

**On the Feasibility
of a Liberal Welfare State:
Agency and Exit Costs in Income Security Clubs¹**

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Abstract

This paper investigates whether individuals might voluntarily 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?

As a point of departure, the paper demonstrates that risk-averse individuals in a setting of substantial income or health uncertainty will voluntarily join *private* income-security *clubs*. Private income-security clubs, however, cannot be entirely voluntary because they must solve the problem of adverse selection, as with entry or exit fees. The paper demonstrates that individuals may opt for governmental provision of income security services, when there is uncertainty about the quality of private club services, because naturally high exit costs allow national governments to economically address the problem of adverse selection. The analysis also suggests that *liberal* income security programs may have constitutional or quasi-constitutional status because of the long-term nature of the insurance contract.

JEL Categories: H4, D6, P5

Key Words: Social Insurance, Agency Problems, Exit, Averse Selection, Welfare State, Social Security, Public Choice, Constitutional Economics, Liberalism

¹ Previous versions of this paper were presented at the European Public Choice Society meetings in 2006 and at a seminar at the Ratio Institute in 2007, where several very useful comments and suggestions were received.

On the Feasibility of a *Liberal* Welfare State

I. Introduction

Many of the national social insurance plans in Europe were initially established by governments dominated by liberal and conservative political parties in the late nineteenth and early twentieth centuries and subsequently continued by governments dominated by social democratic or labor parties. Germany's social security program began in 1889, the United Kingdom's in 1911, and Sweden's in 1913, all a decade or more before social democrats or labor parties had broad legislative power. These new national tax-funded unemployment and pension programs were adopted at about the same time as universal suffrage was adopted, and although never perfect, they have nearly always had broad public support. 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. It was extended to include disability insurance under a Republican administration in 1954 and recently extended to include broader health benefits by another Republican Congress. So, it may well be the case that liberal (in its European sense), rather than egalitarian, ends account for the durable features of many long-standing national social welfare programs.

This paper attempts to determine whether or not there can be a "liberal welfare state." The answer to this question does not depend on whether some government-provided income security is better than no income security, but whether circumstances exist in which government provision of income insurance is likely to be widely thought preferable to private alternatives. As such, the paper contributes to the long-standing philosophical and policy debate on state-sponsored income security programs (Mill 1859, Nozick 1968). The aim of the present analysis, however, is more positive than normative. Can substantial income-security plans be explained by the existence of broadly shared citizen interests without appeals to overarching altruism, egalitarian norms, or rent seeking?

This paper develops an insurance- and club-based theory of the emergence and continuation of modern welfare states that can explain many of the core features of mod-

ern social insurance programs and their continuing broad support. Section 2 of the paper demonstrates that individuals' interests in joining an income security club vary with their risk aversion and with the risk faced in their daily lives. The approach differs from most conventional analyses, because the alternatives considered are private income security clubs, rather than the complete absence of income security or insurance purchased from a private corporation of some kind. The analysis focuses on income security clubs, rather than insurance companies, because such clubs were far more common during the period when central governments began supplying social insurance programs.

Section 3 demonstrates that the viability of income security clubs is affected by the problems of adverse selection and agency costs. Both affect the cost of club membership and the value of the services received. The former implies that some kind of entry or exit cost may be required, while the latter implies that joining income security clubs is not without risk. The analysis shows that in some circumstances a national government can be a less costly source of income security programs than local governments or private clubs, because governmental insurance programs often require *no new entry or exit fees*.

Section 4 analyzes the extent of public insurance that might be adopted under various voting rules and starting points. Support for a national income-security program varies with the decision rule used, differences in citizen risk aversion and perceived economic risk, and beliefs about political and economic agency costs. A liberal social insurance program may be adopted and its general architecture given constitutional protection, although it may not be sustained in the long run by democratic politics. Sections 5 and 6 summarize the results and suggest extensions. Overall, the analysis suggests that differences in risk aversion, income, and the perception of economic and political risks account for a good deal of the observed variation in income security plans around the world.

The theory developed does not require active lobbying by low-income groups, who often could not vote at the times the programs were started and were rarely themselves well organized; nor does it require implicit contracts between the old and the young, which are difficult to ground in democratic politics, because children and the unborn are, at best, only indirectly represented in legislatures.² The analysis complements

² Tullock (1981), for example, argues that transfer programs reflect the interests of those receiving the transfers, advancing rent seeking, rather than utilitarian interests. Kotlikoff and others (1988) suggest that intergenerational transfer programs are social contracts between the old and

the Pareto-improving (Hockman and Rodgers 1969) and market failure (Benabou 2000) models, but requires neither widespread altruism nor market failures to explain the private demand for public income security.

If altruistic or egalitarian ends were the main purpose of social insurance programs, we would expect to see substantially more redistribution in states with generous social insurance programs; yet, Tanzi and Schuknecht (2000) find that only very modest changes in the income distributions of OECD countries can be attributed to the size of national social insurance programs. The Tanzi and Schuknecht results, however, are not surprising if the main end of social insurance programs is risk pooling, rather than redistribution. Insurance, whether publicly or privately provided, has a small effect on the distribution of national income, because insurance reduces the variation in income and wealth associated with exogenous economic and health shocks; although neither type of insurance redistributes income from rich to poor per se.

II. The Demand for 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 when sick has only S hours to allocate between work and leisure. Work produces good Y , which is desired for its own sake, with $Y_i = \omega W_i$, where ω 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, $U = u(Y_i, L_i)$.

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:

young. The present analysis takes the middle ground between the utilitarian and the rent-seeking explanations for state-sponsored income-insurance programs. Even nonaltruistic voters, may have an interest in broad programs that reduce income and health uncertainty (Congleton and Shughart 1990), although they may be opposed to income-equalizing redistribution.

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

and when Alle is unhealthy, she maximizes:

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

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

$$U_Y \omega - U_L = 0 \quad (3)$$

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 $\omega w(H, \omega)$ to $\omega w(S, \omega)$ 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 $Y = (1-t) \omega W_i + G$. If all club receipts are used to fund the guarantee, the income guarantee is $G = (t\omega \Sigma W_j)/N$, when there are N members of the income security club. Given such a program, Alle now maximizes

$$U^H = U((1-t) \omega W_i + G, H - W_i) \quad (5)$$

when healthy and

$$U^S = U((1-t) \omega W_i + G, S - W_i) \quad (6)$$

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

$$U_Y [(1-t) \omega + t\omega/N] - U_L = 0 \equiv Z \quad (7)$$

Equation 7 is very 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:

$$W_i^* = w(T, \omega, t, N) \quad (8)$$

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.

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

$$Wi^*_t = [U_{YY} (W\omega + \omega \Sigma W_j/N) ((1-t) \omega + t\omega/N) + U_Y(-\omega + \omega/N) - U_{LY} (W\omega + \omega \Sigma W_j/N)] / -[Z_W] < 0 \quad (11)$$

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

Strict concavity of the utility function along with the assumed club funding structures (proportional taxation and demogrants) 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 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,

$$(1-P) [U((1-t) \omega W_i * + G - M, H - W_i *)] + P [U((1-t) \omega W_i * + G - M, S - W_i *)] - (1-P) [U(\omega W_i, H - W_i)] - P [U(\omega W_i, S - W_i)] = 0 \equiv \mathcal{L} \quad (12)$$

The implicit function theorem allows M to be written as a function of the other parameters of Alle's decision problems:³

$$M = m(t, P, S, H, \omega, N) \quad (13)$$

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.

$$M_P = [\partial_P] / [-\partial_M] = [(U^{woH} - U^H) + (U^S - U^{woS})] / [-\partial_M] > 0 \quad (14.1)$$

$$M_S = [\partial_S] / [-\partial_M] = [P(U^S_L - U^{woS}_L)] / [-\partial_M] < 0 \quad (14.2)$$

$$M_t = [\partial_t] / [-\partial_M] = [(1-P)U^H_Y(\omega W^{Ave} - \omega W_i^{H*}) + P(U^S_Y(\omega W^{Ave} - \omega W_i^{S*}))] / [-\partial_M] <> 0 \quad (14.3)$$

$$\text{where } [-\partial_M] = (1-P)U^H_Y + PU^S_Y > 0$$

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.⁴ (Recall that the tax or club dues rate t must increase to pay for higher income security payments.)

Alle's ideal income security club 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

³ Recall that $G = (t \omega \Sigma W_j) / N$ which, when N is large, can be written as $t \omega [(1-P) w(H, \omega, t, N) + P w(S, \omega, t, N)]$. The income guarantee is the average amount of tax revenue collected.

healthy. Only if $[(1-P)U^{H_Y}(\omega W^{Ave} - \omega W_i^{H*}) + P(U^{S_Y}(\omega W^{Ave} - \omega W_i^{S*}))] > 0$ over the entire feasible range of t , will Alle prefer a program with complete income security to one that with modest benefits.⁵ This tends to be the case if the marginal utility of income declines very rapidly or the income losses are very 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 $[(1-P)U^{H_Y}(\omega W^{Ave} - \omega W_i^{H*}) + P(U^{S_Y}(\omega W^{Ave} - \omega W_i^{S*}))] < 0$ 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, insofar as governments can be regarded as clubs. Prior to the 20th century, income security was often publicly provided by local governments. (Indeed, this is still substantially the case, at least institutionally, in the United States and Scandinavian countries, although the national governments often mandate minimal guarantees). The local governments of colonial America and those of the early American West clearly can be considered to be clubs. Contemporary suburban local governments of metropolitan areas may also be regarded to be clubs, insofar as the assumptions and results of the Tiebout (1956)-based literature on local public finance are accepted.

⁴ Note that each component of equation 12 is a utility function optimized with respect to time spent working. Thus, the envelope theorem implies that all partial derivatives with respect to W^* can be ignored (e. g., net out to zero).

⁵ 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.

However, club logic alone cannot justify national income security programs, because affiliation with national governments tends to be far less voluntary than affiliation with private clubs, firms, or local governments. Individuals do not often freely join national clubs, because the entry and exit costs are so high. Rather "membership" in nations tends to be determined, for the most part, by the location of one's parents at the time of birth. Exit is possible, but relocation to other nation states is difficult and heavily regulated. It is largely for these reasons that there is less movement of people across national boundaries than among municipalities (and other clubs) within a given country.

To justify national income insurance 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 risks 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

It bears noting that 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 program 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 so 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 can impose an exit fee on members who wish to leave the club within a period shorter than

this natural cycle. Both sorts of fee 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.⁶ 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 $G^* = t^* \omega W^{Ave}$, and "poorly run clubs" collect dues at the same rate, $t^* \omega W$, 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 known to be 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 $E = t^* \omega W$, 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:

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

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

⁶ 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

"uninsured," because such clubs collect dues and charge exit fees, but provide very 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.

$$M^*_F = [L_F] / [-L_M] = [E(U^{wellrun}) - E(U^{poorlyrun})] / [-L_M] > 0 \quad (16.1)$$

$$M^*_E = [L_F] / [-L_M] = [(1-F)(-1)E(U_Y^{poorlyrun})] / [-L_M] < 0 \quad (16.2)$$

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 smaller markets than low-service clubs, because 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. 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.*⁷ Insofar as private exit fees have to be large for income security clubs to be economically viable, or contracts very long term,

that individuals do not pursue the day's optimal wage and insurance combination: no insurance on healthy days and complete coverage on ill days.

⁷ In cases in which the unavoidable cost of leaving a nation with an ample income security 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 increase.

very broad political support would exist for non-redistributive national income security programs.⁸

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 income security insurance.

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 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.⁹ Such long-term “contracts” are not necessarily constitutional in the formal sense that they are incorporated into a nation’s fundamental law, 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 are treated as more or less permanent policies. In the United Kingdom, essentially the entire body of constitutional law is quasi-constitutional in this sense. Such quasi-constitutional laws are also evident in the United States. Examples include the fundamental structure of income tax schedules, election law, and the extent of decentralization.

⁸ 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. (See Congleton [2003] for a discussion of income redistribution dilemmas that democracies have to solve to be viable.)

In the very long run, it is possible that income security programs 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.)

⁹ 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 period should be sufficiently long that the anticipated income realized (sample average) approaches the asymptotic statistical average for the illness of interest.

Such policies have quasi-constitutional status insofar as the basic structure of those public policies is taken for granted and widely agreed to be beyond the scope of ordinary legislation. The general structure of these programs are durable not because of formal constitutional protections, but because a durable consensus exists for the main features of those policies. The results from section 3 suggest that such a consensus for income security programs can exist for nonredistributive income security programs, because of agency costs and adverse selection costs associated with private provision. However, the breadth of support for particular benefit levels may be less than that for the program of public provided insurance, itself.

The demand for insurance benefit levels tends to vary considerably among citizens. The distribution of voter ideal income security programs can be determined by rank ordering individual ideal income guarantees— 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.¹⁰

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 adopting benefit levels will affect the level of income security adopted. 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. 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 $t/2$

¹⁰ 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.

prefer no government program, 0, to program t ; those voters to the right of $t/2$ prefer t to 0.

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! 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.

Note that starting point as well as voting procedures may affect the outcome. If the status quo ante or initial point of negotiation is the maximal security program, $t = 100\%$, unanimous agreement will exist to adopt a less generous program. 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. However, a series of votes over successively smaller programs using majority rule would continue to revise benefit levels until t^{med} is reached, the same program that emerged when the starting point consisted of private programs alone.

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 tends to reflect *median* perceptions of risk and risk aversion, t^{med} , rather than the ideology of the initial agenda setter.

Although the liberal range of income security programs can be broad, the majoritarian range of acceptable programs tends to be wider. The aim of a true liberal welfare state is neither egalitarian nor altruistic, but rather efficient risk pooling. Thus, programs chosen through democratic politics may depart from the "liberal" range, although they need not do so. In the former case, a liberal welfare state may be said to be economically

but not politically feasible. The majoritarian outcome is liberal only if savings from public program are substantial.¹¹

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.

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 reversion points 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 an 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 affect the combination of public and private services observed.

V. Ideological Rhetoric and the 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, because market incentives are weakened and the coercive powers of

¹¹ 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

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.¹²

Many 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.

off. High demanders may “top up” their public insurance by purchasing joining private supplemental insurance clubs.

¹² See Fong (2001) for evidence of the importance of such beliefs in determining social insurance levels.

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, civil liberties, and the provision of social insurance—four 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 many 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.

The analysis above demonstrates that such tendencies also exist within majoritarian states with respect to their social insurance programs, insofar as median citizen preferences and agency problems are more or less similar among nations and through time.

VI. Conclusions: On the Possibility of a Liberal Welfare State

This paper demonstrates that there are plausible conditions under which a liberal welfare state may be said to exist. Income security programs can be explained as consequences of individual self-interest, risks, and risk aversion. The programs adopted 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 harmed by natural catastrophes from those who were not. The program size, thus, does not reflect initial inequalities, per se, but rather income levels and perceived economic and political risks associated with life in the communities of interest. Insofar as 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 these factors also differ among nations, because of weather, specialization,

culture, or political context, the programs adopted will provide substantially different levels of income security and vary with the extent to which governments are responsive to broadly shared citizen demands.

Of course, the fact that liberal welfare states are conceptually possible does not imply that they are observed in modern democratic polities. Day-to-day politics clearly affect the day-to-day details of such durable programs. However, a degree of conformity exists between the large-scale transfer programs that we observe and the analysis developed above. Most social insurance programs provided relatively modest income guarantees during their first several decades. 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, led to expansions of social insurance programs, because women's suffrage created a new median voter with a higher demand for income security. However, women's suffrage did not lead to massive redistributive programs that directly took wealth from men and gave it to women. Moreover, the larger programs of contemporary states produce surprisingly little income equalization, even in countries where social democrats have long held office, as noted by Tanzi and Schuknecht (2000). And, although there are continuing disagreements at the margin about the level of the insurance provided, support for the existence of such tax-funded programs has always extended well beyond those receiving payments from those programs.

The existence of nearly universal political support for national income security programs suggests that such programs are approximately liberal in the sense developed above. This is not to say that 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. Voters may also be affected by ideological and egalitarian passions. 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 these programs have had during the past century suggests that broad private interests are advanced and, consequently, that such programs advance liberal rather than egalitarian aims.

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Figure 1
Distribution of Citizen
Ideal Income Support Levels

