

## **ECONOMIC SECURITY. WHO SHOULD PROVIDE IT?**

(preliminary draft, references not yet included)

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### **Abstract**

Since more than one century ago, in the most advanced countries, Social Security started to provide efficient coverage against the economic consequences of work related injuries, disability and old-age. This contributed enormously to the economic security of the working classes and, more recently, the middle classes that account for the largest lot of society. Today, market solutions could very well instrument even cheaper though equivalent security to most individuals or households through their life-cycle, particularly in face of bio-demographic trends. Only the poor would dependent on welfare for their economic security. Sure? Even this view, however, could be challenged, at least in part, when one looks at ways to stimulate active engagement of individuals in securing their own prosperity. Market oriented solutions and instruments could also serve the less well-off helping the remaining welfare state to overcome criticism that it is one of the main causes of a more than disappointing economic performance in Europe and a lagging labor supply. Should the role of government be to continue to provide economic security directly or to reform market institutions to make them more oriented towards the needs of the middle classes and the less well-off for this purpose? Full development of the civil society also requires devolution to its members of responsibilities that for too long have been in the hands of governments.

## 1. Introduction

The idea of a civil society is a powerful one. Above all when one considers the enormous weight that the middle class carry in any modern nation. Should this part of the population suddenly change their attitudes, preferences or life-styles, enormous adjustments should follow at all levels. Government, tax-and-transfers schemes, industry and services, education, etc. would have to undergo complex restructuring. But middle classes are quiet and predictable everywhere. Too quiet and predictable. To the point that in many countries the middle class has surrendered a considerable amount of responsibility to the government making it hard the building-up of a dynamic civil society fitted to the challenges of the new century.

By surrendering some of their responsibilities to the government, against huge tax bills, the middle classes have gained economic security. Sure? What is economic security and how to buy it? Does a country needs to devote 25 or 30 per cent of its GDP to pay for it? And the rest of society? That is, the rich and the poor. How are their capacities and needs dealt with by the government's arrangements?

The welfare state is most refined device that governments have instrumented to deal with the economic security of the population. As such, it has had precise origins and an evolution towards its current state that has shaped the behavior of hundreds of millions of individuals in developed countries as well as many of their most respected institutions. It has served well their needs in the face of disability, sickness, old-age or survival, or against unemployment, for about a century. It has also suffered adjustments to cope with adverse circumstances that have disappointed the high expectations of many. The welfare state, finally, may have had a perverse effect limiting labor supply and activity and exacerbating the strategic behavior of individuals in search for undeserved benefits.

At the end of the XIX century, just a handful of urban households could enjoy economic security and sufficient resources for a good living. Market instruments for it existed but were unaffordable to most individuals and proper financial culture was only shared among the well-to-do. The meager arrangements that rooted in the guild-type institutions of former centuries still existed in that period were clearly unfitted to provide even the most basic security to sick, old or unemployed workers. Cities' outskirts were already crowded with masses of industrial workers that had nothing but their hands to provide for themselves.

Structural change during the previous decades had been swift compared to the slow adjustment of traditional institutions designed for a world that no longer existed.

Social insurance entered the scene as with a paternalistic approach under which entrepreneurs, workers and governments contributed to pay for benefits in case of work related disability: To this, sickness benefits, old-age and survivors pensions were added and by the first decade of the XXth century a relatively complete array of social insurance benefits, for dependent industrial workers, was established in most advanced countries. Universal social security that provided economic security “from the cradle to the grave” (Lord Beveridge) was the next most comprehensive development for a number of European countries after WWII. This, together with the reconstruction effort pushed by the Marshall Plan, helped to create an unprecedented period of social peace and prosperity in western Europe.

Living standards since then have increased manifold and so has increased the perception that economic security is a basic asset of society comparable to freedom, education or equality of opportunities. For a majority of individuals in Europe, economic security is also a basic social right that should be guaranteed by the government and paid for through a progressive income tax scheme.

It must be accepted without any reservations that economic security institutions are a kind of social asset from which to derive substantial dividends for all and every one of the members of society (A. Atkinson). It can be questioned, however, that this asset can only be built by governments even if its historical development demonstrates an increasing involvement of the former.

One obtains economic security by limiting risky behaviors and properly planning resources to cope with contingencies that occur anyway. Governments are not necessarily better fitted than individuals to provide it. They do not create security out of nothing but need to extract resources from people to fund the institutions and benefits that help individuals to overcome their needs in case of difficulties. This, the majority of individuals in a modern society can do it by themselves with a better understanding of their needs and resources.

Income flows and assets in the hands of representative individuals in most developed countries are substantive nowadays. This would allow them, with the help of proper instruments issued in well regulated markets, to buy better and cheaper economic security than governments offer, or to complement it. Of course, some individuals may lack income

and/or assets and public provision should be made for their needs. Above all, sound policies for equality of opportunities that are cheap and effective when trying to put everyone in the departure line of the course, instead of the massive welfare state that aims at putting all in the winners' place. Other individuals abound in both income and assets and do not need the standard economic security governments can offer. Also, thanks to very imperfect tax systems, they are able to avoid contributing, even at the average rate, to the government budget.

Civil society has to do with individual freedom and responsibility as much as with shared values and productive interactions among agents. Economic security gets reinforced when individuals pool their resources and satisfy their needs through cheap and efficient instruments provided by well regulated markets. It may be questioned that at the beginning of the XXIst century, in advanced societies, a substantive part of individual responsibility and arrangements for economic security still remains in the hands of governments.

## **2. Economic security. Concept and issues**

Economic security could be, somewhat restrictively, defined as an individual's or household's capacity to face the adverse economic consequences of life-cycle contingencies (bad health, disability, old-age, survivorship) that may occur to them without suffering substantive reductions in her standard of living or falling into poverty. This capacity can be based on own assets or other private (insurance, extended family) or public (social security) arrangements. Several issues come immediately to the front.

A society in which the perception that economic security is important is widely shared and that its achievement is an important common goal will be a cohesive one. A variety of positive external effects derived both from the shared value and the joint effort will fuel overall performance in many different fields, included market development and economic growth.

This said, several conditions need to be fulfilled. First, the acceptance that economic security is a distinct "service" that has to be produced at a cost. This cost may be in the form of forgone consumption today in favor of savings, insurance premiums or taxes, or indebtedness. Second, the acceptance that although part of the cost can be beard by others, resources are limited. These limitations are both in the form of total resources available given many other goals and a limited capacity to extract resources from those who pay the final bill. Third, the acceptance that strategic behavior to profit undeservedly from economic security

schemes, if generalized, would do away with the positive effects of the compact. In this case, indeed, very negative effects could be observed.

Economic security (ES) schemes thus have to have their own mechanisms to enforce solvent participation by all according to well designed rules. It should not be an issue whether ES schemes need to be private or public. But it is, and a hot one due to several facts. First, certain individuals will have not, despite all their efforts, the resources required to buy a decent level of ES. Second, many other individuals may not be aware of the importance of making ES arrangements until it is too late. Third, efficiency tends to be different whether a scheme is private or public. Fourth, public schemes are prone to interest group manipulation. Fifth, private schemes may go bankrupt. And last, but not least, history, so to speak, has determined in many advanced countries that governments set up massive programs to finance and provide ES to virtually all.

Economic security thus is neither an straightforward concept nor a result that can be taken for granted. Having in mind the different aspects just evoked, who should provide it so that all could benefit?

### **3. The welfare state and economic security**

In the discussion that follows I will not be concerned with the conventional vision of the welfare state, nor with its historical genesis or even less with an explanation of why it is as it is. I will only be concerned with some basic facts as of today and a critical assessment about whether the welfare state is actually fulfilling its own goals. A rapid glance at the future will help me complete the picture. First the facts, some of them well known.

Overall, the welfare state claims between 20 and 30 per cent of GDP that is collected via social contributions levied on wages or general taxes to pay for an equivalent sum of benefits in cash or in kind of a great variety, ranging from life old-age pensions to sophisticated surgical interventions or from spare glasses to taxi bills. Middle classes receive most of these benefits... and pay for them. Governments own hospitals, equipments and offices and engage hundreds of thousands of personnel to run the necessary operations and manage the transfer schemes. Currently, they decide what the levels of benefits should be, they also set up the eligibility conditions and the contribution rates to be asked from active members. Participation by individuals is normally compulsory and benefits may be contributory (based on actual contribution records), universal or means-tested.

Behind this broad picture there are an enormous diversity of practices in different countries and a very “fine structure” (Atkinson) of qualifying conditions, exceptions and special provisions that makes schemes so well suited to individual circumstances that almost every case finds a tailored solution to his or her particular problem. Let us review in more detail some of the major programs and their particularities.

### 3.1. Health care and sickness benefits

One of the primary causes of economic insecurity is sickness or work related injury. This events cut the flow of labor income in the household on top of the expenses that must be incurred in in order to have the treatments needed. The standard remedy is some sort of insurance that pays for the treatments and provides the lost income flow at lest up to a limit. The welfare state, as it is known, has solved this by either directly providing treatments free of charge or against a modest fee or by reimbursing most of the expenses at charge of the insured person. As for the replacement income while out of work, there are also cash benefits granted that supplement after a certain number of days those paid, in certain countries, by employers. In most developed countries health care is publicly provided to workers and non workers alike.

Replacement benefits are minor compared to health care expenses. European governments devote around 7 per cent of GDP to finance their universal health systems with private expenditure amounting to about 2 per cent. In the United States, however, total health expenditures surpasses 15 per cent of GDP and health indicators there are not better than in Europe.

As for strategic behavior concerning health care, it is hard to conceive of individuals who hurt themselves in order to get treated or even to avoid going to work on Mondays. But it is a common observation that sickness leave increases on Mondays or that certain individuals spend a disproportionate number of days per year on sickness leave. Doctors could explain this very well. If not strategic, at least myopic or unhealthy behaviors cause many individuals to end up with serious health impairments that take them out of work or put them in economic hardship. The welfare state has yet to develop fences against these behaviors although the solution is not evident.

It is hard to avoid thinking that to some extent the former are illustrations of the moral hazard problems that seemingly “free lunches” entail. Against these drawbacks it has to be

acknowledged that national health systems have done a lot to improve health related inequalities and to increase human capital in developed nations.

### 3.2. Disability benefits

Suddenly losing the capacity to carry out a job and earn the corresponding wage because of an accident or sickness is one of the most distressing experiences for a worker and his or her dependants. The very fact of knowing that one is properly covered against this risk, even if a low one, has a great value for workers and enhances their human capital and eagerness to engage in higher paid activity, switch jobs and be more mobile. This feeling of economic security produces intangible benefits for all through positive externalities flowing out of the interactions undertaken by agents.

These benefits are basically life benefits granted to workers unable to continue work for health reasons, either work related or not. Non workers can only have these benefits through a private insurance scheme. Although well suited for the insurance technique, as probability of cases is low in principle, these benefits are mostly financed on pay-as-you-go basis or out of current general taxes. Again, it is hard to conceive of people chopping themselves a hand out in order to get a life disability pension. Doctors however could also explain why disability rates are disproportionately high in many countries. It happens that disability benefits are higher or entail more bonuses than old-age ones. Governments have often used these schemes to cope with lay-offs after industrial restructuring instead of ordinary old-age benefits.

These benefits amount to several percentage points of GDP and are mostly financed through current social contributions. In present value terms however, given the life expectancy of the representative beneficiary, at any point in time, they amount to many more times the current year payments. It is very rare that social security schemes have any accumulated assets to match the present value liabilities implied. They simply expect to be able to collect enough contributions and taxes in the future to pay for these as they come due.

### 3.3. Old age and survivors benefits

Reaching and advanced age seems to be a better perspective than the alternative, but it also has economic consequences. Workers' productivity tends to diminish after an age threshold and, above all, many people aims at enjoying well deserved leisure after a long working life. The work to retirement transition is a "rite de passage" in modern societies.

Thanks to widespread formal pension arrangements, that allow retiring workers to replace a high proportion of their former wages, retirement is a happy transition instead of a stairway to hell. Again, this social compact for economic security facilitates a smooth replacement of generations at the labor market and enhances productivity (Sala-i-Martin). Survivors benefits, on the other hand, often less generous, alleviate considerably the already unhappy circumstances of those who have suffered the loss of a breadwinner.

Old-age benefits can be normally claimed at ages between 60 and 65 or even earlier in certain countries or for certain occupations, even if some would consider an insult to be called old at such ages. Generations born around 1900, in by then advanced countries, would have collapsed to a mere 20 percent sixty five years latter while generations born today will endure at 90 percent their original size in 2070 (Herce et al). This means an enormous increase in life expectancy that will continue to show up. Old-age benefits, as already said, replace former wages at between 60 and 90 per cent and gat indexed with prices or nominal wages in most countries. Also, they are due for life and financed out of current contributions and general taxes. As with disability benefits, their present value is much higher than the current outlays needed yearly. With yearly payments representing from 6 to 10 per cent of GDP (EU Comission) it is no wonder that the present value liabilities of most western old-age pension schemes amount to more than current output everywhere (IMF, OECD)

Old-age pension formulae are the quintessence of refinement and complexity (Herce) and despite that, retiring workers have very limited choices and may get severely penalized if the insist in continue working after 65. *En revanche*, some workers are able to circumvent the system and get stupendous benefits relative to their effective contribution record even if these benefits are low in absolute terms. Reforms aimed at adjusting the schemes to avoid these behaviors or to cope with changed circumstances have met considerable popular resistance everywhere.

### 3.4. The future

Providing economic security to workers and their dependants through the welfare state is thus expensive, but it has also been an enormous success in the past decades. Bio-demographic developments are making however increasingly difficult for governments to deliver the promises of conventional welfare state arrangements. So that a scenario of basic benefits for all instead of the proportional benefits now available is not to be ruled out with ample margin for non-government schemes to play a role.

Bio-demographic developments stands for something more subtle than the conventional view of the deterioration of the “dependency ratio”. The age structure of the population is changing dramatically due to longer lives and lower fertility so that any ratio that puts numbers aged 65 or more in the numerator and numbers aged between 16 and 64 in the denominator is doomed to increase. It happens that 65 is the magic number set for retirement age... in 1882! by von Bismark’s social security law. At that time, just a handful of workers reached that age, in bad health and with few years ahead.

But look at the individual life-cycle. What you see is representative individuals that have a working life that is catching-up rapidly with their life in retirement. Nothing will restore this deteriorating balance, be it immigrants or babies, but an increase of the retirement age and/or, in what concerns pensions, a decrease of expectations. This is the conundrum of problems that public pension schemes are facing everywhere.

As for health expenditures, the welfare state has done almost everything through hospitals, personnel and medicines and is now facing enormous financial stress due to ageing and dependency among ever increasing cohorts of old and very old persons. But it has had very little success to convince individuals to engage in pro-health behaviors and habits.

A better understanding among the population is needed to realize the underlying processes that are causing the welfare state to die out of success. Without this effort, the welfare state will not be able to provide economic security, but all the opposite or, at least, will only be able to provide it at an enormous cost. It is too rigid, too complex and risks demobilizing active members of the society and exacerbating strategic and counter-productive behaviors. Thus paying a thin tribute to its glorious past.

#### **4. The market and economic security**

Meanwhile, market arrangements and instruments do not cease to provide individuals with economic security services. This happens despite the massive stance of the welfare state due to several reasons: (i) Less than satisfactory replacement of labor income by the welfare state. This is actually the case of high wage earners and survivors benefits for all. (ii) Complementary health insurance or other insurance to cope with contingencies not covered by the welfare state that entail high costs (accidents, damage to third parties or to property) or to insure non labor income. (iii) The desire for extra security by risk-averse individuals.

This is however conventional stuff even if the related activities account for a sizeable share of value added by financial firms. Compared to 10-15 per cent of GDP that represent social contributions devoted to pay for publicly provided economic security through pensions that share is not terrific. Markets have yet to witness a pensions revolution in many countries and the insurance industry in particular has to address much better the need households already have for comprehensive economic security in face of a diminishing welfare state. One should not read “diminishing” too literally for the welfare state is there to stay, but given demographic trends, one should expect that benefit thresholds would cease to keep pace with inflation or other growth indices and force individuals increasingly to look at the market for proper arrangements.

If social security were to be reinvented today, as it was invented more than one hundred years ago, legal retirement age would be set above 75 or perhaps only the “very old” would be publicly insured leaving the affluent middle classes to retire at their will through private arrangements. This public engagement towards the very old would have the interesting effect of capping the risk private insurers would run selling open ended life annuities to individuals that could live many years after retirement.

Middle classes today have enormous assets, particularly housing and it is unclear that these could be transformed into cash flows at low transaction costs and risk premia to provide income when needed. These costs are today very high and lock property in the portfolios of their owners that ultimately go to their descendants. This is bad for meanwhile the welfare state is asked to provide individuals with income they could easily obtain from their assets if costs were appropriate. Maybe governments could pay a better service to society regulating financial institutions to work in that direction than by merely taking 30 per cent of GDP from the left pocket of the middle class’ trousers, in form of taxes, to put it back in the right one in form of benefits.

Providing comprehensive economic security to all through the market would have other advantages too. These services would be easily tailored to individuals’ needs without the rigidity, complexity and perverse incentives that welfare state formulae embody. It would also enhance personal involvement in own security creating a more active society.

Fine. But why is it that markets do not see it that way and start offering the corresponding services? Neither markets nor individuals have actually the margin, I believe, to deepen and widen their supplies and demands of economic security services along the lines

I have just described. Annuities are costly and reverse mortgages are risky for sellers. Combined residential and annuities paid by home equity is both expensive and risky. Moreover, the welfare state claims a large proportion of personal income to the representative individual. However the field is opening for those activities little by little but new regulations should seek to open it faster.

The financial and insurance industries need also to innovate in joint ventures with the residential and health care sectors. There is a huge restructuring to do in many areas of the economy as individuals live longer to enjoy the benefits of better health and more assets. It will be done, thanks to the forces of entrepreneurship and competition. But the ground could be better prepared for the planting of the seeds by adequate government policies and open mentalities on the side of consumers.

## **5. Also the poor**

Robert E. Goodin and Julian Le Grand edited a book in the late eighties entitled “Not Only the Poor. The Middle Classes and the Welfare State.” Its major thrust was to show that the middle classes had fully entered, and shaped, everywhere the welfare state of which they now form the backbone even at the expense of its original aim to reduce poverty. And yet, besides alleviating poverty among certain groups of individuals the welfare state has taken up most of the responsibilities that naturally belong to citizens.

Poverty, as currently measured, affects to 15 to 20 per cent of individuals or households in most developed countries. So there are everywhere large parts of society that have after tax/transfers current resources below 50% of median income. Given the above definition, an (almost) egalitarian society will have no poverty although average income could fall below the poverty line in a richer but less egalitarian one. Poverty is a relative phenomenon and there is a continuum of cases down to the distribution of income below the poverty line. This reckoning however mixes up non working individuals more or less deprived from own resources with low-earnings workers that have a certain record of activity.

But most low income households have some assets, mostly in form of housing property or savings. And assets provide economic security. In less developed countries, paradoxically, the poor hold large shares of total property but they cannot claim formal ownership of their holdings nor use them as collateral to engage in business due to absence of property rights institutions (Hernando de Soto).

We have seen that current and expected demographic developments make some welfare state programs unsustainable and thus risky for young and future workers. How this affects the less well-off? Take the case of pensions. Low earnings workers are covered by social security and even if their contribution records are poor or discontinued, as long as they fulfill minimum requirements are given benefits whose present value is generally much higher than the present value of past contributions. This is due to minimum pension provisions that exist in most countries. Their economic security, even if low level, seems to be better than what the market could provide even in the best value for money case.

But poverty is not necessarily a permanent condition even if “poverty trajectories” are kind of inherited due to poor schooling and other cultural traps. The welfare state, by the way, contributes to trap some poor people locking them up into means-tested welfare payments or public housing schemes, etc.

Providing the less well-off with economic security through the market is a difficult issue not only in practice but also in concept. And yet, as Hernando de Soto arguments or Muhammad Yunus record illustrate there are ways to break the trap introducing proper regulations into the market for financial services and property rights. Not banking the poor is costly to the whole society (Nicholas Barr). Maybe the government is not able to keep the welfare state as we know it today, but it will always have the power to legislate for the better prosperity of all encouraging active participation

## **6. Markets and the civil society**

“You do not fall in love with a common market” said Jacques Delors often pointing to more ambitious aims for the EU. But he was well aware that unless you have the basic institutions that ensure a swift functioning of the single market and exploit all the advantages of a larger scale there is little one can get but troubles from whatever “grand design” you may think of. Markets fail, however, and that is why governments step in, but governments also fail and that is why an organized society is needed. In order to check the power of both markets and governments. But without formal markets nor formal rules (or some form of government) there is no society at least in a modern sense. Markets sustain civil society is as much as they provide in an efficient manner the jobs, goods and services and all kind of associated resources needed for an organized individual and social life.

What of economic security? It can be reached in a variety of ways, we have seen. But nowadays it should be promoted through market forces directed to all members of society

with only a minor and subsidiary role reserved for the government. Why? Because what better example of an active and organized society than one in which each of its members takes up his/her own responsibility having available a wide array of affordable and efficient instruments to hedge against all sorts of risks? Promoting economic security for all through the market will indeed help to develop the civil dimension of society completing a job that earlier societies were unable to achieve

It should not be the government who through levying distortionary taxes would assure unconditional and meager benefits to all. This has been more and more the case in the recent past well after the “golden age” of the post-WWII period. Distortionary taxes and unconditional benefits are counterproductive for activity and condemn individual to sub-optimal and expensive choices, not even second best ones.

What indeed characterizes an advanced society is, on the contrary, solvent and ample choices, demanding challenges and efficient solutions to everyday troubles. Governments at all levels should be happy ensuring that the former flow without distortions nor abuse by interested parties, promoting equality of opportunities and above all protecting life and liberty.