74.1	-	-
Norway	60.0	78.3	-	-
Germany	65.5	66.3	-	-
Austria	69.5	72.1	-	-
Australia	42.6	39.4	-	-
New Zealand	53.1	49.1	-	-
Canada	47.9	40.1	-	-
USA	38.3	47.1	-	-
Sweden	60	-	76	21
Norway	62	-	76	17
Germany	53	-	79	30
Austria	50	-	78	20
UK	69	-	79	18
France	68	-	73	16
Czech Republic	72	-	78	19
Poland	85	-	85	28
Spain	79	-	85	28
Portugal	90	-	88	27

Sources: first panel: Svallfors (1997: 288; data for 1992); second panel: Taylor-Gooby (2002: 17; data for 1999).

One should, however, keep in mind that the above results refer to ‘stated preferences’: people expressing their preference for some situation or some type of public policy. The answers given to such ‘value’ questions need not be consistent in time. Moreover, when actually confronted with the costs of their choice, they might change their preference, attempt to free-ride or migrate. Although the method of stated preferences is gaining in popularity in economics, the revealed preferences methodology remains the most common one for analysing individual behaviour. The numbers might, for example, overestimate the true preference for redistribution, providing results that are less pretentious than suggested above. Moreover, the above noted preference for at least some degree of redistribution does not mean that discrimination is not an issue. The data in Table 1, for example, leave the question of who gets the payment and at which rate unanswered.

3.3 Poverty reduction through social transfers

Poverty and poverty reduction

One of the major effects of social protection is to reallocate resources (income) among individuals. In doing so it affects the level of poverty and inequality. Fully comparative data for all the EU Member States are now becoming available through various waves of the European Community Household Panel (ECHP) of Eurostat. The first estimates on inequality and poverty – using the first waves of data from the ECHP – have been published (Eurostat, 1997, Eurostat, 2000, 2001). Table 2 indicates that the incidence of poverty is very diverse in Europe. It also shows that females are, on average, at higher risk

of poverty. This is especially true in Portugal and in the UK. The data in the table demonstrate that the incidence of poverty is sharply reduced by the existing schemes of social security. In this respect, one must be aware that this effect is not the only result of the formal minimum protection schemes but includes the aggregate effect of the entire social protection transfer system. That means that, nearly half of social transfers are directed towards households that do not actually need them to reach the minimum level. However, at the same time, the receipt of social protection transfers by all sections of the population upholds public support for the schemes and, in doing so, guarantees that the built-in minimum income safeguards retain their legitimacy.

Overall the conclusion from Table 2 might be that countries in the social democratic tradition (Northern European countries, including the Netherlands) do a better job at redistributing income and keeping poverty down. Countries in the liberal tradition and southern European countries perform a poorer job on these social indicators. In Muffels and Fouarge (2002a) we use broader welfare indicators than merely income and come to similar conclusions with respect to the effect of the welfare regime, and yet similar conclusions can be drawn when studying indicators of labour market exclusion (Muffels & Fouarge, 2002b). However, concerning the position of migrants in the labour market, it is striking to see that their rate of unemployment is, in many OECD countries, much larger than among nationals. The OECD noted recently that in all European OECD countries, with the exception of Italy and Spain, “the proportion of immigrants or foreign workers of the total unemployed is greater than their proportion of the labour force” (OECD, 2001: 174). The OECD goes on to say that in the Netherlands and Finland “they are two and a half times as numerous in the unemployment count as they are in the labour force. The situation is almost as critical in Belgium, Denmark, Portugal and Sweden”. This ratio is much more favourable in Hungary, Canada, Australia and the United States. With respect to the group of foreign workers, the conclusion could be that the social democratic approach does not work out all that well, especially compared to the liberal approach.¹⁰

¹⁰ It must be said, however, that in the case of the Netherlands and Denmark the unemployment rate among nationals – but also foreigners – is comparatively low. Henceforth, the ratios tend to exaggerate the situation.

Table 2: Percentage of poor persons after social security transfers and poverty rate reduction due to social security transfers (percentages), 1997^{a)}

	Poverty rate after social transfers			Poverty	rate
	Total	Male	Female	reduction	
Belgium	15	13	16		46
Denmark	8	7	9		38
Germany	14	13	15		38
Greece	22	22	22		38
Spain	19	19	19		42
France	17	17	17		41
Ireland	20	19	21		40
Italy	19	19	20		42
Luxembourg ^{b)}	12	12	12		44
The Netherlands	13	12	14		37
Austria	13	12	15		40
Portugal	23	22	25		39
Finland	9	8	9		39
Sweden	12	12	11		45
UK	22	20	25		43
EU	18	17	18		41

a) Poverty line equals 60% of median equivalent income with equivalence scale 1, 0.5, 0.3.

b) Data for 1996.

Sources: *European Commission (2002a)*.

Using similar poverty statistics for a number of European and OECD countries to those presented in Table 2, we showed in Fouarge (2002) that there is a negative linear relationship between the poverty rate on the one hand and the GDP per capita and level of social security expenditure (as a percentage of GDP) on the other. There is a high negative correlation between these two aggregate measurements and the poverty rate. We also found a strong negative correlation (-.88) between public welfare expenditure and disposable income, implying that only countries spending a substantial part of their budget on social security manage to reduce poverty substantially. However, none of these nations have managed to eliminate poverty completely. It is important to note that such correlations are merely an illustration for they give no indication of the direction of the causality among the variables.

Longitudinal aspects of poverty

It would be short-sighted to limit social protection to minimum protection. The aim is, in fact, to prevent people from sliding down to – or below – minimum level. It is not a coincidence that panel analyses have shown that it is above-minimum protection that prevents the majority of the elderly, the disabled and the short-term unemployed from sliding into poverty and even further into a situation of multi-dimensional deprivation and social exclusion. While comparative information on the effect of social protection on the income distribution may be scarce at cross-section level, it is even more so at longitudinal level.¹¹ Evidence from a few of the better-documented countries, however, points to the

¹¹ See, for example, Muffels et al. (1999), Heady et al. (1997, 2000) and Goodin et al. (1999) for international comparative research into the effect of social security transfers on long term poverty and poverty transitions in Germany, the Netherlands, the UK and the US.

plausibility of growing income inequality and a growing dualisation of income distribution and social protection.

As we showed elsewhere (Fouarge, 2002),¹² the rather stable rate of poverty generally found in trend studies conceals remarkable processes of mobility. From the data in Appendix 2, we can conclude that there are large turn-over rates into and out of poverty: more people are confronted with poverty over a longer period than on cross-sectional basis (compare Table 2 and Table A.2.1). Although poverty is generally short term (transient poverty in Table A.2.1), still significant numbers live in persistent poverty, more so in Southern European countries and liberal countries, such as the UK, than in more redistributive social democratic countries, such as Denmark and the Netherlands. Stepping from this longitudinal aspect of poverty to the notion of intergenerational redistribution it remains to be said that social policies have not fully succeeded in breaking the intergenerational link of poverty. For example, growing up in a low-income household seems to affect negatively later-life socio-economic attainments (Jenkins & Schluter, 2002). Furthermore, there is much evidence available suggesting that low socio-economic attainments are being transferred from one immigrant generation to the next.¹³ Henceforth, the socio-economic catching-up of immigrants is likely to be a slow process.

Turning to the dynamics of poverty, the evidence shows that changes in the labour market and in social security status – as well as in human capital and demographic factors, respectively – explain many of the transitions in and out of poverty (see Table A.2.2).¹⁴ Also, because equal opportunity policy is such an important factor in accumulating human capital (see Section 4.3) – it is one of the determinants of economic competitiveness – the equity element of social protection systems cannot simply be disregarded.

Equity is certainly productive in terms of quality of life, but it might also be so when productivity is defined in terms of growth. Advanced empirical research on the equity - productivity relationship would be enlightening. As a matter of fact, according to Kuznets (1955), economic growth is expected to trickle down to the poor. Kuznets' hypothesis is that, in the process of economic growth, inequality will initially increase and then decrease as the poor also profit from the fruits of said growth. From this perspective, growth can be seen as a possible solution to the poverty issue. However, there is evidence that long periods of sustained growth have exacerbated income inequalities and failed to reduce poverty (Arjona et al., 2001, de Beer, 2001). In an in-depth study of economic and social performance in the 1990s in Germany, the Netherlands and the US, Goodin et al. (1999: 129-130) conclude that the fruits of economic growth in the US were not passed on to the middle-income group while they were in Germany and especially in the Netherlands. Furthermore, economic development and increased individualisation undermine the local structure of traditional solidarities in a community (Chassard & Quintin, 1993). Increased labour market mobility in a modern economy increases the need for employment-related protection. However, economic development also makes it easier to generate the funds necessary to finance such a system. It can therefore be concluded that contrary to expectation, economic growth does not automatically trickle down to the poor. Instead, economic development both strengthens the need for social insurance – because of new socio-economic risks (see below) – and facilitates its financing – thanks to the generated wealth .

¹² See also the rather stable poverty rates reported in the Joint report on social inclusion (European Commission, 2002a: 186).

¹³ See, for example, Frick and Wagner (2001).

¹⁴ See also Duncan et al. (1993).

3.4 Income and ‘functionings’

Providing income support to the poor is not the only aim of social policy, neither is poverty solely a matter of having too little income. It is by now widely recognised that social exclusion and poverty are multidimensional concepts. Measuring poverty in terms of income as we did above is like viewing poverty in terms of command over resources or, rather, the lack thereof. Rather than measuring what people have – income, goods and other material resources – the capability approach concentrates on what people do and can do: their ability to transform resources into well-being (Sen, 1983, 1985, 1992). In this approach, ‘functionings’ play an important role. They represent what “the person succeeds in *doing* with the commodities and characteristics at his or her command” (Sen, 1985: 10). What is crucial here is that, while functionings are absolute, the means to achieve them are relative across individuals, time and space. It is the collection of such functionings that determines a person’s capabilities: what he or she can do. What people actually do does not matter, as long as their capabilities set is broad enough. Within this framework, poverty can be defined as a state in which the level of capabilities is unacceptably low compared to the standards of the society one is living in. However, attempts to operationalise this concept of capabilities are scarce and so are empirical studies on the subject. These studies, moreover, tend to focus on functionings rather than capabilities.

Using a set of life style indicators from the ECHP, we constructed non-monetary indicators of poverty, or deprivation indicators. To a certain extent, these deprivation indicators – which account for health condition, financial stress, housing conditions and the possession of durables people want but cannot afford – can be interpreted as indicators of the individual level of ‘functionings’. We analysed the extent to which welfare regimes were able to generate low levels of deprivation and also analysed the intertemporal relationship between income and deprivation (see Muffels & Fouarge, 2002a). We conclude that the correlation between deprivation and financial poverty is not perfect. It is in fact lowest in social-democratic welfare regimes conform Esping-Andersen’s de-commodification concept. However, intertemporal correlation between income and deprivation is stronger than in the short-run. Moreover, contrary to the common conjecture, the social-democratic regime – that prioritises a high level of equality – has almost as high economic welfare (income) as the liberal regime. The social democratic regime also has the lowest level of income poverty and deprivation. However, because the dispersion in the deprivation distribution is much larger than of the income distribution – particularly in the egalitarian countries – we also concluded that to attain income equality does not mean that inequalities in other domains of life are successfully tackled as well.¹⁵

4 Efficiency argument for social policy: the economic cost of non-social policy

Under conditions of pure and perfect competition – and in the absence of market failures – market forces are expected to generate a Pareto efficient outcome.¹⁶ Hence, market provision is superior to State or centralised provision. There are four reasons for this. Firstly, the multiplicity of suppliers on the market makes it possible for the consumers to shop around and choose the price-quality combination that best corresponds to their tastes. This advantage would disappear as soon as there is

¹⁵ See Muffels & Fouarge (2002a) for details.

¹⁶ Pareto efficiency refers to a situation in which it is not possible to make someone better off without making someone else worse off.

only one (central) supplier. Secondly, the needs and preferences are better perceived at a level close to the consumers than at a higher level. It would, therefore, be more efficient to let the market take care of the production so that it better fits the preferences of the consumers. Thirdly, the rate of generation of novel ideas and products usually increases when competition increases. This innovation process increases efficiency and benefits the economy. Finally, it is often argued that efficiency gains of the market might eventually result in lower administration costs than would be the case if the public authority were in charge. This last statement, however, is to be treated with caution (see below). Even if it were true, it does not mean that the cost for the consumer would be lower because private producers are also profit makers.

However, instances can be found where the market is inefficient. Then, corrective action by the State – in the form of regulation, taxation or subsidisation, or public production – is to be considered. These instances have to do with market failures and imperfect information. Market failures refer to imperfect competition (increasing returns to scale and natural monopoly), external effects¹⁷, the production of public goods and merit wants (goods and services the government believes are consumed in too little or too large quantities), the non-existence of a full set of markets (for all dates in future and all risks), failure to attain full equilibrium (under-utilisation of resources). Informational problems include imperfect consumer information, adverse selection, moral hazard and the fact that the probabilities of social risks might be unpredictable, interdependent or close to unity. Imperfect information will possibly result in the absence of some insurance markets. As Barr (1992) argues, the correction of market failures can justify the existence of a residual welfare state. Informational problems, on the other hand call for a welfare state that is more than residual.¹⁸ The key here is that the government engages in a selection of activities that the market is unable to provide efficiently.

Efficiency arguments for social policy relate largely to the existence of such market failures and informational problems causing inefficient allocation of resources. We now turn to this. However, we also show that there is an efficiency argument to be made for the stabilisation and redistributive function of social protection. In other words, it might well be the case that an insufficient level of social protection is inefficient. Our general point is that a more positive view on social policy can be defended which is based on a positive reading of the subsidiarity relationship between the State and the market (see Fouarge, 2002). It states that social policy is an investment in that it promotes market efficiency: rather than just correcting inefficiencies social policy addresses these inefficiencies before they happen.

4.1 Informational problems and the insurance market

One of the underlying assumptions of pure and perfect competition in economics is that information is priceless and perfect. However, this does not always hold. Information is not always priceless because there might be some inefficiency due to the diversity of suppliers on the market. Moreover, information is not always perfect: the market cannot always deal adequately with problems of moral hazard or adverse selection.¹⁹ The State is then called upon to take care of the production of these goods and

¹⁷ Including income externalities of the type discussed in Section 3.2 above.

¹⁸ On the question when social spending becomes a burden, see Mayes and Viren (2002).

¹⁹ Moral hazard occurs when one of the parties in a transaction can take actions that affect the value of the transaction by the other party and that this other party does not have those instruments at its

services – through legislation – although the problem of moral hazard may even persist. Alternatively, it can also – again through legislation – introduce some minimum quality or safety constraints to be respected by private producers in order to convey the adverse selection effect. It can also oblige the individual to buy a given quantity of a good or service to circumvent the adverse selection problem.

Would the ‘invisible hand’ lead to the establishment of social insurance markets? Intuitively, it is clear that self-interested individuals would be in favour of the introduction of a social security safety net. Because individuals do not have perfect information about their future – they might become ill, disabled or lose their jobs – and do not perfectly know the probability of occurrence of these hazards, they want to ensure an income in case such events occur. This results from the common assumption that individuals are risk averse. Without having to appeal to any moral or equity consideration, we can explain why self-interested individuals would be supportive of social protection schemes when put behind the Rawls’ veil of ignorance (see above). However, there is no straightforward way to organise such a scheme on the market. Some might not be willing to pay a price for income protection that they think is too high compared to their perceived probability of needing it. Before the veil of ignorance is lifted, all are ready to participate but, once it is raised, people gain insight into their capabilities and earning potential. This could lead to an adverse selection process that would eventually lead to the disappearance of the market for income protection. Also, some people (the free-riders) might not contribute at all to the system – expecting others to pay – and thus profit from services they did not pay for. Eventually, if the probability of calling upon the social protection scheme can be influenced by the potential recipient of the benefit – a situation referred to as moral hazard – the market solution would not be sustainable either. In these instances of informational problems, the market is not efficient in producing social protection.

Some risks are therefore thought to be uninsurable by the market. This may be because the various risks cannot be pooled, because they involve an adverse selection process or because of moral hazard. In the case of unemployment insurance, for example, informational problems on employability, incentives and search intensity prevent the existence of an unemployment insurance market. Moral hazard occurs when the unemployed are able to influence their chances of getting a job without the insurer knowing about it. However, there is also a second problem. Since unemployment can, potentially, affect many people at once – as during an economic recession – private insurers are not willing to assume that risk. This is because the possibilities for risk pooling are limited due to the positive correlation of the risk insured between insurance policies. Unemployment risk is, therefore, often presented as uninsurable on the market (see Appendix 3 for a detailed presentation), because neither a competitive nor a separating equilibrium is attainable in unemployment insurance. In the area of health care, a similar argument can be made: adverse selection can also occur when insurers cannot discriminate between good and bad risks. These problems reduce the possibility for the development of a viable private insurance market and call for State intervention or regulation. For instance, making insurance compulsory can solve the adverse selection problem.²⁰

Therefore, it is rather unlikely that the market outcome will be Pareto efficient. Indeed, one condition to Pareto efficiency is full information. This condition is hardly ever satisfied in practice. From the above discussion, it appears that the case for a private insurance market is not as

disposal to monitor or enforce the transaction perfectly. Adverse selection occurs when one of the contracting parties to a transaction has relevant information that is not known by the other party.

²⁰ Note again that public insurance still bears the risk associated with moral hazard.

straightforward as it might seem. If private insurers could develop instruments for screening their clients and distinguish the good from the bad risk groups they would concentrate on the former group, leaving the latter to its own fate. Given this selectivity towards the good risks, the economic and social costs of a liberal or residual type of welfare model are likely to be high.²¹

It is such information problems that – alongside of equity (see above) and stabilisation (see below) considerations – lead the State to make social insurance compulsory. In the case of old-age or unemployment, where the risks are, respectively, certain and positively correlated, the State assumes the provision of insurance itself. However, public provision of social support may not result in an increase in total (public and private) support. Public support may crowd-out private support because individuals may then reduce the level of their savings and their support to family and friends.

4.2 Increasing returns to scale and externalities

Aside from the informational problems discussed above, there are several other reasons why the market may fail to produce social protection. First of all, markets may fail when competition fails. This occurs if production costs decline when the scale of production increases.²² The profit-maximising producer will charge a price that is higher than the Pareto efficient price level and produce correspondingly less. In this case, it would be more efficient to have one single supplier – a so-called natural monopoly. When competition fails, correction mechanisms or production by the State may be required. The existence of economies of scale in the production of public goods and in administrative activities may justify production on a larger scale. Mitchell (1998) shows that a 1 percent increase in welfare programme participation leads to a less than proportional increase in the costs to the magnitude of 0.6 to 0.9 percent. Moreover, Gouyette and Pestieau (1999) provide evidence suggesting that publicly managed insurance systems are less costly than privately managed systems. They do point to productive inefficiencies in welfare provision programmes (one could do better with less) – although it has been argued that they overestimate the magnitude of these inefficiencies (Ravallion, 2001) – but recognise that privatisation is not a solution.

Market production is also inefficient whenever there are positive or negative externalities. Externalities occur whenever someone's utility or production relationships include factors that are influenced by another party. Production at a higher level or imposition of a transfer scheme by a senior authority makes it possible to internalise these externalities.²³ A specific case involving income externalities was discussed in Section 3.2. Income externalities call for redistribution mechanisms, both on equity and efficiency grounds.

²¹ See Goodin et al. (1999) for comparative evidence.

²² This is referred to situations of increasing returns to scale.

²³ Coase and Meade have suggested a market solution to the problem of externalities, respectively through negotiation between the parties and merging of the activities of the parties. When none of these solutions is applicable possible solutions are: regulation, imposition of a Pigovian tax/subsidy, or production at a higher level (see Barr, 1989: 62).

4.3 Merit goods: education and training

The quality of labour supply

One of the failures of the market is its inability to produce public goods, or to produce them in optimal quantity.²⁴ There is no incentive here for the private producer to produce these goods since, once these are manufactured, he cannot exclude anybody from consuming them. Therefore, the State must be responsible for the production of these goods. Similarly, it might be more efficient to let the State handle the production of goods for which individual preferences are thought to be distorted (merit goods). Two main arguments can be pointed out. Firstly, if allocated an income supplement, individuals are not likely to purchase the most appropriate level of education, health care, etc. The existence of these merit goods is based on the assumption that individual preferences for these goods are distorted or that income is too low to purchase them. Secondly, since these goods and services directly influence general welfare, the government might wish to have close control of the price, quantity and quality of these goods.

This argument is most applicable in the area of education: education policy, as part of social policy, makes a major contribution to economic performance. Modern economies do, of course, profit from a well-educated, well-trained and healthy workforce. Human capital accumulation is the key to a sustained economic growth, since it stimulates productivity and investments. Specifically, investment in human capital – to improve the quality and the skills of the labour force – can be used to upgrade the productivity of workers whom productivity level is too low compared to the level of the minimum wage. Much research has been devoted to showing the positive effect of human capital on economic performance.²⁵ Education and training contribute to developing talent into human capital that can be used in the production process. Education increases the quality of the labour force, thereby enhancing marginal productivity. This effect can be amplified through on-the-job training. By the same token, education contributes to the development of the infrastructure, which has an undeniable effect on the investment climate, especially investment in the high technology/high qualification sector. It must be stressed that investment in education only has positive effects in the medium and long-term. This is best illustrated by the UK situation. Here employers have urged the government to support primary schools in order to avoid the extension of illiteracy. In the longer term, this might have important consequences for the maintenance of labour skills. Education and training of the long-term unemployed is also productive in that it maintains human capital stock which can be used in the production process when necessary (economic upturns).

Using an overlapping-generations model, Chiu (1998) shows that a more equal distribution of income implies higher human capital accumulation and economic performance. He argues that in a market economy, one's material resources have an impact on the possibility to develop and use one's talent. Assuming that receiving education is a necessary condition for fully developing one's talent and that education is costly – and assuming declining marginal utility – the wealthy will find it cheaper to

²⁴ Public goods, such as national defence, are characterised by non-excludability and non-rivalry: nobody can be excluded from consuming the public good and the consumption by one more individual has no effect on the level of consumption by others.

²⁵ Barro and Sala-i-Martin (1995), Temple (2000) and, more recently, de la Fuente and Ciccone (2002) provide a review of the literature.

educate their offspring and purchase more education. This possibility would be denied to children from poorer families. Assuming that talented individuals create more human capital, total human capital increases when wealth is redistributed from rich to poor. Rich families will see the opportunity cost of sending their less talented children to college increase and will stop sending them while the poor, who are made richer, find buying education justifiable for their more talented offspring (more talented than the riches' offspring who drop out). To the extent that human capital is a determinant to growth, greater income equality will then contribute to better economic performance.²⁶

Life-long learning and equal opportunities

In the context of skilled-biased technological change (see e.g. Autor et al., 1998), schooling and especially training and life-long learning take an important place. In a logic of economic specialisation, high levels of education call for high levels of training. The role of the welfare state is to provide for adequate initial schooling, but stimulating 'learning by doing' and 'on the job training' are also productive strategies. In this respect employers have an active role to play. In the context of the knowledge-based economy strategies to support life-long learning are crucial to counter the depreciation of skills over time (de la Fuente & Ciccone, 2002).

Investing in human capital gains weight in the context of the ageing workforce in Europe. But not only the older workers need to be trained in order to ensure the continuity of labour supply. Schooling and training is also crucial for migrant workers – who often have lower educational levels – and female workers in order to warrant their participation in the economic process. An approach in terms of equal opportunities is likely to promote economic efficiency and to prevent social exclusion (Rubery et al., 1998). From the point of view of gender equality, it has been shown that male and female workers have more or less equal chances to participate in job related training but that such training is more likely to be paid or subsidised by the employer in the case of male workers (OECD, 1999). The same publication also presents evidence of reinforcement of skills differences in the economy. Better-educated workers receive more often training than lower educated workers. This is, however, less so the case in Nordic countries and the Netherlands (which we qualified as social democratic regimes) and Ireland. One reason for this could be the better involvement of the social partners in policy making in these countries. The reinforcement of skills differences appears to be strongest in Southern welfare regimes and Belgium. There are lessons to be drawn here if one wants to limit exclusion from knowledge.

Externalities and return to education and training

One problem with education and schooling programmes resides in the evaluation of their social and private returns (see Temple, 2000). Whether such programmes should be financed with public money or not depends on the existence of social returns. By the same token, whether employers are wishing to engage in training of their work force depends on whether or not they expect their gain from training to

²⁶ Note that his conclusion does not sustain the idea that redistributive taxation will improve economic performance because it does not take into account the disincentive effects. The conclusion holds if the disincentive effect of making taxation more progressive is low or if there is a one-off – previously unannounced – increase in progressive taxation.

be larger than the costs they incur. Because of externalities to training and schooling, it is difficult to bring about the socially optimal level of schooling or training.

Stevens (1996) showed that the standard distinction between general and specific training does not cover all types of training. She points to the existence of externalities to transferable training: “a labour market in which skills are transferable but not perfectly general is likely to be imperfectly competitive” (Stevens, 1996: 23). Snower (1996) identified two other sources of externalities: training supply and vacancy supply externalities. The first type of externality implies that the larger the number of skilled workers, the greater the probability that firms find skilled workers to fill their vacancies. Henceforth, the private return to schooling falls short of the social return. The vacancy supply externality implies that the greater the number of skilled vacancies, the greater the probability that skilled workers find a good job. Hence the return to schooling is expected to increase. This means that when a firm creates a vacancy, its private return falls short of the social return (which also includes the increased return to training of the workers). His conclusion is that there is a case for the government to stimulate the acquisition of skills. This can be done either through education subsidy or skilled employment subsidy. Both types would stimulate workers to acquire more skills (Snower, 1996: 121). However, education subsidy will not change the number of skilled jobs. A skilled employment subsidy would stimulate both the supply of skilled jobs and of skilled workers, and therefore lead to overall upgrading on the labour market.

In relation to poverty dynamics in three European countries (the Netherlands, Germany and Great Britain), we have identified human capital to be an important predictor – both in terms of magnitude and significance – of the probability of making a transition either into or out of poverty (see Table A.2.2 in Appendix 2). The larger the person’s level of human capital, the lower the probability he or she will make a transition into poverty and, when in poverty, the sooner he or she is expected to exit. Hence, in terms of diminishing the poverty risk – especially the long term poverty risk – human capital has positive private returns. Provided that poverty is an undesirable social phenomenon, then the social return can also be said to be positive.

Finally, upon studying German and US data, Acemoglu and Pischke (1998: 23) suggests that the fact that both low and high skilled workers receive training in Germany while it is concentrated among high skilled workers in the US contributes to wage compression in the former country and wage dispersion in the latter.

4.4 Social protection enhancing allocative efficiency

While it is often recognised that the benefit system has a disincentive effect on work effort, it may also induce risk-taking. Sinn’s theoretical model indeed shows that the welfare state fulfils a risk reducing function (Sinn, 1995, 1996). When protected by the benefit system, people engage in risky and profitable economic activities which they would probably not undertake otherwise. Using panel data for the US and Western Europe, Bird (2001) indeed shows that measures of risk are positively correlated to the GDP share of social spending. In a paper on self-employment in OECD countries, Blanchflower (2000) shows that the 1996 rate of self-employment is comparatively low in the US. All EU countries display a higher rate of self-employment than the US. Furthermore, he shows that in terms of an indicator of flexibility based on the willingness to move the US does indeed ranks first, but it is closely followed by the Netherlands and Germany, despite their more generous welfare states (see Table 3). However, further investigation is needed to determine how much the dominant culture of a nation (for example, US *vs.* European countries) affects the behaviour of individuals.

Table 3: Rank on ‘willingness to move’ flexibility-index and rate of self-employment

	Rank on willingness to move (1995)	Self-employment rate (1996)
Austria	10	9.4
Canada	5	7.6
Germany	3	6.7
Ireland	13	11.7
Italy	12	14.7
Japan	11	13.5
The Netherlands	2	8.2
New Zealand	7	14.4
Norway	8	6.5
Spain	8	11.6
Sweden	6	7.6
United Kingdom	4	9.3
USA	1	6.1

Source: Blanchflower (2000: 47)

On the basis of the job search theory, one would expect that higher unemployment benefits would increase the duration of unemployment. Yet, a review of the research done by Jehoel-Gijsbers et al. (1995) in the Netherlands shows no conclusive evidence for this theoretical expectation. The effects found are often insignificant. When significant effects are reported, they are generally small. Moffitt (1992), when reviewing the US literature, concludes that welfare programmes (Food Stamps, AFDC) affect people’s behaviour: higher benefits lead to more participation in these programmes. He does, however, point out that the effects on the labour supply are not very large. Layte and Callan (2001) have found significant, but small negative effects of unemployment benefits on duration for Ireland. Moreover, no significant effect was found for unemployment assistance recipients. The above findings suggest that the pretended negative labour supply effects of welfare programmes may well be small.

One could also argue that income support for the unemployed, ill, those on maternity leave, etc. has a positive effect on transitions within the labour market and, therefore, on its flexibility. Because of the existence of social security there can be more flexibility in employment contracts and job search can be more efficient. Because unemployment insurance secures an income when out of work, the unemployed are able to search for another job that is in line with their skills (Atkinson & Mogensen, 1993). A recent study of UK unemployed suggests that those who took longer to find jobs indeed tend to be rewarded with more stable employment (Böheim & Taylor, 2000). Two corollaries are that human capital is used more efficiently and that mismatch is less likely. Because the unemployed receive benefits when out of work, they are able to interact in economic and social life and invest in training. In the long run, it helps them maintain their employability and facilitates their reintegration into the labour force. An active labour market policy obviously has a role to play here. For the long-term unemployed, in particular, an active labour market might increase the chances of re-employment.

As strange as it may seem, unemployment benefits can also be expected to have a beneficial effect on the mobility and flexibility of the labour force. This is in spite of the fact that the welfare state is often under attack because of the suggested distortive effect of labour market regulations and social programmes, which are said to reduce labour market flexibility. In Europe, provisions such as maternity leave, parental leave and palliative care represent opportunities offered by the social protection system on to which more flexibility on the labour market can be grafted. Such facilities respond to family needs while, at the same time, guaranteeing a high level of job security. This European approach is quite different from that in the US. In fact, there is little or no evidence that

social programmes have a negative effect on labour market flexibility. The contributors in Blank (1994) show that:

- The relaxation of lay-off regulations in Belgium, France and Germany has not lead to an adjustment of the number of hours worked in response to macro-economic shocks;
- Despite its stricter labour market regulations, Japan achieved a higher rate of economic growth in the 1980s than the US;
- While it is expected that the State, through its housing market policy, would impede labour market mobility and flexibility – it tends to tie workers to one location – there is little evidence for such effects;
- In Spain, mandated fringe benefits taxes have had little impact on the labour market;
- In the US and the UK, there is little difference between the public and the private sector in labour market response to economic changes.

One comes to the conclusion, when analysing labour market incentives, that labour market elasticities are quite small as are the effects of taxes and transfers on the labour supply (Atkinson & Mogensen, 1993). Although there is evidence that specific welfare transfer payments (retirement, sickness, parental leave) affect the number of hours worked, taxes and transfers generally have a smaller effect on male than on female participation (Atkinson & Mogensen, 1993).²⁷

Given that the welfare state provides income support when out of employment, this should also cut back the black economy. However, empirical research in the Netherlands shows that no clear conclusion can be drawn on this issue, but it seems to be that black market participation is less common for the inactive population than among labour market participants.²⁸

The absence of the social welfare system would, however, mean loss of allocative efficiency. This is clearest in the case of health and safety. Occupational accidents and illness impose a cost on the economy in terms of productivity loss. The welfare state plays a preventive function in setting health and safety regulations that help prevent accidents and their associated productivity loss. When accidents or illnesses do occur, health care contributes to a prompt restoration of good health and limits productivity loss.

Finally, equal opportunity policies as part of social policy have an important contribution in terms of allocation. It has been argued that such policies contribute to increasing the welfare of women and society as a whole by increasing flexibility and by reducing individual as well as social risk (Rubery et al., 1998). Equal opportunity policies contribute to a more effective utilisation of human and social capital – which is important in changing labour markets – and can therefore be seen as an investment.

4.5 Efficiency argument with regard to stabilisation

Anti-cyclical effect of social protection

To begin with, the social protection systems can be viewed as a form of institutional saving. Through compulsory old-age and unemployment insurance, for example, workers operate an intergenerational or

²⁷ See also Moffit (1992) for an extensive review of the incentive effects of the welfare system in the US.

²⁸ See Jehoel-Gijsbers et al. (1995: Table 2.23).

intertemporal income transfer. They trade off consumption today for consumption when retired or unemployed, and therefore also limit the volatility of aggregate demand.

This anti-cyclical effect of the benefit system comes into play because expenditure tend to rise when there is a downturn in the business cycle and fall when there is an upturn. Social protection then helps limit the dead-weight loss resulting from volatility in the economy. Evidence for the US and Canada shows that federal tax and transfer flows cushion 31 and 17 percent, respectively, of regional income shocks (Bayoumi & Masson, 1995). The long-term redistribution effects are estimated at 22 and 39 percent, respectively. The estimates for the EU Member States are similar to the US. Sala-i-Martin and Sachs (1991) estimate that tax and transfer adjustments eliminate up to 40 percent of income declines. These estimates show that it is possible to cushion adverse economic shocks by borrowing and budget deficit. The fiscal constraints of the EMU, however, do limit the Member States' possibilities to do so.

If social spending has a positive effect in terms of automatic stabilizer, then this should be most obvious in open economies. Rodrik (1998) explored the positive association between the degree of openness of economies and the size of government spending, using a sample of over hundred countries. He concludes that government spending indeed provides a social insurance in economies subject to external shocks. When the share of total trade²⁹ in GDP increases by ten percentage-points, government consumption would increase by 0.8 percentage-points for a country at the mean of the cross-country distribution of the terms-of-trade instability. He also provides evidence for the fact that the risk-reducing role of government spending is strong for social security and welfare spending. This is particularly true in advanced countries, which have the requisite administrative capacity to manage social welfare transfers. In those countries, it is not government consumption but social spending that correlates with external risk. In the same vein, Andersen (2002) elaborated a theoretical model in which he shows that tighter integration of product markets conducts to higher volatility of private consumption. Henceforth, there is a case for expanding the social insurance provided through state-contingent public activities. This finding is relevant within the context of the EU.

The stabilisation argument presented above must be seen in the context of Keynesian economic policy: by guaranteeing income during unemployment, illness, etc., the benefit system stimulates demand and restores economic growth. The significance of social assistance also has to be valued in this context. It is the protection of last resort. Residents who have no rights to replacement income – or have lost these rights – can still benefit from social assistance if they satisfy the conditions of means test. Social assistance then clearly plays an economic role in terms of sustaining aggregate demand. An active policy of reinsertion – along with social assistance – can play a major role in training long-term recipients and putting them into the labour market.

Nonetheless, the social protection system has often been under attack because it is believed to impede growth. However, a review of a large number of studies by Atkinson (1996, 1999) shows that there is no conclusive evidence for this. There is also evidence that large amounts of public spending lead to better outcomes in terms of social indicators and have only minor effects on economic performance. There are, however, boundaries to this relationship. As Mayes & Viren (2002) demonstrate, the relationship between social spending and economic performance is asymmetric. While increasing social spending will initially stimulate economic performance, the relationship is reversed when some turnover point is passed. More recently, Arjona et al. (2001) have provided evidence with

²⁹ Total trade equals exports plus imports.

respect to increased market inequality in almost all countries in the OECD. They note that total household income inequality has also increased, but this trend was less general. A close examination of the data does not lead to the conclusion that a wider income inequality is good for growth. The authors do suggest that, on balance, social expenditure is bad for growth. However, it does depend on the type of expenditure considered. In the margin, spending on active policies seems to have a positive effect on growth.

Income redistribution through market mechanisms

In an in-depth study of poverty and income redistribution in the short and the long term in the Netherlands, Germany and Great Britain, Fouarge (2002) comes to the following conclusions. In the period 1985-1995 the Dutch model has managed to keep poverty and inequality lower than the liberal British model while, at the same time, the economy generated above-EU average GDP and labour market participation growth rates. Nevertheless, although income and employment have been rising in all three countries over the past decade, poverty and inequality levels have certainly not decreased. In all three countries, both pre- and post-transfer inequality and poverty increased these years. Hence, contrary to Kuznets' hypothesis (Kuznets, 1955), the fruits of economic growth do not seem to have trickled down to the poor in a way that reduces the incidence of poverty.

Table 4: Pre- and post-government poverty and welfare state redistribution (percentages): short-, medium- and long-term^{a)}

	The Netherlands			Germany			Great Britain		
	Pre	Post	Redist.	Pre	Post	Redist.	Pre	Post	Redist.
Short term									
1993	27.9	9.8	65	32.3	9.2	72	35.2	14.8	58
Medium term ^{b)}									
1985-1989	25.0	3.7	85	26.6	4.0	85	-	-	-
1991-1995	26.9	4.8	82	28.7	4.8	83	33.2	8.9	73
Long term ^{b)}									
1985-1994	25.6	2.4	91	23.9	2.6	89	-	-	-

a) Poverty line equals 50% of median equivalent income with equivalence scale 1, 0.5, 0.3.³⁰

b) Household income is aggregated over the period.

Source: Fouarge (2002: 123).

In Table 4, the short, medium and long-term poverty figures are given for the Netherlands, Germany and Great Britain. The poverty figures are computed before (pre) and after (post) social transfers.³¹ In all of those countries, income smoothing over the years leads to a reduction in poverty. Provided the labour market offers opportunities for all to improve their income positions in the long-run, one would expect the rate of reduction in pre-transfer poverty – when extending the observation period – to be larger than that of post-transfer poverty. That, however, is not the case: the rate of

³⁰ In the study cited, the poverty line equals 50% of median equivalent income. It is to be noted that the results are qualitatively similar for a poverty line defined at 60%, as is the case in the EU social inclusion strategy.

³¹ Social transfers include all social security payments and pensions. Redistribution is defined as the proportional decrease in poverty due to those transfers.

reduction in post-transfer poverty is larger than that of pre-transfers poverty. This means that the redistributive effect of transfers, in the long run, is larger than in the short run, even in a liberal regime such as Britain. Pre-transfer poverty remains high, presumably because of a high level of income volatility or economic mobility. This means that, due to the operation of the market, situations of income shortfall are followed – but only partly compensated – by instances of income surplus. This suggests that it is certainly not the market that evens out poverty over time, it is the operation of the welfare state through income transfer policies. Welfare state policies are generally more egalitarian in the longer term. The downsizing of poverty in the longer run appears to be due to the success of the market-government nexus. In the same study, it is shown that permanent income displays larger fluctuations in liberal welfare states: permanent income inequalities and permanent poverty are largest in Great Britain (Fouarge, 2002: 159).³² The income smoothing effect is strongest in the Netherlands, which operates in the social-democratic tradition.

De Beer (2001) and Fouarge (2002) have shown that – for the Netherlands and the Netherlands, Germany and Great Britain, respectively – high levels of economic growth and a large increase in labour market participation in the 1980s and 1990s did not reduce poverty.³³ However, not always the same people were poor over the years. The more or less stable poverty percentages on cross-section basis hide a high level of turn-over into and out of poverty. Although at the individual level labour market participation – and changes of labour market status – explains many of these transitions, at the macro-level it is insufficient to get poverty down. Whether or not economic growth would succeed in eliminating poverty can therefore be questioned. In particular, poverty traps seem to be in effect so that the lower end of the distribution does not automatically take advantage of economic growth. Substantial parts of the population still live in persistent poverty, even in welfare states which had high levels of economic growth during the 1990s. Upon studying the effects of the welfare regime, however, we found that long-term poverty is lower in countries with social democratic or corporatist characteristics (Fouarge, 2002). Targeted policy seems necessary to ensure that those people at the lower end also take part to the economic process.

4.6 Social capital and social peace

Although problems of definition and measurement are undeniable, the notion of social capital – which can be defined in terms of trust or participation to social networks – is gaining much attention, also in the field of economics.³⁴ There is increasing evidence that social capital formation has a positive

³² A panel regression model was used to disentangle permanent and transitory components of household income.

³³ See Defina (2002) for US evidence on the limits of the relationship between unemployment and poverty. In the same vein, Dickens and Ellwood (2001) conclude that a purely employment-based policy – which does not deal with changes in demographics nor with the wage dispersion – is unlikely to have a large effect on relative poverty.

³⁴ Also the World Bank is giving much attention to social capital in the framework of sustainable economic and social development. See www.worldbank.org/poverty/scapital.

contribution to economic performance (for a review, see Temple, 2000).³⁵ Social capital, so it can be argued, can contribute to improved allocative efficiency, but also to macro-economic stability. Intuitively, the idea is that in societies with low levels of social capital – or trust – resources are diverted towards verification of other party's action and protection of one's position and rights. This means that resources are diverted from their productive aim. To put it another way, trust provides a way out of the prisoner's dilemma by increasing the odds of a cooperative solution with higher pay-off. From the point of view of social networks, intuition tells us that in societies where such networks are better developed, the transfer or spill-over of knowledge between actors is greater.

As Woolcock (2001: 13) defines it, "social capital refers to the norms and networks that facilitate collective action". Solidaristic or "dense" social relationships, according to Coleman (1986), are attractive not only from a pure sociological point of view, but also from an economic one. One is more likely to engage in economic exchange with people one trusts. Dense social relationships enhance social trust and reciprocity and, therefore, increase the chance that people will engage in economic exchange. Putnam (1993) also shows that social integration – through social networks – is a key element of economic development. He presents evidence that social integration can go hand in hand with economic success: membership of choral societies as well as co-operatives and football clubs are good predictors of a strong and effective local democracy and economy. Moreover, to the extent that the welfare state contributes to social inclusion, it contributes to the supply of labour and, in the longer term, to an improvement of its quality (Pedroso, 1997).

Since Putnam's work numerous studies on the relationship between social capital and economic indicators have been carried out. In particular, the effect of social capital on economic growth has received much attention. In their article on the economic pay-off of social capital in a sample of market economies, Knack and Keefer (1997) found that indicators of trust and civic norm were significantly and positively associated with economic growth.³⁶ They refute Putnam's finding that membership in formal groups is associated with economic performance but they state that a ten percentage-points increase in trust results in a 0.8 percentage-points increase in growth. The effect they found runs through raising the share of investment in GDP. In a recent paper, Beugelsdijk et al. (2002) have submitted the Knack and Keefer results to a series of robustness tests and have given critical comments on their findings. They found a lower growth effect of trust ranging between 0.4 and 0.8 percent. Moreover, the significance of the relationship is affected by the way investments are operationalised.

Perhaps of greater relevance to the European context is Beugelsdijk and van Schaik's study of the relationship between social capital and growth in 54 European regions (Beugelsdijk & van Schaik, 2001). Two major findings emerge from their research. The first is that – contrary to their later research (Beugelsdijk et al., 2002) – their measure of trust is found to have no significant effect on the growth rate across European regions. The second is that not only the existence of network relationships is associated with higher growth but also that the level of active involvement in these networks is beneficial for growth.

³⁵ See Portes (1998) for a review of the sociological implications of social capital. Portes also points to some negative effects of social capital.

³⁶ Using growth data for the 1960-1985 period in a large number of developing countries Temple and Johnson (1998) demonstrate that economists would have reached better prediction of economic development had they accounted for the effect of social capital.

The social capital argument also implies that divided societies will have greater difficulty in coping with adverse economic shocks. This expectation finds support in Rodrik (1999) who provides econometric evidence showing that the economies which experienced the sharpest fall in growth rates in the 1970s are those with weak institutions and divided social ties. In relation to this, we can also point to the role of social partners as a form of social capital. For example, in the Netherlands, the social partners have been intensely involved in designing the Dutch socio-economic policy. This is often seen as the reason behind the Dutch economic success.³⁷ The Dutch and Irish experiences also tell us that the involvement of the social partners is required in order to come to a better integration of social and economic policy.³⁸

More generally, there is an opportunity cost of not having (or having an insufficient level of) social protection. For example, in the absence of socialised health care, health insurance would have to be provided privately. This can turn out to be very costly and still leave many unprotected, as is clearly the case in the US. It can be noted that social transfers enhance social cohesion and, therefore, reduce the risk of production disruption due to social conflicts.³⁹ The opportunity cost of inadequate redistributive policies is not only inequity but also higher crime and social unrest, leading to higher private security and insurance costs. Hence, an adequate level of social provisions is expected to contribute to social peace. Because social conflicts disrupt employment, destroy infrastructure and deter investment, their prevention – through the benefit system – is beneficial for investments and productivity. Social cohesion is expected to have a positive effect on the creation of prosperity (Begg & Berghman, 2001). In this sense, social transfers contribute positively to the social climate. When the social climate is good, enterprises can go about their business without concern for possible disruptions. Kennedy et al. (1998) provide some evidence for the relationship among inequality, social capital and social peace. The authors, using data for 39 US states, come to the conclusion that income inequality correlates strongly with violent firearm criminality and social capital indicators such as per capita group membership and lack of social trust. Social capital variables also correlate strongly with violent firearm criminality. The authors also suggest that the effect of inequality on criminality is partly mediated by social capital.

Recent trends towards individualisation have substantially increased the risk of family instability and single parenthood. These demographic processes are not without consequence for the general well-being of, in particular, lone mothers and their children. This is especially true because the primary sphere of redistribution and welfare is the household, i.e. the most basic social network. Social assistance is one way of preserving well-being. It mends the problems of a social protection system that is not fully equipped to deal with the changing reality of society, but equal opportunity policies have an important role in this context because it contributes to the economic autonomy of female workers. Our study of the Dutch, German and British case (Fouarge, 2002) has made clear that lone parents are not only more likely to be poor but also more likely to be persistently poor. The Dutch welfare state, however, was found to perform significantly better than the German and British welfare states with respect to this group.

³⁷ Also in a large number of other Member States partnerships between the social partners and the governments have been built up (European Commission, 2002b).

³⁸ See Muffels & Fouarge (2001), Arents et al. (2001), Hodson (2001).

³⁹ To some extent, Jordan's (1996) application of the theory of clubs as an explanation for social exclusion can be linked to the debate on social capital as social networks.

Although the relationships between social capital and economic performance, on the one hand, and between social policy and social capital, on the other, needs further investigation, what the argumentation above shows is that there is but a thin line between social and economic or employment objectives.

4.7 The true size of social protection schemes

Social protection systems affect the level of welfare and its distribution. Moreover, although it is not the ultimate aim of social protection to improve economic growth or performance, social protection plays an unmistakably positive role in the economy. Without intending to indicate that there might be an optimal size for the public sector, we can illustrate the effect of public spending on economic and social performance. Tanzi and Schuknecht (1997) evaluated this performance with respect to a number of welfare indicators for nations grouped according to their level of public spending relative to GDP. We must, however, realise that social security spending represents only about half of total public spending. Their results are reproduced in Table 5.

Table 5: Size of government and welfare performance, 1990

Indicator	Size of public expenditure in percent of GDP		
	More than 50% ^{a)}	Between 40 and 50% ^{b)}	Between 30 and 40% ^{c)}
Total public expenditure ^{d)}	55.1	44.9	34.6
Economic indicators:			
Real GDP growth (1986-1994)	2.0	2.6	2.5
Standard deviation of GDP growth	1.6	2.1	1.9
Gross fixed capital formation ^{d)}	20.5	21.3	20.7
Inflation rate	3.9	3.7	3.7
Unemployment rate	8.5	11.9	6.6
Public debt ^{d)}	79.0	59.9	53.3
Social indicators:			
Life expectancy (years)	77	77	77
Infant mortality / 1,000 births	6.7	7.1	6.4
Secondary school enrolment	92.8	[99.1] ^{e)}	89.0
Income share of poorest 40%	24.1	21.6	20.8

a) Includes Belgium, Italy, the Netherlands, Norway and Sweden.

b) Includes Austria, Canada, France, Germany, Ireland, New Zealand and Spain.

c) Includes Australia, Japan, Switzerland, the United Kingdom and the United States of America.

d) Percentage of GDP.

e) It seems to us [Tanzi & Schuknecht] that this percentage should be around the 90%.

Source: reproduced from Tanzi & Schuknecht (1997: 167).

In their article, the authors conclude that “small governments generally show better indicators than big governments” (Tanzi & Schuknecht, 1997: 168). While this might be the case for variables such as the unemployment rate and public debt, the differences are negligible for the other variables of economic performance. Moreover, a large public sector – or less liberal approach – tends to perform better in such areas as ‘secondary school enrolment’ and inequality. Although such data are useful in supplying an overall descriptive picture, their relevance for evaluating the counter-productive effect of public intervention is limited. At any rate, however, these data clearly do not show that a larger public sector leads to poorer economic performance (see also Section 4.5).

Until the early 1900s, public spending remained low. In the period that followed, new ideas concerning the role of the State seemed to justify a higher level of public involvement and spending. In Europe, after the Second World War, the role of the State in the economy was extended from the mere production of public goods to include a redistributive function through the welfare state. This had an inflating effect on public spending. The economic crisis in the 1970s increased the pressure on the government's budget and the State involvement in economic activity. In particular, the sustainability of the welfare state was questioned. Now, social protection spending represents a large percentage of the GDP. Through their social welfare programmes, governments mobilise, allocate and redistribute resources. In practice, the redistributive function through social security represents a substantial part of the governments' budgets in European countries. In fact, in 1998, in the EU, social expenditure amounted to 27.7 percent of GDP, which is an increase of 2.5 percentage points compared to 1990 (see Amerini, 2000).

The welfare state is regularly under attack because of these large levels of expenditure. It is claimed to be counter-productive with disincentive and distortive effects on the market. In particular, it is felt that the EU is at a comparative disadvantage with respect to the US, which has a lower level of spending. Computations by the OECD show that the variations in the level of public expenditure are, to a certain extent, compensated by variations of private expenditure. The figures in the first column of Table 6 are gross figures based on expenditures by the social protection institutions. Correcting them for taxes and social contributions that are levied on benefits leads to rather different figures of net public expenditure. Moreover, when expenditure on social risks by private insurance schemes are taken into account, the picture again changes, resulting in a sharp decrease in the difference between the Member States of the EU and the US (see Table 6).

Table 6: Gross and net public and private expenditure for social protection as percentage of GDP, 1997

	Gross public social expenditure	Net current public social expenditure	Private expenditure	social expenditure	Net total social expenditure
Belgium	30.4	26.3	2.2		28.5
Denmark	35.9	26.7	0.8		27.5
Germany	29.2	27.2	1.6		28.8
Ireland	19.6	17.1	1.3		18.4
Italy	29.4	24.1	1.2		25.3
Netherlands	27.1	20.3	3.7		24.0
Austria	28.5	23.4	1.2		24.6
Finland	33.3	24.8	0.8		25.6
Sweden	35.7	28.5	2.1		30.6
UK	23.8	21.6	3.0		24.6
Japan	15.1	14.8	0.9		15.7
US	15.8	16.4	7.0		23.4
Variance (unweighted)	50.1				18.0
95% confidence interval	[22.5-31.5]				[22.1-27.4]

Source: Adema (2001) and own calculations.

Going from gross to net total social spending reduces the variance between the twelve OECD countries included in the table by two-thirds. Moreover, US net total social spending does not appear to be significantly lower than average. Because people are risk averse, they will prefer a situation with to one without insurance. The conclusion is that no matter how one wants to organise the system of social

protection, one will have to pay the cost, either through State contributions or through the market. Limited State insurance supplemented through the market, as in the liberal model, is likely to have a large social cost leaving many unprotected because they are unable to afford private insurance. Disregard for the concept of ‘ability to pay’ may be a factor of social exclusion.

5 Quality social policy

Investing in economic and social capabilities

It has been argued that social policy is far from an economic burden and Member States from the EU now seem to recognise the necessity of striking a better balance between economic and social policy. This interplay between economic and social policy will determine the socio-economic outcome within the Member States. Social policy is more than just a financial burden. It is a productive factor contributing to political stability and economic dynamics.

In the first place, social policy can be carried out through legislation. The aim is then to impose economic costs to certain transactions and behaviours. It can range from minimum wage regulations to retirement and anti-discrimination laws. In the second place, social policy can take the form of transfers, possibly coupled to reintegration programmes. Social transfers can compensate for negative income shocks due to, e.g., unemployment, disability or old-age. These two dimensions of social policy are generally referred to as passive ones. From the point of view of positive subsidiarity, however, there is a third, more active dimension to social policy. Taking the stand of positive subsidiarity, the State can be viewed as a facilitator of collective action and as sustaining and encouraging the co-ordination of actors. Actors have an active role to play in the promotion of welfare, but so has the State: it is to promote individual autonomy and to aid the fuller development of lower bodies, in particular when human dignity and human rights are at stake (Fouarge, 2002). From this emanates the view of preventive and active social policy designed to avoid social failures.

Member States, having lost some instruments for economic stabilisation to the EU, will have to rely more heavily on flexible and dynamic labour markets in order to absorb employment shocks. Flexibilisation is also required to make – and keep – the EU competitive. Flexibilisation, however, requires a well-designed safety net because it will generally have a substantial effect on one’s income level (Muffels & Fouarge, 2002b). To the extent that flexibilisation drives people out at the lower end of the labour market, increasing their productive capacities – human and social capital – needs policy attention. Flexibilisation also refers to increased dynamics within the labour market. In transitional labour markets, mobility is expected to become more common. Periods of employment might be followed by periods of unemployment. Transitions between employment and caring activities are also expected to increase, as are transitions between employment and education, full-time and part-time employment, etc. (Schmid, 1998). Adequate safety nets – possibly at a higher than minimum level – are necessary in order to bridge periods of unemployment, education and care on the transitional labour markets. However, increasing the dynamics in the labour market also necessitates recasting social protection systems to make them more adaptable to new economic situations.

The key here is the safeguard of social protection rights when people make transitions in the labour market. Keeping people employed and employable means that they have to be given adequate, marketable skills. Model estimations do indeed show that human capital has a significant effect on the poverty risk. A skilled labour force is the key to Europe’s economic success, especially in the advent of the knowledge-based economy. This is also endorsed within the framework of the European

Employment Strategy. Investing in people's capabilities – i.e. providing them with the means of action – could be a new road for social policy (Raveaud & Salais, 2001), with an eye on both social and economic quality. Improving people's productive capabilities (relating to the economic domain) and social capabilities (relating to the social domain) will serve both economic efficiency and equity. Schooling and training fit within a logic of investment in people. This goes further than the mere compensation or reparation of risks. Investing in people is an effective way of minimising the risk of exclusion while, at the same time, promoting productivity.

In the wake of the knowledge-based society, this argument based on human and social capital is not an unimportant one. In a survey held in 2000 Dutch men and women were asked to report on their expectations for the future with respect to the economy, the labour market and social security (Ester & Vinken, 2001). The Dutch respondents clearly anticipate a further intensification of the knowledge-based society. They also expect diminishing solidarity ties but increasing possibilities for self-development within jobs which require different skills and abilities than today's jobs. Some authors have already pointed out that the demand for high skills has increased (Autor et al., 1998). All this means that there is a need to increase the skills of workers at all levels such as to increase their productivity and reduce the risk of exclusion from the production process. To invest in people's productive capacities is important to cater for a high quality of the labour supply and to comply with the requirements of the flexible economy. As de la Fuente and Ciccone (2002: 4) conclude from their research on the growth effects of human and social capital, "investment in people is both a crucial growth factor, particularly in the current context of rapid technological change, and a key instrument for enhancing social cohesion, and are therefore supportive of the policy strategy set out in Lisbon". It requires an active attitude from the individual and an active welfare state.

We noted earlier that although the costs of social policy are generally readily visible, the benefits are more difficult to quantify for most of these are long term. This is particularly true for social policies with an investment character and needs to be kept in mind when assessing the impact of policy measures.⁴⁰ From a long-term perspective, investing in people's capabilities is expected to be fruitful because it makes the labour force more responsive to changing economic conditions. It is a way to solve the trilemma of high employment, high equality and balanced budget (see Section 2.3). Focusing on the promotion of life chances fits into a preventive approach to social policy. This preventive approach is believed to be more fruitful than the curative one, based on the reparation of damages caused by the realisation of social and economic risks. Training and activation programmes should be integrated. Shaping the role of the State along the line of positive subsidiarity and the development of capabilities involves more pro-active policies focussed on developing one's life chances, especially for the long-term excluded.

Role for the EU

At this time, the EU has a limited role to play in the delivery of social protection or the combat against exclusion. It addresses these areas as a matter of common concern and has a role in facilitating the exchange of information, data, best practices and research. In the wake of the European Employment Strategy, the EU is taking part in the development of the employment policy of the Member States through soft laws, the introduction of national action plans and a peer-reviews monitoring system. The

⁴⁰ See the communication on 'impact assessment' (European Commission, 2002c).

EU does not have any formal competencies in that area, but it plays a stimulating role which it takes seriously. It is also rather effective, since, in that exchange of information no Member State wants to be at the bottom of the class. Madsen et al. (2002) indicate that there is a potential for policy learning and the transfer of policy practice among Member States in the wake of the European Employment Strategy. On the basis of an analysis of the NAPs/employment 1999 and 2000, they note a shift towards more active policies in a number of European countries. Changes in policy practice are associated with positive achievements in terms of employment and social exclusion. Although these changes cannot simply be ascribed to the open method of co-ordination, the authors show that the findings are in line with the hypothesis that policy learning is taking place. The national welfare states – but also the EU – should encourage developments towards active and human capital-enhancing policies, since that would contribute towards making Europe both social and competitive.

6 Conclusion

To conclude, we can say that there is an efficiency argument to be made for social policy. Economic efficiency and equity certainly do not necessarily conflict with one another. They can easily complement each other. The theoretical arguments for the existence of social policy have been articulated according to the three classical economic functions of government intervention: allocation, stabilisation and redistribution. Although the most important role of the welfare state is to redistribute resources, it also has an allocation and stabilisation function.

It is important to realise that however one wants to provide social insurance – through the market or through state provision – one has to pay for it. Private provision might not be cheaper, but what is sure, private provision entails larger risk of exclusion with a large share of the population in poverty and excluded from participation into the schemes. The social costs of non-social policy are high. Our discussion shows that social efficiency and the promotion of well-being do not by definition engender loss of economic efficiency. However, the pursuit of economic efficiency only will generally harm the distribution of well-being. As we have discussed, the fruits of economic growth in Europe do not seem to have trickled down to the poor in a way that reduces the incidence of poverty. At the macro level, job creation is insufficient for poverty reduction since it is likely to merely increase the turn-over rate at the lower end of the income distribution. The liberal approach, therefore, has to accept fairly high levels of recurrent and persistent poverty among particular groups, i.e. single parent families and the unemployed. Even in the longer run, the major part of redistribution is performed by the welfare state. Relying solely on market processes is therefore unlikely to bring about the desired social outcomes. On the other hand, relying solely on income redistribution by the welfare state is insufficient to increase people's life chances.

On the side of the economic costs of non-social policy we have shown that social policy contributes to economic stabilisation and smoothing of the business cycle, and it has a positive effect on allocation efficiency. Publicly provided social protection offers the possibility to cope with adverse selection, internalise (income) externalities and take advantage of economies of scales. Social policy also contributes to the quality of the labour force and the formation of social capital. On changing and dynamic labour markets – such as transitional labour markets with increased flexibility of the labour market, part-time work, non-linear careers – it contributes to smoothing new social and economic risks. With the rise of the knowledge-based society, some people will face new risks and uncertainties and may lack adequate skills to enter or re-enter the labour market. Social policy has an important role to play here: investing in people's productive and social capabilities. Productive capabilities – such as

human capital – improve directly the marketable skills of people. Social capital is important because it is one of the assets people can draw from in order to find their place in the social and economic process. This logic of investment fits well within Sen’s approach to poverty.

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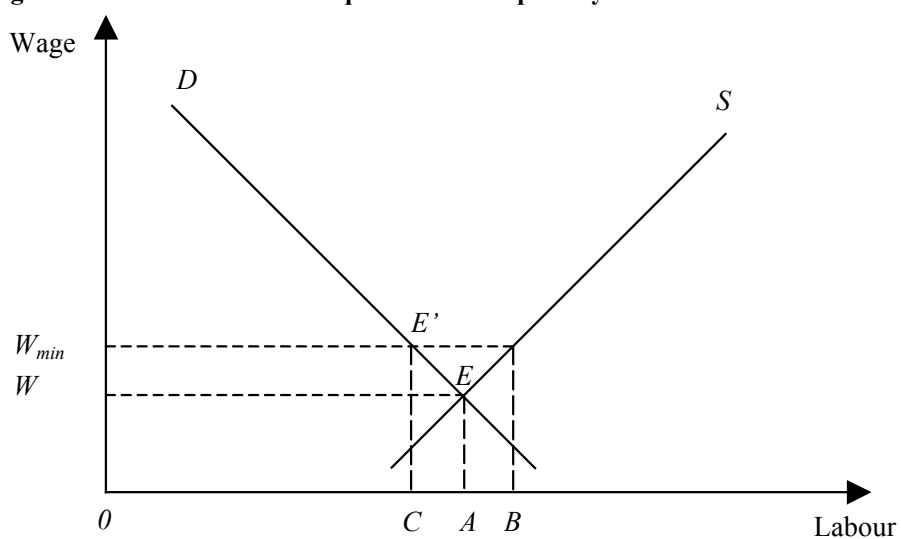
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Appendix 1: Labour market equilibrium and poverty

In the standard model (Figure A.1.1) with supply curve S and demand curve D , the equilibrium situation on the labour market is depicted by point E . Let us suppose that there is some minimum subsistence level below which a person does not reach a standard of living that is considered acceptable within the community (a poverty line). This minimum subsistence level is depicted by the dotted W_{min} -line. At the new equilibrium situation E' , up to OB persons want a job, but only OC will get one, leaving CB unemployed. These people could offer their labour along the supply curve towards the equilibrium point E , but the wage they would get (W) would be lower than the minimum subsistence level. Hence, they would be living in poverty.

Figure A.1.1: Labour market equilibrium and poverty



Appendix 2: Poverty profiles and mobility into poverty

Taking a longitudinal view on poverty, we can distinguish among four types of poverty profiles (see Fouarge 2002: 122):

- The persistent non-poor: never poor during the accounting period;
- The transient poor: poor only once during the accounting period;
- The recurrent poor: poor more than once, but never longer than two consecutive years;
- The persistent poor: poor for a consecutive period of at least three consecutive years.

This indicator of longitudinal poverty captures the aspects of income mobility as well as persistent poverty. The results using this indicator are presented in Table A.2.1. These poverty profiles were computed on the first five waves of ECHP data where the poverty line was set at sixty percent of median standardised income. Income was standardised using the modified OECD equivalence scale attributing a weight of 1 to the first adult in the household, 0.5 to other persons aged 14 or more and 0.3 to children younger than 14. Note that the rate of persistent poverty in the table differs from that presented in the ‘Joint report on social inclusion’ because it is computed on five wave of data rather than three (European Commission, 2002a: 193).

Table A.2.1: Poverty profiles 1993-1997; percentage of persons never, transient, recurrent or persistent poor

	Never	Transient	Recurrent	Persistent	Total
Denmark	77	13	6	4	100
The Netherlands	78	10	6	6	100
Germany	73	11	8	8	100
Belgium	64	13	11	12	100
France	68	10	8	13	100
Italy	62	13	12	13	100
Greece	59	14	12	15	100
Spain	60	13	15	11	100
Portugal	59	14	10	18	100
Ireland	64	11	11	15	100
UK	61	13	11	14	100
EU	66	12	10	12	100

Source: ECHP waves 1 through 5; see Fouarge and Layte (2003)

In Table A.2.2, we present the results of the estimation of the transition probabilities out of poverty in three European countries in the 1990s.

Table A.2.2: Pooled logit model for poverty^{a)} transitions into poverty between 1991(0)-1995(4)^{b)}, in the Netherlands, Germany and Great Britain, household head aged 16 to 65, beta coefficient (absolute robust t-value)

	The Netherlands (n=32,624)	Germany (n=50,434)	Great Britain (n=25,575)
Age of household head			
16-25	-	-	-
26-45	-0.913 (4.85)**	-0.384 (2.12)*	-0.595 (3.90)**
46-65	-1.395 (7.11)**	-0.884 (4.34)**	-1.729 (10.06)**
Gender of the household head			
Male	-	-	-
Female	0.178 (1.58)	0.293 (2.73)**	0.241 (3.22)**
Educational level of household head			
Less than high school	-	-	-
High school level	-0.504 (6.40)**	-0.252 (2.51)*	-0.275 (2.29)*
Higher than high school	-0.410 (3.49)**	-0.879 (5.14)**	-0.323 (3.82)**
Number of children			
	0.241 (6.15)**	0.349 (7.47)**	0.246 (7.22)**
Number of adults			
	0.513 (8.67)**	-0.133 (1.74)	0.233 (4.74)**
Number of employed persons			
	-0.416 (4.79)**	-0.306 (3.34)**	-0.803 (8.76)**
Use of work potential in household			
0-10%	-	-	-
11-25%	0.802 (3.37)**	-0.289 (0.99)	0.596 (2.68)**
26-50%	0.514 (2.42)*	-0.036 (0.11)	-0.573 (2.86)**
51-75%	0.179 (0.76)	-0.697 (2.24)*	-1.216 (5.55)**
>75%	-0.333 (1.20)	-1.208 (3.77)**	-1.644 (6.68)**
Proportion of social security income in total household income			
0-10%	-2.255 (12.50)**	-1.048 (3.38)**	-0.961 (4.83)**
11-25%	-1.534 (9.06)**	-0.574 (1.90)	-0.856 (4.80)**
26-50%	-0.997 (5.92)**	-0.398 (1.41)	-0.343 (1.93)
51-75%	-0.506 (2.82)**	-0.093 (0.31)	-0.553 (3.72)**
>75%	-	-	-

Table A.2.2, continued	The Netherlands	Germany	Great Britain
Change in demographic, labour market and social security variables			
Change in number of children			
No change	-	-	-
Increase	-0.401 (1.70)	0.763 (4.22)**	0.315 (2.51)*
Decrease	-0.004 (0.02)	0.603 (3.18)**	0.892 (4.17)**
Change in number of adults			
No change	-	-	-
Increase	-0.086 (0.34)	-1.850 (7.80)**	-0.753 (3.53)**
Decrease	0.619 (5.98)**	1.214 (9.29)**	1.203 (12.37)**
Change in use of work potential			
No change	-	-	-
Increase	0.158 (1.17)	-0.619 (3.37)**	-0.550 (3.78)**
Decrease	1.878 (16.89)**	2.017 (18.43)**	0.871 (9.50)**
Change in social security income receipt			
No change	-	-	-
Increase	1.777 (18.92)**	1.064 (8.72)**	0.779 (6.91)**
Decrease	0.502 (5.69)**	0.815 (7.56)**	-1.352 (11.51)**
Constant	-3.705 (12.01)**	-2.638 (8.42)**	-0.599 (2.29)*
R ²	0.23	0.24	0.35

* significant at 5%; ** significant at 1%.

a) here poverty is defined as having an equivalised household income below 50% of the median.

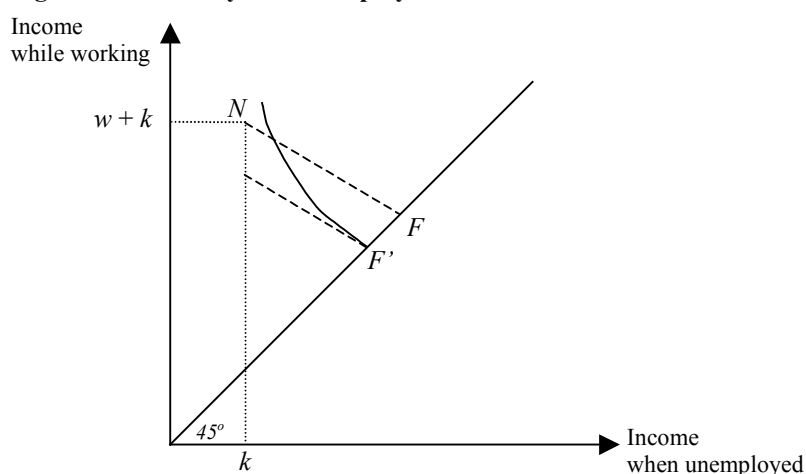
b) data for 1990-1994 for the Netherlands and 1991-1995 for Great Britain and Germany.

Sources: SEP (1991-1995), GSOEP (1992-1996), BHPS (1991-1995), see Fouarge (2002: 129-130).

Appendix 3: A simple insurance model

The aim of social protection is to replace lost income (due to illness, old age, etc.), to supplement income (family benefits) or to prevent income losses (i.e. by providing information and establishing safety rules). We will confine ourselves primarily to the first of these three aims. The following model shows how the private market for social insurance, in the form of minimum protection, is not sustainable. As an illustration, we use the simplified insurance model presented by Atkinson (1989: 112-116). The model considers a worker with the probability p of becoming unemployed and losing his wage income as well as the probability $(1-p)$ of remaining in work and earning his wage w . In both states, he would get income from capital k . Say δ is the premium paid and b is the social minimum benefit received when unemployed. If employed, the worker would receive an income of $(1-\delta)w+k$ with a probability $(1-p)$ and, when unemployed, an income of $b+k$ with a probability of p .

Figure A.3.1: Utility and unemployment insurance



In the no-insurance situation, the worker would get $w+k$ if in work and k if unemployed (point N in Figure). Supposing there are no administrative costs and that the insurance is actuarially fair, then in the case of full insurance: $(1-p)\delta w = pb$.⁴¹ The worker is then allowed to move along the line NF , with slope equal to $-p/(1-p)$, according to his preference. Assuming the worker is maximising his utility and that utility of income is the same in both situations, then the worker maximises the following function: $(1-p) U[w(1-\delta)+k] + p U[b+k]$. In case of risk aversion, the chosen point would be F , the point giving total insurance.⁴² Full insurance would be chosen by all risk averse persons, whatever their degree of risk aversion. Say the administrative cost per insurance policy equals a , then the amount pa has to be deducted from the benefit paid. This shifts the dashed line in Figure downward, bringing the full

⁴¹ A lottery is said to be actuarially fair when the expectation of net gain is zero.

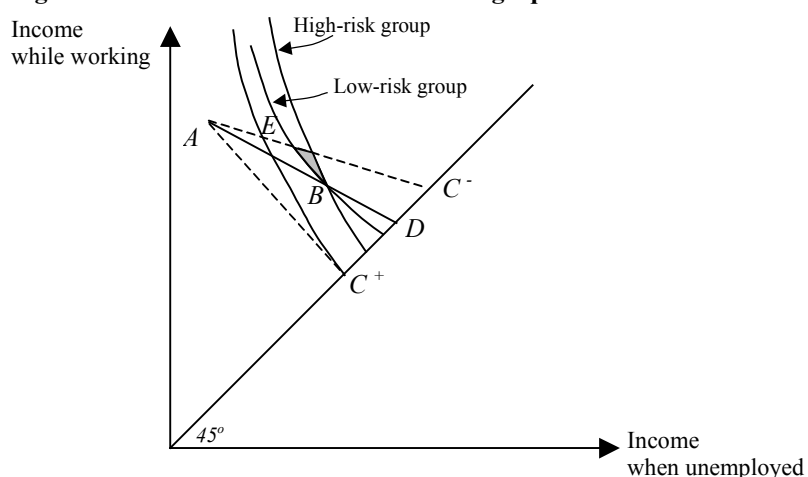
⁴² When individuals are risk averse, their utility function is strictly concave. A fundamental theorem of risk theory states that if the utility function of an individual is strictly increasing and concave, then the risk premium associated to any lottery is positive. The individual prefers insuring the risk than not insuring it.

insurance point in F^* . Whether or not the point of full insurance is the one that will actually be chosen depends on the degree of risk aversion – i.e. the curvature of the indifference curve – and the level of the administrative costs relative to the incurred income loss. The person depicted in the figure is better off with full insurance, but if its indifference curves were flatter (if he was less risk averse) or the administrative costs were higher, he might prefer the no-insurance situation. We see that, in this situation, people take either full insurance or they take no insurance at all.

If administrative costs of State insurance are higher than those of private insurance, as it is sometimes argued, then we can expect more people to choose full insurance. Therefore, the distortion resulting from the administrative costs will be lower in a private minimum protection scheme. However, because of the economies of scale possible with state insurance, this form of insurance might have an advantage over a multiplicity of private insurers. Atkinson also argues that, if compulsory state insurance has lower costs (as they might indeed have, see Gouyette & Pestieau, 1999), it is possible that everybody would be better off and social welfare would therefore rise.

Compulsory state insurance, however, offers less diversity of choice because it does not allow people to opt out. Also, the argument in terms of diversity assumes that perfect competition makes it possible to have a multitude of private insurers from which the customer can choose. What if perfect competition is not sustainable on the insurance market? In order to understand this, consider the situation in which people differ only in their risk of becoming unemployed and that this risk is not readily observable to insurers. One group has a probability p^+ of losing employment while for the other group, this probability equals p^- , with $p^+ > p^-$. Both groups have the same degree of risk aversion. In Figure A.3.2, the indifference curves for both groups are depicted such that in each point the slope of the indifference curve of the high-risk group is higher than the slope of the indifference curve of the low-risk group. The line $A-D$ shows all contracts that would break even if both high and low risks purchase the minimum protection insurance. The slope of this line depends on the probabilities p^+ and p^- and on the proportion of both groups in the population. The line AC^+ is the locus of contracts that would break even if only the high risks purchase insurance and AC^- is the equivalent locus if only the low risks purchase insurance. In such a situation, a problem of adverse selection appears.

Figure A.3.2: Private insurance and sorting equilibrium



Assuming the insurers do not know, ex-ante, the risk of their prospective clients, it is impossible to attain a competitive equilibrium, i.e. a set of insurance contracts such that no other contract exists

which, if offered, would make a profit. Supposing an insurer offers a contract as soon as it can make a profit – and that it can do so without influencing the behaviour of other insurers – then a solution could be somewhere on the locus $A-D$, where both low and high risks purchase the same contract, say B . At that point, however, any contract in the shaded area would attract people from the low-risk group. Insurers then have the possibility to make a profit. This type of pooling equilibrium can, therefore, never be stable.

Alternatively, we can look for a separating equilibrium, with contracts along AC^+ offered to the high-risk group and contracts along AC^- offered to the low-risk group. Here, the constraint is that, for this latter group, the contract lies on the segment $A-E$, so that the high-risk group will not be attracted. In this case, a contract such as B , would be profitable because it would attract people from the low-risk group.