

**On the Feasibility
of a Liberal Welfare State:
Agency, Exit, and Income Security**

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Abstract

This paper investigates whether individuals might choose to join and remain members of a state in which high levels of social insurance are provided. That is to say, are there plausible circumstances in which a social welfare state can be regarded as "liberal" in the sense that it has the universal support of its citizens?

The paper demonstrates that risk-averse individuals in a setting of substantial income or health uncertainty will voluntarily join *private* income-security clubs. However, the willingness of individuals to join private income-security clubs requires relatively efficient club management and low cost solutions to the problem of adverse selection. The paper demonstrates that individuals may opt for governmental provision of income security services, because national governments can more easily address the problem of adverse selection and therefore be low-cost providers of such insurance. These governmental income security programs will tend to have constitutional or quasi-constitutional status because of the nature of the services provided.

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On the Feasibility of a *Liberal* Welfare State

I. Introduction

This paper attempts to determine whether or not there can be a "liberal" welfare state. Can substantial income-security plans be justified on the basis of citizen interests, without appeals to overarching altruistic or egalitarian norms? The answer to this question does not depend on whether some income security is better than none, but rather whether there are cases in which government insurance is likely to be preferable to private insurance. As such, the paper attempts to contribute to the long-standing philosophical and policy debate on state-sponsored income security programs. It does not, however, address the parallel debate on optimal redistribution, which is often raised at the same time in both political discussion and economic analysis, but which is a different issue involving different public policies. Pareto-improving redistribution requires assumptions of substantial altruism (Hockman and Rodgers, 1969) or market failures (Benabou, 2000) and is unlikely to be achieved privately, whereas personal income security may well be achieved privately through private insurance markets.

Tanzi and Schuknect (2000, Ch. 4) find that only modest changes in the income distributions of OECD countries can be attributed to national social insurance programs. Their evidence suggests that most major transfer programs should be regarded as income *security* programs, rather than income *redistribution* programs, that is, as programs that transfer money among members of essentially similar income classes, rather than from rich to poor. Unemployment insurance and employment programs take from the employed middle class and transfer it to those who are also more or less middle class, but unfortunately between jobs. (Although instances of long-term unemployment occur, most persons return to the job market in fairly short order.) Public pension programs take money from the young middle class and give it to the old middle class, rather than to poor persons. Even national health insurance programs largely transfer money from the middle class healthy to the middle class ill.

It bears noting that many of the national social insurance plans in Europe were initially established by governments dominated by liberal and conservative political parties in the early twentieth century and later continued by governments dominated by social democrats or labor parties. The social security program of Germany began in 1889, of Sweden in 1909, and that of the United Kingdom in 1911, all well before social democrats or labor parties had broad legislative power. The social security programs of the United States were adopted much later, but by a Republican Congress in 1935, albeit at the insistence of a Democratic president and with much dissension, and was extended to include disability insurance under a Republican administration in 1954. So, it may well be the case that liberal rather than egalitarian ends inform the durable features of many long-standing national transfer programs.

The question addressed in this paper is the extent to which those income security programs might advance the private interests of typical citizens in the country of interest, rather than demonstrate the influence of altruism or rent seeking by recipient groups. If a "liberal" welfare state is possible, as opposed to an egalitarian welfare state, it must advance the interests of essentially all who are citizens of those states.

This paper analyzes first the possibility that a liberal welfare state may emerge in settings in which individuals face income uncertainty, the reasons why income security programs might be constitutionalized, and the post constitutional size of a majoritarian welfare state. Section 2 of the paper demonstrates that individual interests in income security varies with their risk aversion and with the risk faced in their ordinary lives. A wide range of private income-security clubs may, thus, be voluntarily joined, according to circumstance and preferences of individuals. Section 3 demonstrates that an individual's demand for membership in such clubs is also affected by the problems of adverse selection and agency costs. It demonstrates that in some circumstances, a national government can be a better source of income security programs than local governments or private clubs, because governmental programs can more economically solve relevant adverse selection problems. Section 4 analyzes the size and types of long-term benefits that might be adopted under various voting rules and starting points. It demonstrates that the extent of a liberal income

security program varies with the decision rule used, differences in citizen risk aversion, and beliefs about political and economic agency costs. Agenda setting power matters only when super majority rule is used to select benefit levels. Section 5 summarizes the results and suggests extensions. The analysis suggests that differences in risk aversion, agency costs, and the perception of economic and political risks may account for a good deal of the observed variation in income security plans around the world.

II. Private Income Insurance Clubs

Consider a setting in which a debilitating disease randomly strikes people and saps their ability to work and play. To simplify the analysis, assume that only these two states of health are possible and that the probability of being sick is P and being healthy is $1-P$. When healthy, a typical person, Alle, has H hours to allocate between work, W , and leisure, L , and that when sick, Alle has only S hours to allocate between work and leisure. Work produces good Y , which is desired for its own sake, with $Y_i = \mathbf{w}W_i$, where \mathbf{w} is the marginal and average product of labor. The individual chooses his or her work week, according to his or her health, to maximize a strictly concave utility function defined over good Y , which will be referred to as income, and leisure, $U = u(Y, L)$.

A. Labor-Leisure Choices in a Setting of Uncertainty

In the absence of an income insurance program, when Alle, is healthy, she (or he) maximizes:

$$U^{woH} = u(\mathbf{w}W_i, H - W_i) \quad (1)$$

and when Alle is unhealthy, she maximizes:

$$U^{woS} = u(\mathbf{w}W_i, S - W_i) \quad (2)$$

In either case, Alle's work day will satisfy similar first order conditions:

$$U_Y \mathbf{w} - U_L = 0 \quad (3)$$

Alle works at the level that sets the marginal utility of the income produced by her (or his) work equal to the marginal cost of that work in terms of the reduced utility from leisure. The implicit function theorem implies that Alle's work day can be characterized as:

$$W_i^* = w(T, \omega) \quad (4)$$

The work day varies with Alle's marginal product (wage rate) and state of health $T = H$ or $T = S$, as does her income, which varies from $w(H, \mathbf{w})$ to $w(S, \mathbf{w})$ according to Alle's health.

Now consider the case in which Alle can join an income security club that collects a fraction of the output produced by each member and returns it on a uniform basis to club members, guaranteeing each member G units of good Y . In this case, Alle's net income is $Y = (1-t) \mathbf{w} W_i + G$. If all club receipts are used to fund the guarantee, the income guarantee is $G = (t\mathbf{w} \mathbf{S} W)/N$, when there are N members of the income security club. Given such a program, Alle now maximizes

$$U^H = U((1-t) \mathbf{w} W_i + G, H - W_i) \quad (5)$$

when healthy and

$$U^S = U((1-t) \mathbf{w} W_i + G, S - W_i) \quad (6)$$

when sick, which in either case requires a work day that satisfies

$$U_Y [(1-t) \mathbf{w} + t\mathbf{w}/N] - U_L = 0 \quad (7)$$

Equation 7 is similar to equation 3, except that now Alle equates the marginal utility of net income produced by working (which is now a combination of direct effects of club dues and effects of the club's income security guarantee) to the marginal opportunity cost of the time spent working. The implicit function describing Alle's work day becomes:

$$W_i^* = w(T, \mathbf{w}, t, \mathbf{N}) \quad (8)$$

Note that equation 8 is the same as equation 4 if the club dues and benefits equal zero. T again represents the individual's state of health and takes the value H if he or she is healthy, and S if he or she is sick.

Note that Alle works more when she is healthy than sick and works less when she is in a social insurance program than when she is not.

$$Wi^*_T = [U_{YT} [(1-t) \mathbf{w} + t\mathbf{w}/N] - U_{LL}] / -[Z_w] < 0 \quad (10)$$

$$Wi^*_i = [U_{YY} (W\mathbf{w} + \mathbf{w} \mathbf{S} W_j/N) ((1-t) \mathbf{w} + t\mathbf{w}/N) + U_Y(-\mathbf{w} + \mathbf{w}/N) - U_{LY} (W\mathbf{w} + \mathbf{w} \mathbf{S} W_j/N)] / -[Z_w] < 0 \quad (11)$$

$$\text{where } Z_w = U_{YY} [(1-t) \mathbf{w} + t\mathbf{w}/N]^2 - 2 U_Y [(1-t) \mathbf{w} + t\mathbf{w}/N] - U_{LL} < 0$$

Strict concavity of the utility function along with the assumed club funding structures (proportional taxation and demograts) allows both derivatives to be signed unambiguously.

As critics have long maintained, the existence of a social insurance program reduces the extent of labor supplied to market activities and thereby reduces expected income. There is an unavoidable "moral hazard" problem associated with income security programs. Nonetheless, an income security program may increase expected utility for those eligible to join.

B. The Private Value of Social Insurance

Alle's reservation price for joining an income security club is the price, M , which sets the expected value of lifetime membership in the club equal to that of non-membership. That is to say, M , makes Alle indifferent between having an income guarantee and not having one. Individuals will join an income security club if their reservation price is greater than zero. Alle's reservation price, M , satisfies:

$$(1-P) U^{H*} + P U^{S*} = (1-P) U^{woH*} + P U^{woS*}$$

or substituting,

$$(1-P) [U((1-t) \mathbf{w} W_i^* + G - M, H - W_i^*)] + P [U((1-t) \mathbf{w} W_i^* + G - M, S - W_i^*)] - (1-P) [U(\mathbf{w} W_i, H - W_i)] - P [U(\mathbf{w} W_i, S - W_i)] = 0 \quad (12)$$

The implicit function theorem allows M to be written as a function of the other parameters of Alle's decision problems:¹

$$M = m(t, P, S, H, \mathbf{w}, N) \quad (13)$$

¹ Recall that $G = (t \mathbf{w} \mathbf{S} W_j)/N$, which, when N is large, can be written as $t\omega [(1-P) w(H, \omega, t, N) + Pw(S, \omega, t, N)]$. The income guarantee is the average amount of tax revenue collected.

Three derivatives of Alle's reservation price for income insurance are of special interest for the purposes of this paper: first, that with respect to the probability of being sick; second, that with respect to the severity of the illness; and third, that with respect to the size of the income guarantee, which can be represented with the club's "tax" rate t over the range of interest.

$$M_P = [\mathcal{L}_P] / [-\mathcal{L}_M] = [(U^{woH} - U^H) + (U^S - U^{woS})] / [-\mathcal{L}_M] > 0 \quad (14.1)$$

$$M_S = [\mathcal{L}_S] / [-\mathcal{L}_M] = [P(U_L^S - U^{woS}_L)] / [-\mathcal{L}_M] < 0 \quad (14.2)$$

$$M_t = [\mathcal{L}_t] / [-\mathcal{L}_M] = [(1-P)U_Y^H(\mathbf{w}W^{Ave} - \mathbf{w}W_i^H) + P(U_Y^S(\mathbf{w}W^{Ave} - \mathbf{w}W_i^S))] / [-\mathcal{L}_M] <> 0 \quad (14.3)$$

$$\text{where } [-\mathcal{L}_M] = (1-P)U_Y^H + PU_Y^S > 0$$

Alle's willingness to pay for club membership increases as the probability of being sick increases, but decreases as the loss from illness declines ($H-S$) and may increase or decrease with the extent of the social insurance provided according to whether the higher guarantee is more valuable than the higher dues that must be paid.² (Recall that the tax or club dues rate t must increase to pay for higher income security payments.)

Alle's ideal income security club of interest is the one that maximizes her reservation price. The optimal insurance program sets the club dues or "tax rate," t^* , so that equation 14.3 equals zero. Alle's reservation price rises as t approaches t^* , thus, M^* increases with increases in t if $t < t^*$ and it falls with increases in t for $t > t^*$. It bears noting that corner solutions are possible for t according to the degree of perceived income risk and the extent to which Alle is risk averse. Note that the first term of equation 14.3 is negative and the second is positive. Alle gains from the program when she is sick, but loses when she is healthy. Only if $[(1-P)U_Y^H(\mathbf{w}W^{Ave} - \mathbf{w}W_i^H) + P(U_Y^S(\mathbf{w}W^{Ave} - \mathbf{w}W_i^S))] > 0$ over the entire feasible range of t , Alle will prefer a program with complete income security to one that with modest benefits.³ This tends to be the case if the marginal utility of income declines rapidly

² Note that each component of equation 12 is a utility function optimized with respect to time spent working. Thus, the envelop theorem implies that all partial derivatives with respect to W^* can be ignored (e. g., net out to zero).

or the income losses are large and club members have a very inelastic supply of labor function (e.g., $W_i^{Ave} - W_i^{Ave/wo}$ small), the benefits of insurance exceed its costs. On the other hand, it is also possible that $[(1-P)U_Y^H(\omega W^{Ave} - \omega W_i^H *) + P(U_Y^S(\omega W^{Ave} - \omega W_i^S*))] < 0$ over the entire range of interest; in which case, Alle will never voluntarily join an income security club. Such would be the case if the supply of labor is very elastic, the losses from illness are minor, and Alle is not very risk averse.

The point of this analysis is not to suggest that a voluntary income security program is necessarily large or small, but to demonstrate that *voluntary* social insurance clubs are possible and that the insurance demanded *is not necessarily trivial*. A wide range of income security clubs may advance an individual's interest in income stability according to his or her risk aversion and assessment of the objective risks faced. Historically, many individuals have joined private “friendly clubs” or belonged to church-based organizations, guilds, and labor unions that provided income security among other services. The fact that individuals may voluntarily join income security clubs suggests that a liberal welfare state is conceptually possible, at least in cases in which a government can be regarded as a club.

The suburbs of modern metropolitan areas are largely populated by "volunteers," as emphasized in the Tiebout (1956)-based literature on local public finance, insofar as individuals are more or less free to choose among suburban communities. The local governments of colonial America and those of the early American West can also be considered to be clubs of the sort characterized above. This may partially explain why income security was often a local government service prior to the 20th century. (Indeed, this is still substantially the case, at least institutionally, in the United States and Scandinavian countries, although the national governments often mandate minimal income guarantees).

A modern nation state, however, differs from local governments and private clubs in many respects. Individuals do not often freely join national clubs. Rather "membership" in nations tends to be determined by the location of one's parents at the time of birth. Exit is possible, although it is usually expensive, and relocation is often difficult and heavily

³ Note, that risk aversion may partly explain the emergence of salary-based compensation schemes in private industry, more than piece rate-based schemes, in which salaries are not affected by sick days below some threshold.

regulated. It is largely for these reasons that there is less movement of people across national boundaries than among municipalities and firms within a given country. Club logic alone cannot justify national income security programs, because affiliation with national governments tends to be less voluntary than affiliation with private clubs, firms, or local governments.

To justify national programs on liberal, as opposed to egalitarian, grounds, problems must exist with local and private income security programs that are overcome by national programs. For example, "correlated" illnesses might be commonplace, as when an epidemic or hurricane sweeps through a region that is larger than the territories in which clubs normally draw their memberships or are governed by local governments. Such health problems could make private and local government income security programs financially impossible. Another problem of greater interest for the present analysis is that moral hazard and agency problems associated with organizing income security programs *limit how voluntary* an income security program can be.

III. Self Selection, Agency Problems, and Exit Costs within Social Insurance Clubs

Membership in an income security club *cannot be completely voluntary* in the sense that members are free to join and leave at will, because in that case individuals would join insurance clubs on days when they were unemployed or sick and leave as soon as they were well. Such clubs would have only sick members and could provide no income security. To be viable, a club must ensure that members contribute to the income security package whether they need it or not on a given day.

Two related payment schedules can accomplish this. First, income security clubs may require payment of dues for a sufficiently long period that the average member will experience both sickness and health during the term of the contract. Such commitments would have to be lengthy in cases in which the conditions to be insured are infrequent or develop gradually over a person's lifetime. Second, income security clubs may impose an exit fee on members who wish to leave the club within a period shorter than this natural cycle. Both sorts of fees schedules can be combined to encourage members to remain in the clubs

for a sufficiently long period. It is, for example, common for clubs and cooperatives to only partially refund member dues when a member leaves; that is to say, the refunds are often less than the prorated fraction of initial and subsequent payments.⁴ The difference between prepayments and the refund is an exit fee.

Consider the case in which membership in income security clubs is managed with exit fee, E , but the income security payment provided by a club cannot be directly observed by nonmembers. Assume that there are two kinds of clubs. Well-run clubs provide income support at Alle's optimal level as characterized above, with $G^* = t^*wW^{ave}$, and poorly run clubs collect dues at the same rate, t^*wW , but provide no income support, $G = 0$. The managers of poorly run clubs may simply divert club revenues to their own purposes or improvidently invest the insurance fund. Suppose the fraction of well-run clubs is F and that exit fees are E . The smallest exit fee that discourages entry and exit from income security clubs according to one's state of health is $E = t^*wW$, which is the "transfer" made by healthy members to sick members in well-managed clubs.

Alle's reservation price for membership in an income security club is clearly reduced by the existence of poorly managed clubs and exit fees, although she only pays the exit fee if she mistakenly joins a poorly managed club. M^* now satisfies:

$$\begin{aligned}
& (1-P)F [U((1-t^*) w W_i^* + G^* - M, H - W_i^*)] + \\
& P F [U((1-t^*) w W_i^* + G^* - M, S - W_i^*)] + \\
& (1-P) (1-F) [U((1-t^*) w W_i^* - E - M, H - W_i^*)] \\
& + P (1-F) [U((1-t^*) w W_i^* -E - M, S - W_i^*)] \\
& - (1-P) [U(w W_i, H - W_i)] - P [U(w W_i, S - W_i)] = 0 \quad \bullet \quad \mathcal{L} \quad (15)
\end{aligned}$$

⁴ This provides one explanation for the provision of health care insurance by employers rather than individuals. Most employees will be healthy on a given day, but firms normally "force" their employees to contribute toward their insurance policies regardless of their personal health as part of the standard wage contract. The choice of basic coverage is made collectively rather than individually. Shifting between firms having insurance to those without is evidently sufficiently costly that individuals do not pursue the day's optimal wage and insurance combination: no insurance on healthy days and complete coverage on ill days.

The middle terms reflect the expected loss from accidentally joining a poorly run club. Membership in such clubs necessarily makes their members worse off than remaining "uninsured," because such clubs collect dues and charge exit fees, but provide poor services.

The implicit function theorem can again be used to characterize Alle's reservation price. Differentiating with respect to the fraction of well-run clubs and exit fees demonstrates that Alle's demand for income security clubs increases as the fraction of well-managed clubs increases and diminishes as exit costs increase.

$$M^*_F = [\mathcal{L}_F] / [-\mathcal{L}_M] = [E(U^{\text{wellrun}}) - E(U^{\text{poorlyrun}})] / [-\mathcal{L}_M] > 0 \quad (16.1)$$

$$M^*_E = [\mathcal{L}_F] / [-\mathcal{L}_M] = [(1-F)(-1)E(U^{\text{poorlyrun}})] / [-\mathcal{L}_M] < 0 \quad (16.2)$$

Indeed, the fact that the expected utility of membership in poorly run clubs is below that of nonmembership implies that many combinations of F and E exist in which Alle will no longer be willing to join an income security club even if income risks are large and Alle is very risk averse. In such cases, private income security clubs are *not economically feasible*, whether organized by local governments or private firms. In settings in which income security clubs are feasible, it is clear that high-service clubs will serve a smaller market than low-service clubs because the exit fees have to be so much higher for the high-service programs.

In either case, a liberal case for a welfare state now exists that is independent of the specific types of illnesses (or other economic risks) that are to be insured. National governments might regulate income insurance clubs by mandating minimal service levels, enforcing club promises, and providing fraud insurance—in effect serving as an insurer of insurance programs. Alternatively, or additionally, the national government may directly provide the income security insurance.

In cases in which "natural" or *unavoidable exit costs from the country as a whole* are sufficient to solve the adverse-selection problem, and government management is considered to be approximately as trustworthy as the average club management is, *individuals are more willing to join an income security program managed by the national government than one provided by local governments or private clubs, because no new exit fees have to be paid.*⁵ Insofar as private exit fees have to be large

⁵ In cases in which the unavoidable cost of leaving a nation with an ample income security

for income security clubs to be economically viable, or contracts very long term, broad political support would exist for non-redistributive national income security programs.⁶

IV. Social Insurance as a Social Contract

If citizens ask their government to provide income security services, it is entirely appropriate that those commitments be put into a form that cannot be entered or exited at will for reasons noted above, nor altered unilaterally by one of the contracting parties. It is, thus, entirely appropriate that constitutional or quasi-constitutional guarantees be provided for income security programs for which the natural period of coverage is relatively long.⁷

Such long term contracts are not necessarily constitutional in the formal sense, but have to be stable and durable in order to provide long term income security. Many quasi-constitutional laws are adopted as ordinary legislation, yet treated as more or less permanent policies. In the United Kingdom, essentially the entire body of constitutional law is quasi-constitutional in this sense. Examples within the United States include the fundamental structure of income tax schedules, election law, and the extent of

program when healthy and returning when ill is not sufficient to avoid the adverse selection problem faced by a national income security program, it still tends to be the case that any new exit fee that must be introduced tends to fall below those required by local governments and private clubs, which have far lower "natural" exit costs.

On the other hand, if the anticipated quality of national management is significantly below that of local government or private management, individuals might still prefer local or private income security programs to national ones even though overall exit costs increased.

⁶ For the purposes of the present analysis, it is assumed that both democracy and income security programs are feasible over the time horizon of interest. The fact that income security programs are as old or older than universal suffrage in many European countries suggests that social security programs are no less "feasible" than is democratic governance, itself.

In the very long run, it is possible that income security programs would undermine cultural support for markets and democracy (Linbeck, 1995a). Such effects would also reduce the political attractiveness of the policies themselves, and the democratic polities that adopt them. However, it bears noting that the Scandinavian countries, which are widely known for their income security programs, have relatively high income levels, relatively low unemployment levels, and generally receive relatively high marks for civil and economic liberties (Lindbeck, 1997b). (Skeptics might nonetheless note that extensive welfare states are less than two generations old.)

⁷ Natural period of coverage again means that the time period (sample) is long enough that the average outcome is close to the expected value of the random event of interest. In the sickness and health case modeled, the time period was sufficiently long that the anticipated income realized (sample average) approached the asymptotic statistical average for the illness of interest.

decentralization. Such policies have quasi-constitutional status insofar as the basic structure of those public policies is taken for granted and widely believed to be beyond the scope of ordinary legislation. Such rules are durable not because of formal constitutional protections, but rather because a durable consensus exists concerning the main features of such policies. The results from section 3 suggests that such a consensus for income security programs can exist for nonredistributive income security programs, because of agency costs and adverse selection.

The demand for insurance benefit levels, however, may vary considerably among citizens, and program support levels will necessarily be decided politically. The distribution of voter ideal points can be determined by rank ordering individual ideal points— t^* 's in the model above—from low to high and plotting the associated frequency distribution of citizen preferences for benefit levels. Figure 1 illustrates such a frequency distribution of citizen ideal points. As depicted, it is assumed that the ideal points are interior solutions to equation 14.3, although the existence of corner solutions would not materially affect the conclusions, as long as such interior solutions were sufficiently common that the median voter has an interior solution.⁸

If citizen preferences are approximately spatial (as they are in the model developed above), figure 1 can also be used to illustrate how different procedures for quasi-constitutional reform may affect the level of income security adopted under various decision rules. In the case depicted, unanimous support exists for a range of public insurance programs over the more expensive guarantees provided by private insurance clubs. Such programs characterize the liberal welfare state. Although this liberal range can be broad, the majoritarian range of acceptable programs tends to be wider. Thus, the program chosen may depart from the "liberal" range, although it need not.

⁸ Figure 1 implicitly assumes that the cost savings of the public program are sufficient to cause all individuals to prefer some uniformly provided public provision to the available private clubs. This geometry is implied by the discussion of exit costs in the previous section of the paper.

A more expensive private income security program may be preferred to a less expensive governmental alternative by individuals who find the public program far too small. This problem can (and often is) be reduced by linking benefit levels and contributions to income levels. In such cases, support for public provision tends to increase insofar as desired benefit levels and income are positively correlated.

First, it is clear that the level of political support *falls* as income support levels increase. The level of support for program t is characterized by the area under the frequency distribution to the right of $t/2$. Those citizens with ideal points to the left of $t/2$ prefer no government program, 0, to program t ; those voters to the right prefer of $t/2$ prefer t to 0. Second, if an entirely new income security program is to be adopted, it is possible that quite large programs gain majority approval, because of the all-or-nothing nature of an initial proposal. Indeed, figure 1 demonstrates that the largest program with majority support relative to no income security program can even exceed t^{00} , the largest program that is ideal for an individual voter! Third, if instead of a single all or nothing offer, a sequence of votes ultimately determines program levels, in which each new proposal is judged relative to the last one to obtain majority approval, the median citizen's ideal program is adopted, t^{med} . No increase beyond t^{med} will secure majority support, although every increment up to t^{med} will receive majority support.

Fourth, if the status quo ante or initial point of negotiation is the maximal security program, $t = 100\%$, is unlikely to be adopted, because unanimous agreement will exist to adopt a less generous programs. Perhaps surprisingly, the smallest program that could secure majority approval over the maximal program can be below the smallest program considered ideal by any voter, t^0 . Again, the all-or-nothing nature of an initial offer allows somewhat extreme policies to be adopted by majority rule. The smallest program that is preferred to the maximal program is approximately twice as far below the maximal program as is the median voter's ideal policy.

Fifth, a series of votes over successively smaller programs using majority rule would continue until t^{med} is reached, the same program as emerged when the status quo ante consisted of only private programs. For reasons related to the median voter theorem rather than the Coase theorem, an incremental decisionmaking procedure under majority rule reaches the same policy result regardless of the starting point. In the long run, the program adopted under majority rule would reflect *median* perceptions of risk and risk aversion, t^{med} , rather than the ideology of the initial agenda setter. This political outcome is not necessarily

liberal in the sense used in this paper, but tends to be liberal if the costs savings of the public program are substantial.⁹

Sixth, under other decision rules, the starting point of constitutional negotiations will matter, as indicated by the two unanimity cases. For example, a series of small increases adopted by a two-thirds supermajority rule with 0 as the initial point of departure will yield an income security program that is smaller than that preferred by the median voter. This point is labeled t^{min} in figure 1, where area I is twice as large as area II. Similarly, a two-thirds rule will produce an income security program that is larger than that desired by the median voter if the status quo ante is initially above the median citizen's ideal and incremental reductions are voted on. In the case illustrated, the policy chosen will be t^{max} , where area IV is twice as large as area III.

Seventh, if supermajority decision rules are used to determine the level of income security constitutionalized, the political bargains struck in social welfare states and liberal welfare states differ, because the initial points of departure differ. In such cases, *a liberal welfare state tends to adopt a constitutional income guarantee that is below that preferred by the median voter, and a initially social democratic state will adopt one that is higher*. In the former case, however, local governments and private income security clubs would be free to provide additional support according to local circumstances and demand. Political procedures and starting points, as well as citizen demands for services both affect the bargain reached.

V. Conclusion: On the Feasibility of a Liberal Social Welfare State

For more than a century, there have been ongoing debates between liberals and social democrats in Europe on a wide range of policies, but especially with respect to the optimal magnitude of government income security programs and extent of redistribution. Within the United States, a similar debate has taken place between Democrats and Republicans for nearly as long. European liberals (and Republicans) generally argue that, as income security programs become large, they endanger personal liberty and prospects for economic growth,

⁹ Low demanders of insurance in the liberal case receive (and pay for) more insurance than they would have purchased in the private market, but at a sufficiently lower cost to make them better off. High demanders may "top up" their public insurance by purchasing joining private supplemental insurance clubs.

because market incentives are weakened and the coercive powers of the state are implicitly increased. Liberals also occasionally argue that the high taxes associated with large social welfare programs also tend to reduce social mobility and weaken private incentives to save and invest in education. Social democrats (and Democrats) tend to be less concerned with economic growth and more concerned about individual misfortunes that might be generated by "bad luck" associated with chance events and unrestrained markets. Social insurance is, in their view, necessary to redress the misfortunes of persons who do poorly through no fault of their own.

Liberals and social democrats also differ in their fundamental theories of the state. Liberals regard the "public sector" to be a consequence of private decisions to delegate control of resources to governmental organizations that would otherwise be controlled by individuals. From this perspective, individual rights (civil and political liberties) are logically prior to government and constrain the proper domain of governance. The ideal scope of public control is determined by independent individuals who agree to transfer authority over various policies and resources to collective management. What is "public" is simply the private "use rights" that citizens agree to turn over to government as a method of solving prisoner's dilemma and coordination problems. For social democrats, property is not logically prior to government. Rather, private wealth is an indirect consequence of public policy and for the most part private rights (usufruct) are those that democratic governments decide are best controlled by individuals and small groups. Government policies define both private and communal use rights, set the penalties that assure that those rights are protected, and establish the court systems in which conflicts on use rights, whether public or private, are settled peacefully. To a social democrat, that which should be private is that which promotes broad "social goals," such as prosperity, equity, and quality of life. It is the scope of rights transferred to individuals from the governmental sphere that determines the private sector. From this perspective, private property does not exist without laws that are designed and enforced by government.

It might be thought that these fundamental disagreements on property rights would lead to radically different civil law and public policies, and many politically active liberals and

social democrats evidently believe this to be the case. However, considerable agreement exists among mainstream liberals and social democrats concerning the importance of the rule of law, democratic political institutions, and civil liberties—three fundamental policy areas that jointly determine the meta-constitution of modern political life in industrialized democracies. Although the great conceptual divide on "property rights," tends to inform the great and small policy debates between social democrats and liberals, the Coase theorem suggests that starting points may be less critical than one imagines. A government that specifies private rights to maximize prosperity, equity, and the quality of life may well resemble that which emerges when use rights are gradually transferred from private to collective management in order to more effectively pursue common purposes. Here, we may note that the civil and property law of contemporary Sweden is not radically different from that of Switzerland. This paper has demonstrated that similar tendencies may exist within majoritarian states with respect to their social insurance programs, if citizen preferences and agency problems are similar.

This paper has demonstrated that the phrase "liberal welfare state" is not a contradiction in terms. Income security programs can be justified on the basis of individual self-interest, because pure income security programs are not redistributive in the sense that the poor receive resources from the rich. Rather, the sick receive "transfers" from the healthy, the unemployed from the employed, and those in harm's way from natural catastrophies from those who were not. The aim of a liberal welfare state is neither egalitarian nor altruistic, but rather risk pooling, and the program sizes reflect not initial inequalities, but rather perceptions of risks, both economic and political, associated with life in the communities of interest. Because individuals differ in their risk aversion and in their assessments of the economic and political risks at hand, they will differ in their demands for national income security programs. To the extent that risk aversion and risk assessments differ among nations, the programs enacted will provide substantially different levels of income security, and with the extent to which governments are responsive to citizen demands.

Of course, the fact that a liberal welfare state is possible does not imply that they are the observed outcomes of modern democratic polities. However, a degree of conformity exists between the large-scale transfer programs that we observe and the analysis developed above. Massive "transfer" programs produce surprisingly little income equalization, even in countries where social democrats have long held office as noted by Tanzi and Schuknect (2000). Lott and Kenny (1999) find that enfranchisement of women voters, who may be presumed to be more risk averse and face greater risks than men, lead to expansions of social insurance programs, because woman's suffrage created a new median voter with a higher demand for income security. Woman's suffrage did not, however, lead to massive redistributive programs that directly took wealth from men and gave it to women, per se. Also consistent with the present analysis is the fact that middle-class income security programs such as disability, unemployment, and public pension programs are generally far more inclusive and far more broadly supported than are programs with truly egalitarian aims. The existence of essentially universal political support for a national income security programs suggests that such programs are liberal in the sense developed above.

Tullock (1981) argues that transfer programs reflect the interests of those receiving the transfers, rent-seeking rather than egalitarian interests. The above analysis is consistent with Tullock's hypothesis, although it stresses the voluntary nature of major income security programs rather than the checks sent to claimants. The above analysis suggests that voters, even nonaltruistic voters, may have an interest in broad programs that reduce income uncertainty, Congleton and Shughart (1990), although they are opposed to income equalizing redistribution. Voters may also be affected by ideological or egalitarian passions, but the analysis above suggests that income security programs would exist even without such extensions of the rational choice model.

This is not to say voter-citizens never make systematic mistakes or vote against their own interests. It is clearly possible that some risks are overweighed or poorly estimated and that voters may support the "wrong" income support program, or cast votes for symbolic rather than instrumental reasons. National income security programs may, consequently, be a bit too large or too small, judged relative to the true interests of the median voter—or most

voters (Browning 1974). On the other hand, the continuous and broad support that many of these programs have had over the past century suggest that broad private interests are advanced, and consequently, that such income security programs advance liberal rather than egalitarian aims.

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Figure 1
Distribution of Citizen
Ideal Income Support Levels

