The Advantages and Disadvantages of Different Social Welfare Strategies

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The following was delivered by the author to the High Level American Meeting of Experts on The Challenges of Social Reform and New Administrative and Financial Management Techniques. The meeting, which took place September 5–7, 1994, in Mar del Plata, Argentina, was sponsored by the International Social Security Association at the invitation of the Argentine Secretariat for Social Security in collaboration with the ISSA Member Organizations of that country.

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Throughout the world, societies are reexamining, reforming, and restructuring their social welfare systems. New ways are being sought to manage and finance these systems, and new approaches are being developed that alter the relative roles of government, private business, and individuals. Not surprisingly, this activity has triggered spirited debate about the relative merits of the various ways of structuring social welfare systems in general and social security programs in particular.

The current changes respond to a variety of forces. First, many societies are adjusting their institutions to reflect changes in social philosophies about the relative responsibilities of government and the individual. These philosophical changes are especially dramatic in China, the former socialist countries of Eastern Europe, and the former Soviet Union; but they are also occurring in what has traditionally been thought of as the capitalist West. Second, some societies are struggling to adjust to the rising costs associated with aging populations, a problem particularly acute in the OECD countries of Asia, Europe, and North America. Third, some countries are adjusting their social institutions to reflect new development strategies, a change particularly important in those countries in the Americas that seek economic growth through greater economic integration. And, finally, in many parts of the world, social welfare reform is motivated by the need to adjust the costs of welfare systems to economies that are no longer growing as fast as they did in the first three or four decades after World War II.

Whatever their motivation, these changes are being discussed and debated widely. And the current discussions seem in several ways to reflect a new level of sophistication about the complexities of social welfare policy. One example of this is the recognition of the important relationships between social welfare systems and the economy in which they exist. The state of its economy will often influence a society's willingness to support its social welfare system. Healthier economies facilitate more generous social welfare systems, while economic difficulties frequently lead, sooner or later, to retrenchments. At the same time, the size and structure of

social welfare systems can themselves influence the pace and rate of growth of economic activity. Social welfare systems that inadvertently discourage work activity—or encourage a shift from the formal sector to the informal sector—can reduce the aggregate amount of income available for distribution among society's members. Similarly, a system which discourages domestic savings can have the effect of slowing economic growth, while, given the proper environment, one that increases domestic savings could enhance economic growth.

Another indication of the increased sophistication of current debates is the realization that social welfare policies are developed to achieve a variety of different and often competing social objectives. These social objectives include the effective protection of the population from various economic risks, the promotion of increased economic activity, the redistribution of economic resources, the facilitation of the smooth operation of a free labor market, and the efficient operation of social institutions. No single policy will be best able to achieve all of these various objectives, so the choices actually made will necessarily reflect decisions, either implicit or explicit, about the relative importance of the various objectives.

Since assessments of the relative importance of competing social objectives will vary from country to country and from time to time, social welfare policies appropriate in one time and place need not necessarily be appropriate in another. Moreover, the degree to which a particular approach to the social welfare system does, in fact, advance a particular objective will also vary from place to place and from time to time. Put simply, the policy that is most effective in achieving a given objective in Argentina may not achieve that objective in the United States, and the people of the United States may wish to pursue a particular objective with their social welfare system that is not as important to the people of Argentina. No particular structure is the most appropriate one at all times and in all societies.

Philosophical considerations will always be important to social welfare decisions. But careful and objective analyses of the many implications of each possible social welfare option are also very important. That conclusion emerged from a recent expert meeting hosted by the International Labor Office (ILO) in Mexico City. The experts noted that a key element of social security reform was: "...careful and rigorous exploration of all of the options—in a particular country's context—considering [such objectives as] administrative efficiency, cost containment, breadth of coverage, and transparency...."

My purpose in developing this paper is to contribute to the rational debate and discourse referred to in the ILO communique by developing further some of the thoughts I have just outlined. In particular, I wish to suggest a framework for thinking about the various goals, objectives, and structures and to offer some suggestions about the relative advantages and disadvantages of different approaches to achieving the various goals.

I seek to further the dialogue about these topics by producing a document that will provoke others to think and react. Some may suggest the addition of important social objectives that they believe I have overlooked. Others may suggest additional ways in which particular social and economic structures may help achieve a given social objective. All such suggestions and elaborations will help us to increase our understanding of these important issues.

Finally, in order to simplify (somewhat) an already complicated discussion, my analysis focuses almost exclusively on programs that supply cash benefits; indeed the implicit focus is almost exclusively on pension programs. Much of the discussion contained here would be appropriate for other major social welfare programs, such as those concerned with acute health care services. But health programs also introduce other issues that go beyond the scope of this paper, such as provider reactions to different institutional arrangements.

The Competing Approaches

Most advanced societies rely on some combination of six approaches (or close variations) to structuring income support programs.[1] I begin by describing briefly each in turn.

Social Insurance

Social insurance is the largest single element in and the foundation for the social welfare system of most countries. It grew out of voluntary insurance arrangements of the medieval European craft guilds, was institutionalized by European governments in the late 19th and early 20th centuries, and soon spread from there to the Americas. Since social insurance is the foundation of so many social welfare systems, it seems the reasonable starting place for this discussion.

Although details vary from one country to another, social insurance programs throughout the world share certain characteristics. The interaction of these characteristics gives social insurance a unique set of attributes, and the differences between social insurance and other social welfare approaches can be traced primarily to differences in the mix of these characteristics. Some expert commentators cite seven characteristics as essential elements of social insurance.

1. Compulsory participation. Most people participating in social insurance programs do so as a result of a legal requirement. In some programs, a small minority may be allowed to choose whether to participate.[2]

2. Government sponsorship (and regulation). Governments create and supervise social insurance programs, but do not necessarily manage them. The programs may actually be operated entirely by private sector institutions (for example, the German health and pension systems); by a combination of public agencies and private contractors (the model used for Medicare, the health insurance program for the aged in the United States); or directly by a public sector agency (the model used by Anglo-Saxon countries for operating their public pension programs). Where the private sector runs these programs, however, operations are tightly supervised by the public sector.

3. Contributory finance. Most—sometimes virtually all—of the resources needed to run the program are raised through explicit contributions collected from the employer or from both the employer and the employee. A worker's contribution is usually a fixed percentage of his or her wage or income.[3]

4. Eligibility derived from contributions. Eligibility for benefits under social insurance programs rests, in part, on current or previous contributions by the individual and/or the individual's employer.

5. Benefits prescribed in law. Uniform sets of entitling events and schedules of benefits are developed, announced, and applied to all participants. Administrators of the program have little discretion in determining who should get benefits or how much they should get.

6. Benefits not directly related to contributions. Social insurance programs usually redistribute toward lower-wage workers or toward persons engaged in activities deemed to be socially desirable. Perhaps the most dramatic redistribution occurs in health insurance and flat pension benefit programs, in which higher-wage workers contribute more than lower-wage workers but everyone receives the same benefits. In most public pension programs, benefits are scaled to previous earnings. Even then, the lower-wage worker tends to get back proportionately more than the higher-wage worker, sometimes much more. Many social insurance schemes also subsidize benefits for nonworking members of the families of workers, students, members of the armed forces, homemakers caring for children, and others whose activities are deemed to be socially beneficial.

7. Separate accounting and explicit long-range financing plan. Social insurance contributions are usually earmarked to pay the social insurance benefits. Governments typically keep separate accounts that permit comparisons of program receipts and program benefits, though they may also present financial information that integrates the social insurance programs with the other government operations. Governments also typically develop an explicit plan showing that projected revenues are sufficient to finance projected expenditures for several years into the future (or, if revenues are not sufficient, explaining how the government proposes to balance projected receipts and scheduled benefits).

Some of these characteristics are necessarily linked. For example, if a social insurance program is to provide adequate support to lower-income households, it must redistribute from higher-income participants to lower-income participants (characteristic 6). But a program that redistributes explicitly and significantly must also be compulsory (characteristic 1) or else higher-income people will choose not to participate. And a program that is compulsory must be sponsored by the government (characteristic 2).

Other characteristics combine to give social insurance some of its key attributes. For example, advocates of the social insurance approach argue that it delivers benefits in a way that promotes a sense of individual worth and dignity among recipients. They argue that this result flows from the fact that social insurance is financed by explicit contributions (characteristic 3) and that entitlement to benefits derives from the payment of these contributions (characteristic 4). The underlying philosophy of the program, then, is that beneficiaries have earned the right to receive their benefits by paying in their contributions. The linkage between contributions and benefits can also serve as an incentive for compliance with social security taxes, although the strength of this incentive will obviously depend on how closely benefit amounts are linked to prior contributions.

Some advocates of the social insurance approach also argue that it introduces fiscal discipline into the political process. Beneficiaries of social welfare programs (whether pensioners or health care providers) naturally favor raising the level of benefits paid under the program. Because of the combination of contributory finance (characteristic 3) and the separate accounting of program receipts and benefits (characteristic 7), however, program expansions are likely to require an increase in contribution rates. Thus, they argue, wage earners—who will have to pay higher contributions to finance program expansions—have an incentive

Characteristics of competing social welfare approaches

Item	Social insurance	Employer mandates	Employee mandates	Voluntary tax expenditures	Means-tested programs	Universal programs
Participation compulsory	Yes	Yes	Yes	No	N/A	N/A
Government sponsors	Yes	No	No	No	Yes	Yes
Contributory finance	Yes	Yes	Yes	Yes	No	No
Eligibility based on contributions	Yes	Yes	Yes	Yes	No	No
Benefits specified in law	Yes	No, but	No, but	No	Yes, but	Yes
Benefits related to contributions	No	Yes	Yes	Yes	No	No
Separate accounting	Yes	Yes	Yes	Yes	No	No
Reserve financing required	No	No, but	Yes	No, but	No	No

NA = not applicable.

to support restraints on the growth in social insurance benefits.[4]

8. Reserve financing not required. Reserve financing is a final attribute worth noting because it is not necessary—and, in fact, is relatively rare—in social insurance, whereas it is more common in some of the alternative institutional arrangements. Financial reserves are frequently required in private sector pension plans in order to help assure that pension promises are met. Social insurance can be financed on a pay-as-you-go basis only because it is backed ultimately by the taxing power of the State.

Employer Mandates

Another approach to providing social welfare benefits involves government mandates that all employers (or all large employers) provide or finance specific social welfare benefits to their employees. Employer mandates and social insurance share many characteristics. In both cases: (1) the social welfare program results from explicit government sponsorship (though, in this case, not government operation), (2) eligibility for benefits is connected to employment, (3) participation is compulsory, (4) benefits are financed primarily from employer (and, occasionally, employee) contributions, and (5) benefits are financed according to an explicit plan. Also, employer mandates invariably involve specification in law of either a minimum level of contribution or a minimum benefit package, although employers are usually free to offer a better package than the minimum.[5]

The two approaches differ in at least two important ways. First, programs resulting from employer mandates are less likely to redistribute; they focus almost exclusively on individual equity at the expense of social solidarity. Second, employer-sponsored pension plans are more frequently (though not universally) advance funded. That is, financial reserves are accumulated in advance to pay claims.

Employee Mandates

Employee mandates have long been a part of the health insurance systems of several countries and have been used more recently in other countries as a means of providing pensions. Employee mandates share many of the attributes of employer mandates: programs are sponsored and regulated by the government, eligibility for benefits is linked closely to the payment of contributions, and benefits are financed to a significant degree from contributions. Perhaps two differences between employer and employee mandates are worth noting. First, employee-mandated pensions *must* be advance funded; as far as I know, there is no other way to organize them. Also, in principle, a substantial amount of redistribution could be built into an employee mandate program through the use of targeted, government subsidies.[6] Designing an employer mandate program with a substantial amount of redistribution would be more difficult.

Voluntary Arrangements (Tax Expenditures)

Governments often encourage employers to provide (and/or individuals to make) private arrangements which either replace or supplement public sector social welfare programs. The encouragement usually takes the form of a "tax expenditure"—an arrangement whereby someone's (usually the individual's) tax liability is lower than it otherwise would be as a result of the undertaking of the activity. Government encouragement of private arrangements is probably most common in the area of retirement savings, but is also associated with some health care benefits in many places.

Although voluntary programs are by definition not compulsory, their shape is frequently influenced by government because programs qualifying for the special tax treatment must meet certain minimum conditions. As with the employer and employee mandates, these programs rarely redistribute explicitly. Voluntary programs targeted at individuals do not have to be connected in any way to particular employment patterns or situations, although they can only be effective with individuals who have a reasonable income from which to make the voluntary contributions.

Means-Tested Programs

Means-tested programs, often referred to as social assistance, pay benefits to those who first demonstrate limited economic resources. In such programs, entitlement has nothing to do with whether claimants have had prior earnings or have ever paid taxes. A major advantage of means-tested programs is that in contrast to social insurance, or employer and employee mandates, they do not link eligibility for benefits to prior economic behavior. As a result, benefits can be tailored to current individual circumstances and assistance can be concentrated on those with the fewest resources, who need them the most. Means-tested programs are financed from government general revenues so that program costs are not separately identified (except by analysts who pore over budget documents).

Universal Programs

Some programs provide social welfare benefits to all legal residents. These universal programs share several characteristics with social insurance: benefits are prescribed in law and participation is compulsory (to the extent that participation is a meaningful concept for these programs). They differ in other important ways. Financing for universal programs usually comes from general revenues; eligibility is tied to residence rather than previous earnings or contributions; and financing for the program is not planned for separately from the planning for other types of government expenditures. Since there is no separate financing arrangement, there is no possibility of advance funding through accumulation of reserves.

Combinations and Hybrids

Although presented here as separate and distinct, the differences among these approaches sometimes become blurred in actual practice. Societies often construct social welfare systems that rely on a combination of the approaches; for instance, public pensions in Canada are provided through the combination of a flat rate, universal program and an earnings-related social insurance program. Occasionally, a new approach is

developed by combining features of two or more of the traditional approaches; for instance, medical insurance for the aged in the United States is provided through a program that shares many of the attributes of universal programs (at least for those age 65 and over), but which, technically, is voluntary and involves the payment of a partial premium. Finally, hybrids also arise as different ways evolve to administer these programs; for instance, at the option of employers, the earnings-related pensions in the United Kingdom are either operated by the State in the form of social insurance or by employers in the form of an employer mandate program. And, under certain circumstances, employees may contract out directly.

Social Objectives

I shall focus on attributes that can be clustered around two broad social objectives for the purposes of this discussion, recognizing that other categorizations would be equally valid.[7]

The first involves attributes related to providing effective social protection to the population. The social protection cluster includes:

- Treating people with dignity and respect.
- Assuring the most complete coverage possible for the system. A social welfare system cannot provide effective protection to people that it does not cover.
- Distributing equitably the costs and benefits of the system; in particular, assuring that those with more limited economic resources are protected adequately.
- Efficient operation of social welfare institutions so that, to the extent possible, the resources devoted to them go to the improvement of beneficiary welfare rather than administrative overhead.

My second cluster involves attributes that can help promote a healthy economic environment. It recognizes that an effective social welfare system can rest only on the foundation of a healthy economy. It includes:

- Encouraging individual thrift and not discouraging, unintentionally, individual work effort.[8]
- Fostering responsible government fiscal policies by discouraging the tendency to overpromise social welfare benefits and assuring that private saving is available to finance capital formation.
- Facilitating the smooth operation of markets, especially labor markets, particularly by constructing institutions that minimize the social costs of economic change.

Interaction of Approaches and Objectives

Having sketched the alternative institutional approaches for constructing social welfare systems and the alternative social objectives for such systems, I now turn to the interaction of the two. In particular, the following discussion compares the strengths and weaknesses of the different approaches and explores how effective each is likely to be in achieving the different social objectives.

Individual dignity.—One objective is simply to organize the system in a way that treats each member of society with dignity and respect. As noted earlier, social insurance promotes individual respect and dignity through the philosophy that those who make contributions have earned the right to the benefits. Other employer-provided benefits, as well as voluntary and employee-mandated approaches should be equally effective in promoting this objective. In contrast, those who receive means-tested benefits are often stigmatized.

Universal programs should be just as effective at promoting individual respect and dignity as are the employment-based programs, as long as they remain universally available. Some fear, however, that universal programs are politically unstable—that they will be vulnerable to the introduction of means-testing as a way of dealing with some future budget crisis.

Those who value highly the objective of assuring the dignity of recipients and fear that universal programs may eventually be means-tested usually advocate one of the employment-based approaches, social insurance, or either employer or employee mandates. They see the explicit contributions associated with social insurance as building a political bulwark against future means-testing:

Comparative ratings of competing social welfare approaches

Item	Social insurance	Employer mandates	Employee mandates	Tax expenditures	Means-tested programs	Universal programs
Dignity	A	A	A	A	F	B+
Coverage	B	C	C	F	N/A	A
Costs and benefits scaled to ability to pay	C	F	F	F	A	C
Administrative costs	B	D	D	D	F	A
Encourage individual thrift	D	B	A	A	F	D
Fiscal discipline	A	F	A	F	C	C
Facilitate labor market adjustment	A	F	A	F	A	A
Budget cost	D	A	A	A	B	F

N/A = not applicable.

those who have been paying the contributions will resist program changes that would deprive them of the benefits that they feel they have earned.

Developments in the Canadian public pension system raise concerns about the stability of universal programs (and suggest that social insurance is somewhat more stable), but they fall short of confirming the worst-case scenario just outlined. Canadian public pensions consist of two separate programs: (1) a universal flat pension financed from general revenues, supplemented by (2) an earnings-related pension paid under a contributory social insurance program. In 1988, in response to budget difficulties, Canada amended its personal income tax law to "claw back" at least part of the universal pension payment from the higher-income elderly and to tax it away entirely from those whose incomes are above a certain higher level. Canada does not "claw back" social insurance benefits.[9]

Coverage.—Social welfare programs cannot be effective if they do not reach the population in need. Broad coverage is achieved easily under universal programs for which, by definition, everyone is eligible. Broad coverage is more difficult under both social insurance and employer mandates because eligibility requires attachment to employment. Some people simply do not have sufficient attachment to gain eligibility; others are employed in informal and casual labor markets, in which many employers do not comply with the law. Employee mandates are likely to be even harder to enforce than are employer mandates and voluntary programs are likely to have an even lower rate of participation. Finally, means-tested programs may fail to reach a substantial fraction of the population they are intended to serve, in part because not all of the target population knows the program is available and in part because some of them are discouraged by the hassle of applying for benefits or the stigma associated with accepting them.

Distribution of benefits and costs.—The distribution of benefits and costs under a system of social insurance is likely to differ from that under a universal program only to the extent that the revenue bases of the two programs differ. Social insurance contributions tend to be proportional to wage income, except among the highest earners. Furthermore, earnings tend to be a larger fraction of total income for households in the middle of the income distribution and a smaller fraction for households at the lowest and highest income levels. As a result, wage-related financing is more regressive than personal income taxes; but is not necessarily more so than corporate taxes or sales, excise, and value-added taxes. A universal program financed by higher personal income taxes would probably be more progressive than social insurance; one financed by increases in value-added taxes may well be less progressive.

In general, social insurance approaches will be more redistributive than private sector arrangements, whether these arrangements are mandated or voluntary. In health insurance, the greater progressivity derives largely from the difference between wage-related contributions and individual premiums. In pensions, it tends to derive from the provisions that afford lower wage workers proportionately higher benefits under social insurance programs. In principle, some greater redistribution can be built into private sector programs through the use of targeted government subsidies. This would appear to be more feasible for employee mandates and voluntary individual programs where a subsidy can be based directly on the household income of the intended recipient than it is for employer-based programs where the subsidy cannot be targeted to apply only to particular participants.

People with relatively less taste for redistribution will be more likely to favor private sector approaches, and those who favor private sector approaches may do so precisely because they prefer less redistribution. At least in the United States, higher-income workers occasionally argue that they should not be required to participate in Social Security since they could get a higher return on the amount they must contribute to the program if allowed to invest it privately. They are probably correct. But the lower return they receive under Social Security is mainly the result of the redistribution built into the program.[10] Whether an entire birth cohort can receive a higher return under private arrangements depends on the relationship between the rate of growth of productivity and of population, on the one hand, and the real interest rate on the other. Whatever the relationship may be, the gap between the two is not likely to be large and consistently in one direction or the other for long periods.[11]

Means-tested programs assure a greater redistribution because other transfer programs are less effective at targeting benefits to those who are most in need. Paradoxically, their more effective targeting does not mean that means-tested benefits are necessarily more effective in serving low-income beneficiaries. These beneficiaries are less apt to apply for benefits that carry the stigma associated with the means test than they would be for benefits paid through a universal or social insurance system.

Administrative cost.—Administrative expenses increase the total cost of the social welfare system without increasing benefits the system can pay, and can vary dramatically from one system to another. Major administrative cost elements include the cost of revenue generation, money management, benefit eligibility determination, and ongoing benefit administration.

Of the alternatives discussed here, universal programs probably have potentially the lowest administrative cost. Revenues are raised as a part of general tax collection procedures, there are no money management costs, and eligibility usually depends on meeting a few, relatively easily verifiable conditions. The administrative costs of social insurance are also potentially quite modest since eligibility tends to be based on information that can be collected and maintained relatively easily. On the other hand, means-tested programs can be relatively expensive to operate because of the need to collect and verify extensive financial information in order to assure that individuals are (and remain) eligible for benefits.[12]

Generalizations are more difficult about the relative administrative costs of public and private sector programs.

Public sector programs usually enjoy potentially greater economies of scale in their operations and avoid a substantial amount of the sales expenses of private sector firms. At any given time and place, however, inefficiencies inherent in many public sector enterprises—such as facilities or excess staff resulting from political pressures—may more than offset the potential advantages enjoyed by the public sector, especially if the private sector firms are exposed to effective competition.[13] Within the private sector, one would expect that employer-sponsored approaches would involve fewer administrative expenses than would employee-sponsored approaches since the former should more frequently be associated with larger institutions that are better able to capture economies of scale and that would have lower costs of sales per individual served.

Work and savings incentives.—For several decades economists have explored the effects on individual behavior of various elements of the social welfare system.[14] In general, their analyses suggest that work effort would be somewhat higher in the absence of the payment of cash benefits. The magnitudes are not overwhelming, however, and the studies do not address such crucial issues as whether, on balance, social welfare is increased by allowing the elderly to work less. These studies do suggest that restrictions on the amount that can be earned while still receiving retirement benefits will further reduce work effort among the elderly, at least somewhat. In general, studies have not attempted to analyze differences in the impact that different approaches to constructing the social welfare system might have.

Studies of the effect of taxation on work effort have, in general, also shown only weak linkages. Higher tax rates may have as much of an impact on compliance as on actual work effort. In principle, tax payments that are linked to future benefit increases might introduce less of a work disincentive, but the effect, if any, appears to be slight.

A number of economists have examined the impact that the pay-as-you-go social security system in the United States has had on individual savings. On balance, their results do not support the fear that such a system will seriously erode savings and capital formation. On the other hand, studies in the United States also suggest that funded pension plans do have a positive effect on savings. National savings may increase by 30 to 40 percent of any increase in the aggregate amount of assets being held in pension and other retirement accounts.[15] Taken together, these two results suggest that, in the absence of offsetting changes in government fiscal operations, shifting from a pay-as-you-go social security system to an advance-funded pension system would have a positive effect on national savings.

Fiscal discipline.—Another objective is to counter the natural tendency for political decision makers to overpromise. Granting benefit increases is popular, but entails the assumption of future liabilities. If these liabilities become too large, their costs can eventually have undesirable economic and social consequences, such as:

- An increase in evasion of legislated responsibilities or the growth of the informal sector, either of which makes the social welfare program less effective at protecting citizens;
- A reduction in international competitiveness of domestic businesses, which will eventually undercut living standards and reduce social welfare;
- Inflationary pressures, as governments seek to support a greater level of expenditures than can be financed through current tax receipts, which will eventually interfere with economic growth; or
- Reducing benefits for current beneficiaries—who might have arranged their economic affairs differently had they known that promises were not going to be kept. (Benefit reductions can occur either directly through legislated reductions or indirectly through inadequate adjustments for inflation.)

Of the various approaches, social insurance and employee mandates are unique in mobilizing countervailing political pressures to constrain program costs. As discussed earlier, the possibility of an increase in social insurance contribution rates to balance revenues and expenditures helps to create a political constituency for restraining benefits. The linkage between current contribution rates and future benefit level is even more obvious under employee mandates.[16]

In contrast, under other approaches, the cost of social welfare programs is frequently less visible. Cost increases in programs financed out of general revenue generate pressures on politicians to devise ways to finance the additions to the total budget. But, they do not translate directly into tax increases that voters will realize are directly linked to developments in social welfare programs. Fiscal discipline can be preserved if appropriate budget procedures can be adopted and enforced. But, these procedures operate on total spending, and do not prevent runaway costs in a social welfare program from crowding out expenditures on other governmental activities.

Similarly, sooner or later, increases in social welfare costs imposed on employers will show up as smaller increases in wages. In this way, workers will ultimately pay for the social welfare benefits that their employers are required to provide. But, the linkage is far less direct and far less obvious to workers. Thus, workers cannot be counted on to form an effective constituency for restraining the costs of employer mandates.

Politicians are not the only members of society prone to over promising. The same phenomenon can affect private sector institutions. Left to themselves, employers may promise their workers that smaller wage increases today will allow for improved pensions in the future and then never actually set aside the resources necessary to assure payment of the pensions. Similarly, competition for business may cause investment companies to undertake risky investments in the hope that they can produce a better return than their competitors. In either case, the State may eventually find that it is required to fulfill inadvisable promises made by private sector institutions. The irony, then, is that where the State wishes to rely on private sector institutions, it

may be forced to regulate these institutions closely to assure that they respect the fiscal discipline of the market place.

The status of the national government's budget can also influence both the structure of social welfare institutions and the economic effect of social welfare policies. For one thing, political choices may be influenced by a desire to minimize the costs that appear in the budget. A major disadvantage of universal programs is that they involve substantial budget outlays. Measured by budget outlays, social insurance programs are almost as expensive as universal programs; presumably, they will be equally expensive if coverage were as extensive. One potential advantage that social insurance has, however, is that by construction, it brings its own revenue stream with it. This doesn't change the total amount that government must raise or will spend, but it may make raising revenues easier. An advantage of means-tested programs is that they require far less of public resources.

The great attraction of employer and employee mandates is that their cost does not appear directly in the government budget (though the cost of employer mandates may be reflected indirectly in lower business tax collections). Even when they must be supplemented by gap-filler programs, mandated programs are likely to appear cheaper.

Another important impact of government budget policy involves the linkage, if any, between retirement savings and national savings. History gives many examples of social insurance programs in which large surplus balances were diverted to other government uses, either directly through politically motivated investments or indirectly through government borrowing of the social insurance surplus to cover deficits elsewhere in the budget. In either event, government actions serve to offset the increased savings and capital formation that would otherwise have been supported by retirement program surpluses. It may be that governments are somewhat more likely to "spend" reserves in public sector programs than they are those in private sector programs. If this is the case, and if retirement program surpluses are to be used as a mechanism for increasing national saving, use of mandated private sector programs would have a somewhat higher probability of actually producing the desired economic result.

Facilitating market adjustments.—Though economic growth benefits society as a whole, frequently, growth disrupts the lives of particular people and institutions. Less productive firms and industries must be allowed to shrink to make room for more productive firms and industries. Such changes cause jobs to move from one firm to another and, perhaps, from one geographic area to another. Minimizing the impact of such economic shifts on the social welfare of the population is worthwhile in itself, and it will increase the political acceptability of the economic growth and change process.

The approaches to constructing the social welfare system most vulnerable to disruption as a result of economic growth and change are those tied closely to particular employers—either the employer mandate or the voluntary, employer-based systems. The other approaches break the link between social welfare benefits and any one particular employer, thereby helping to insulate the system from the disruption of change.

Concluding Comments

Public social welfare systems have become more complex and varied over the years. The earliest systems focused on what we now think of as means-tested assistance programs. Government-sponsored social insurance emerged about a century ago. Although voluntary employer-provided social welfare benefits predate social insurance, the idea of relying systematically on employer mandates is a later development. And employee mandates are even more recent.

For many years, social welfare debates were dominated by the set of concerns associated with providing effective protection, particularly coverage and cost distribution. More recently, as the social welfare systems have grown to account for substantial portions of government budgets, social welfare debates have broadened to include questions about the wise use of administrative resources and the impact that these systems are having on the wider economy.

The growth in the set of options available for constructing these systems, along with the broadening of objectives some think these systems ought to serve, has led to debates that are often vocal but not always productive. The premise of this paper is that such debates will be much more productive if their participants agree that there is no one correct way to organize a social welfare system. The various alternative approaches have different strengths and weaknesses. Most options are well suited to achieving one or more particular social goals, but are not particularly well suited to achieving another.

We should not be surprised if social welfare systems continue to become both more diverse and more complex. Since societies seek to achieve a variety of social objectives simultaneously, we should not be surprised to find them turning increasingly to mixtures that utilize some combination of the various approaches outlined here, rather than relying primarily on one approach. And, since different societies attach different importance to different goals, at any given time we should expect to find different structural arrangements favored at different places. And, finally, since social goals change over time, we can expect that the particular mixture of approaches employed in any one place will also evolve and change over time.

In this paper I have suggested a framework for discussing the various options. I have also suggested some of the advantages and disadvantages of using each of the approaches to achieve each of the possible social objectives. In some cases, my comments have been supported by empirical evidence; in other cases, they have been more speculative. In all cases, they are more apt to reflect experience in Western Europe and North America than elsewhere. I trust that others will be able to modify or elaborate on my analysis based on their own studies and their own country's experiences, and that in doing so, they will help us all to understand better these important issues.

Notes

[1] If we were speaking about social welfare policy more broadly, we would also have to consider a seventh approach, direct provision of social welfare services by the government. This is a common strategy for delivering health services, but not relevant to a discussion of pensions.

[2] This list is adapted from the definition of social insurance developed by the Committee on Social Insurance Terminology of the Commission on Insurance Terminology of the American Risk and Insurance Association. This group also specifies that social insurance coverage must extend beyond government employees. See Robert J. Myers, *Social Security*, 3d ed., Bryn Mawr, PA: McCahan Foundation, 1985, pp. 995–996.

[3] In some countries, such as the United States, social insurance contributions are indistinguishable from taxes since they are specified in law and collected by the taxing authority. The connection between taxes and contributions is not quite so close in some other countries. For example, each German sickness fund (technically, a private sector institution) establishes its own contribution rate and collects all social insurance contributions from its members. Also, voluntary supplemental contributions are allowed under several countries' pension programs.

[4] Social insurance developments around the world suggest that this is an argument more applicable in some political and social systems than in others. Whereas these arrangements appear to have helped assure fiscal discipline in Germany or the United States, different institutional arrangements may be required in other countries to prevent over promising.

[5] Social insurance also tends to offer a uniform package of benefits, with employers having the option to provide separate, supplemental programs.

[6] As a practical matter, this may be more important for health insurance than pensions. A good case can be made for subsidizing health insurance costs for those with low current period income. It is less clear whether one would want to subsidize pension contributions for those with low current period income. Presumably in pension programs redistribution is more appropriately based on lifetime income rather than current period income.

[7] For example, see Nicolas Barr, "Economic Theory and the Welfare State: A Survey and Interpretation," *Journal of Economic Literature*, Vol. 3, No. 2, June 1992, pp. 741–803. Barr develops the following objectives of the welfare state: macro efficiency, micro efficiency, economic incentives, poverty relief, protection of accustomed living standards, income smoothing, vertical equity, horizontal equity, dignity, social solidarity, intelligibility, and absence of abuse.

[8] Since the major social purpose of retirement programs is to allow people to retire, these programs will necessarily produce some reduction in work effort relative to the situation that would exist in their absence; if they did not produce any reduction in work effort, they would have failed. Other things equal, however, one would want them to not discourage work effort prior to retirement or to prevent those who decide to retire from supplementing their retirement incomes, should they desire to do so.

[9] Nor does the "claw back" policy apply to Canadian health insurance, which also follows the model of a universal program.

[10] See U.S. General Accounting Office, *Social Security: Analysis of a Proposal to Privatize Trust Fund Reserves*, Washington, DC: U.S. Government Printing Office, 1991.

[11] See Henry J. Aaron, "The Social Insurance Paradox," *Canadian Journal of Economics and Political Science*, Vol. 32, No. 3, August 1966, pp. 371–374.

[12] Experience in the United States illustrates the relative magnitudes. The annual administrative costs for the U.S. Old-Age and Survivors social insurance program average about 0.8 percent of annual benefit payments. By comparison, the administrative costs of the parallel means-tested program for the aged and disabled operated by the same agency averages about 7.6 percent of benefit payments.

[13] North American health insurance illustrates the potential size of the gap between private and public sector institutions (and among public sector institutions employing different approaches). The Canadian national health insurance system follows the universal model and experiences administrative costs of just under 1 percent of total outlays. The U.S. national health insurance for the aged follows the social insurance model and employs more complicated provider payment mechanisms; its administrative costs run about 2 percent of outlays. U.S. private health insurance companies' administrative costs average 10 to 12 percent of outlays. See U.S. General Accounting Office, *Canadian Health Insurance: Lessons from the United States*. (GAO/HRD-91–90, June 1991) Washington, DC: U.S. Government Printing Office, 1991, p. 31.

[14] For example, Henry J. Aaron, *Economic Effects of Social Security*, Washington, DC: The Brookings Institution, 1982; and Michael V. Leonesio, "Social Security and Older Workers," *Social Security Bulletin*, Vol. 56, No. 2 (Summer) 1993, pp. 47-57.

[15] Presumably, the rest of the increase in pension assets is either offset by larger liabilities elsewhere in the economy or replaces asset accumulation that would have occurred in the absence of private pensions. For example, Alicia H. Munnell, *The Economics of Private Pensions*, Washington, DC: The Brookings Institution, 1982.

[16] One can see the importance of this effect in recent reforms in German health care financing. Germany uses contributory social insurance to help finance personal health care services, and in recent years, has enacted a series of reforms that have reduced physician incomes and pharmaceutical company revenues. These reforms could be achieved even though important interest groups were being forced to absorb economic losses because they were advertised as necessary to keep worker contribution rates from rising. In other words, the political influence of those paying the contributions offset the political influence of those benefiting from the program. The same effect was illustrated in the United States in 1983, when the Congress adopted limited taxation of Social Security benefits and a higher retirement age as part of a package to restore fiscal balance to that program. Neither proposal would have been adopted had not the alternative been another increase in the Social Security contribution rate.