

Economic changes to the welfare state



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Write a 2000 words essay describing the economic aftermath of the Welfare state in the last century

I. Introduction

A welfare state is broadly defined as a state in which the government/the public sector undertakes key roles in the production and distribution of economic activities with the objective of protecting and promoting the economic and social well-being of its citizens. A welfare state is essentially a mixed economy type of economic system where the government undertakes a greater proportion of economic activities. This essay describes the economic aftermath of the welfare state in the last century. The essay is organised as follows. Section II focuses on the theoretical foundations of the welfare state, while Section III concentrates on the economic aftermath of the welfare state. Section IV finally concludes the essay.

II. Theoretical Foundations of the Welfare State

The theoretical foundations described in this essay are from; (a) classical economics, (b) Keynesian economics, (c) Suzumura (1999), (d) Barr (1992), and (e) Heath (2011)

Classical economics

The classical economists including Adam Smith favoured a minimal role for the public sector. Their preference was for a limited role for the government in the provision of essential public works, the maintenance of law and order, and the defence of the country. They believe that the government's role is to

provide these core activities to provide an enabling environment for the market/private sector to undertake economic activities for economic growth.

Keynesian economics

Keynesian economics was used to justify an expansion in the economic role of the public sector. Keynesian economics created pressures on the government to stabilise the economy by helping to sustain the disposable income of individuals during cyclical fluctuations.

Suzumura (1999) argues that welfare economics plays critical roles in enhancing human well-being and in the design and implementation of welfare state policies. Welfare economics is a normative concept and in general takes account of both efficiency and equity. On equity grounds, society may prefer an inefficient resource allocation for reasons for equity justice and this provides a justification for government intervention in the economy. Suzumura argues that the enlarged concept of welfare economics to incorporate equity justice has also extended the concept of well-being to incorporate/capture the basic considerations as liberty, opportunity and procedural justice and that this widening of the concept of well-being should reflect itself properly in the concept and agenda of the welfare state. Based on this conceptual framework, Suzumura then employs Amartya Sen's concepts of functions and capabilities as vehicles to examine an individual's advantages in the welfare state. To Suzumura the welfare state consists of one main system of competitive mechanism and three subsystems of (i) the competitive policy subsystem, (ii) the co-ordination policy subsystem, and (iii) the social security subsystem. Suzumura concludes that the task of the

welfare economics in the welfare state is to deliberately design the main system and the three subsystems of the welfare state so that the whole system becomes incentive compatible to make it work effectively to maximise the well-being of the individuals in the society in terms of liberty, opportunity and procedural justice.

Barr (1992) provides another theoretical foundation of the welfare state. Barr's thesis and his contribution is on information problems for an efficiency case for various types of state intervention. He identifies two broad types of imperfect information problems leading to market failure in dealing with risks as adverse selection and moral hazard. The insurance industry was the focus of Barr's analysis. Adverse selection results from asymmetric information between buyers and sellers of insurance, with buyers having more information than sellers and thus making it difficult to establish the ideal price for each individual. These characteristics of adverse selection cause the problems of (i) unstable pooling equilibrium because low risks drop out or because of competitive behaviour by insurers, and (ii) inefficient separating equilibrium, if it exists. Thus, in the face of adverse selection, the market is inefficient, or fails entirely and the state intervenes by making membership compulsory with social insurance as a typical example.

Heath (2011) identifies the three normative models as redistributive, communitarian and public economics. The redistributive model describes the redistribution of resources to ensure that the outcomes produced by the market economy are less unequal.. The underlying assumption under the redistributive model is that the market is to maximise efficiency while the state promotes equity through redistribution by allocating initial

endowments and adjusting final outcomes. The communitarian model considers the imposition of moral limits on the scope of the market so as to resist the commodification of certain domain of interaction. It is argued under this model that basic human needs should be satisfied through communal provision in which everyone is guaranteed a share rather than through commodification. The public economics model regards the state as correcting market failure, either through regulation, subsidisation and taxation, or the direct provision of goods and services. This model is referred to as the economic model because of the emphasis put on Pareto efficiency and the narrow conception of public goods based on Samuelson's definition. Under the public economics model, market failure allows for the intervention of the state in economic activities.

III. Economic Aftermath of the Welfare State

The economic measure of welfare state activities is given by the proportion of public expenditure/spending to the Gross Domestic Product (GDP), that is, as a share of GDP.

Gwartney, Holcombe and Lawson (1998) argue that even after providing for a generous definition of the concept of core functions to include (i) the protection of persons and property, (ii) expenditures on national security, (iii) expenditure on education, (iv) expenditure on physical infrastructure, and (v) the operational costs of the central bank to maintain a stable monetary regime; the share of the expenditures on core functions for most developed countries did not exceed 15% of GDP up to 1996. Meanwhile as at 1996, the share of government expenditure as a percentage of GDP was above 45% in

most developed countries. The authors argue that this higher percentage above the required percentage for the core functions exerted a negative impact on the economy in terms of slower economic growth. Their findings indicate that a 10% increase in government expenditure as a share of GDP results in approximately 1% reduction in GDP growth. The authors assigned the following reasons for this outcome; (i) higher taxes/and or additional borrowing to finance government expenditures impose excess burden on the economy, (ii) as government grows, its productivity declines. This is characterised by the following trajectory - expenditure on core functions increases productivity but expenditure exceeding the core functions leads to diminishing returns and more and more expenditure eventually produces negative returns which leads to productivity declines, (iii) the political process accompanying increased public expenditure inhibits the entrepreneurship that drives economic growth through the discovery process. It is argued that as entrepreneurs discover new and improved technologies, better methods of production and opportunities that were previously overlooked, they are able to combine resources into goods and services that create wealth and economic growth, and (iv) the growth in government expenditure was characterised by heavy involvement in redistribution of income and regulatory activities that encouraged individuals to seek personal income via government favours rather than through production in exchange for income. Eventually resources are shifted from wealth creating activities toward the pursuit of wealth transfer which retards economic growth and generate income levels well below the economy's potential.

Tanzi and Schuknecht (1998) argue that from the late 19th century to early 20th century total government expenditure was less than 12% of GDP with expenditure covering the core functions. In the 1920s, the average total expenditure increased to nearly 20% of GDP. In 1937 public spending went up to an average of 23% of GDP resulting from the effects of the Great Depression. Between 1960 and 1980, there was a rapid increase in public spending from around 28% of GDP around 1960 to 43% of GDP in 1980. They further argue that the increased public expenditure/spending reflecting welfare state activities produced the following effects; (i) growing public spending and debt, (ii) rising real interest, (iii) slower growth, (iv) less attractive investment destination by international investors, even under growing globalisation, growing competition and capital mobility, (v) disincentive effects caused by higher taxation, and (vi) large-scale redistributive expenditures with negative impact on growth, employment and welfare. The authors' table 6 (page 83) provides a comparative analysis on the size of government and economic performance as at 1990 between big governments and small governments. Big governments are equated to states with higher government expenditure, that is, with GDP shares exceeding 40% while small governments show government expenditures of less than 40% of GDP. The main findings were based on the following indicators of economic performance; (i) real GDP growth, (ii) Gross fixed capital formation (in percent of GDP), (iii) inflation (1986-1994), (iv) public debt (in percent of GDP), (v) economic freedom indicator, (vi) size of shadow economy (in percent of GDP), (vii) PPP-based per capita GNP (in US\$), and (viii) standard deviation of GDP growth. The summary findings were as follows; (a) real GDP growth over a longer period lower in big government

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countries and that could account for growing unemployment experienced in welfare states with big governments, (b) GDP per capita based on Purchasing Power Parity (PPP) much higher in countries with small governments, (c) based on the ratio of the standard deviation and the average growth rate (the coefficient of variation), there was no evidence that higher public spending leads to more stable growth (i. e no evidence that welfare states exhibited more stable growth rates). This indicator was to provide evidence on one of the main justifications of Keynesian economics that growing public spending is needed for a stabilisation policy to reduce fluctuations in growth over the business cycle, (d) gross fixed capital formation and inflation did not show much difference across groups of countries (i. e both big and small governments recorded almost the same rates), (e) public debt averages almost 80% of GDP in countries with big governments in 1990 - leading to the payment of considerable risk premiums on public debt obligations (higher real interest rates), (f) economic freedom in countries with big governments worse than countries with small governments, and (g) a strong correlation between spending by governments (and corresponding taxes) and the size of the shadow economy (almost 18% of GDP for big governments compared with 9. 4% for small governments in 1996). The authors recommend that fiscal reforms and lower public spending are needed in many countries with big governments in order to increase economic growth without sacrificing much social and economic well-being.

IV. Conclusion

In the current globalised world where technology is making major strides, the role of the state should be significantly different from the role played to the

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end of last century. The economic aftermath of the welfare state in the last century indicates that to increase economic growth, the state should now play a more significant and intelligent regulatory role of providing a level playing field which allows the private sector to expand to areas traditionally undertaken by the state. The role of the state in income redistribution and in providing safety nets is very important but needs reassessment by policymakers. Targeted coverage and not universal coverage is what is needed and with the concept of redistribution narrowly defined to avoid many inefficient policies pursued under the justification of redistributing income.

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