
Welfare expenditures (Stiglitz ch. 14 and 15; Gruber ch.13, 14, 17; Rosen ch.9,10,11)

- Social programmes
 - Reasons for public intervention
 - Efficiency and equity effects
 - An example: the unemployment benefits
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Social assistance and social insurance/1

- Social insurance and social assistance represent the largest share of public expenditures in most OECD countries. All rich nations have large welfare states.
 - **Social assistance** has a redistributive role:
 - It provides cash and/or in kind benefits (housing, food health care, etc.) to the poor.
 - It is financed with income taxation.
 - It is usually means tested: only individuals whose financial resources fall below a certain level can receive benefits
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Social insurance and social assistance/2

- **Social insurance (or social security)** is a form of forced savings to insure against adverse events, such as unemployment, sickness, old age, invalidity.
- It has an insurance role and it is usually financed on payroll taxes (social security contributions) by firms and workers. Differently from private insurances, it also redistribute income, because benefits are not related to individual characteristics and payments.
- Participation is compulsory
- Eligibility and benefit levels depend in part on past contributions made by the worker (insurance)
- Benefit payments begin with some identifiable occurrence (unemployment, illness, retirement)
- The programmes are not means tested (i.e. do not depend on the financial conditions of beneficiaries)

Table 2.1: Categorisation of benefits with a social purpose^{1,2}

	Public		Private	
	<i>Mandatory</i>	<i>Voluntary</i>	<i>Mandatory</i>	<i>Voluntary</i>
Redistribution	Means-tested benefits, social insurance benefits	Voluntary participation in public insurance programmes. Self-employed 'opting in' to obtain insurance coverage.	Employer-provided sickness benefits, benefits accruing from mandatory contributions, to, for example, pension or disability insurance.	Tax-advantaged benefits, e.g. individual retirement accounts, occupational pensions, employer-provided health plans
No redistribution	Benefits from government managed individual saving schemes		Non tax-advantaged actuarially fair pension benefits	<i>Exclusively private:</i> Benefits accruing from insurance plans bought at market prices given individual preferences.

- (1) By definition transfers between individuals, even when of a social nature, are not considered to be within the social domain.
- (2) The shaded cells reflect benefits that are NOT classified as social.

Social expenditures: US vs Europe

- The overall size of welfare expenditures is far more similar than most believe, domains are similar & mostly similarly sized. Redistribution is however much more extensive in Europe.
 - Some disadvantaged categories (sick, elderly, large families) also have protection in the US (although less than Europe), very few transfers to the “poor” per se in the US.
 - Relative to European countries, the US:
 - Spend relatively more in health care
 - Spend less on cash & early education
 - Rely on safety nets & contribution related benefits rather than universal benefits
 - Charity contributions are much larger in the US than In Europe: charity per capita in the US in 2000 is \$691 per capita, against 141 for UK and 57 for Europe as a whole.
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Social expenditures in % GDP, 1980-2003

Year	1980	1985	1990	1995	2000	2003
Country						
<u>Australia</u>	10,9	13,0	14,1	17,1	17,9	17,9
<u>Austria</u>	22,6	23,9	23,7	26,6	25,3	26,1
<u>Belgium</u>	23,5	26,1	25,0	26,4	25,3	26,5
<u>Canada</u>	14,1	17,3	18,4	19,2	16,7	17,3
<u>Czech Republic</u>	..	..	16,0	18,2	20,3	21,1
<u>Denmark</u>	25,2	24,2	25,5	28,9	25,8	27,6
<u>Finland</u>	18,4	22,8	24,5	27,4	21,3	22,5
<u>France</u>	20,8	25,8	25,3	28,3	27,6	28,7
<u>Germany</u>	23,0	23,6	22,5	26,6	26,3	27,3
<u>Greece</u>	11,5	17,9	18,6	19,3	21,3	21,3
<u>Hungary</u>	..	..	..	..	20,6	22,7
<u>Ireland</u>	16,8	21,8	15,5	16,3	13,6	15,9
<u>Italy</u>	18,0	20,8	19,9	19,8	23,2	24,2
<u>Netherlands</u>	24,1	24,2	24,4	22,8	19,3	20,7
<u>Poland</u>	..	..	15,1	23,1	21,2	22,9
<u>Portugal</u>	10,8	11,0	13,7	18,1	20,2	23,5
<u>Slovak Republic</u>	..	..	..	18,9	18,1	17,3
<u>Spain</u>	15,5	17,8	20,0	21,5	20,4	20,3
<u>Sweden</u>	28,6	29,7	30,5	32,5	28,8	31,3
<u>United Kingdom</u>	16,6	19,6	17,2	20,4	19,1	20,6
<u>United States</u>	13,3	12,9	13,4	15,4	14,6	16,2
OECD - Total	15,9	17,6	17,9	19,9	19,4	20,7

Chart 4.2: Since 1990, growth in real social spending has outpaced real GDP growth

Annual growth in real public social spending and real GDP, Index 1990 = 100, 1990-2005

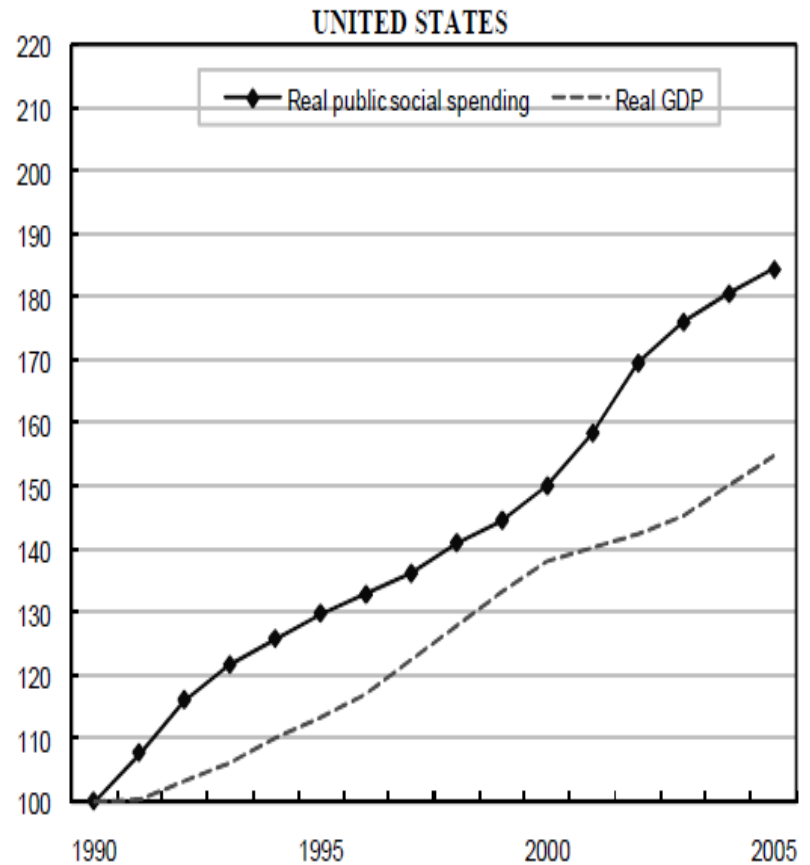
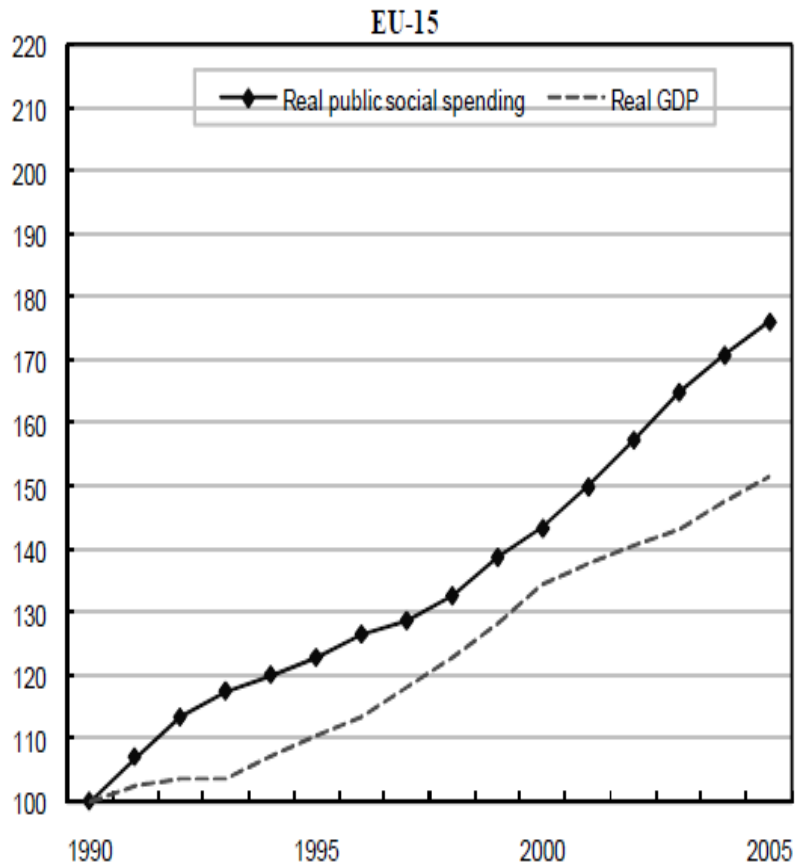
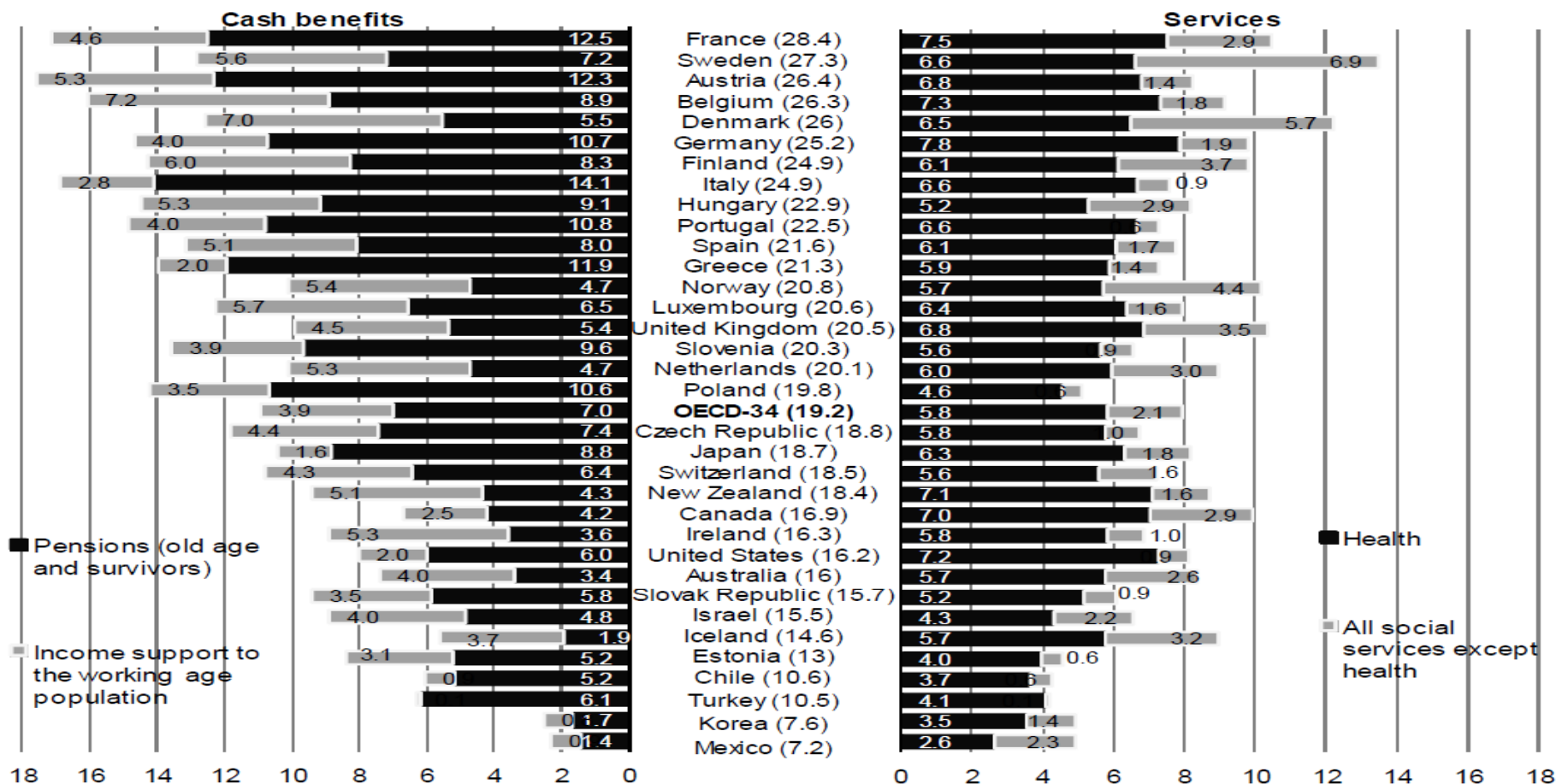


Chart I.5: On average OECD countries spend 7% of GDP on pensions and 6% on health services

Public social expenditure by broad social policy area in percentage of GDP, 2007

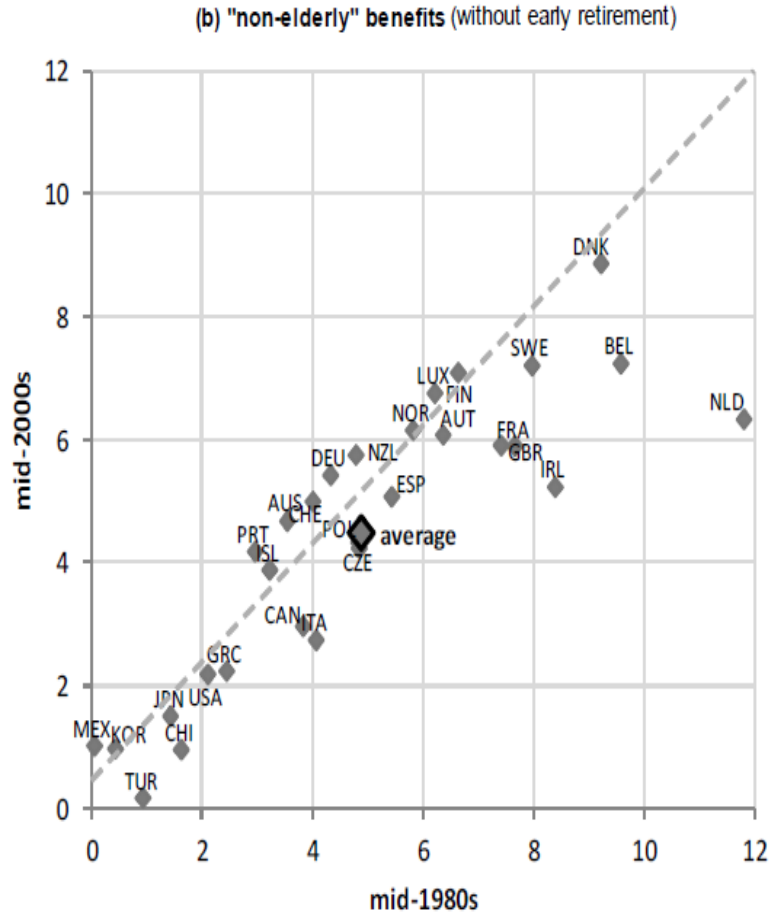
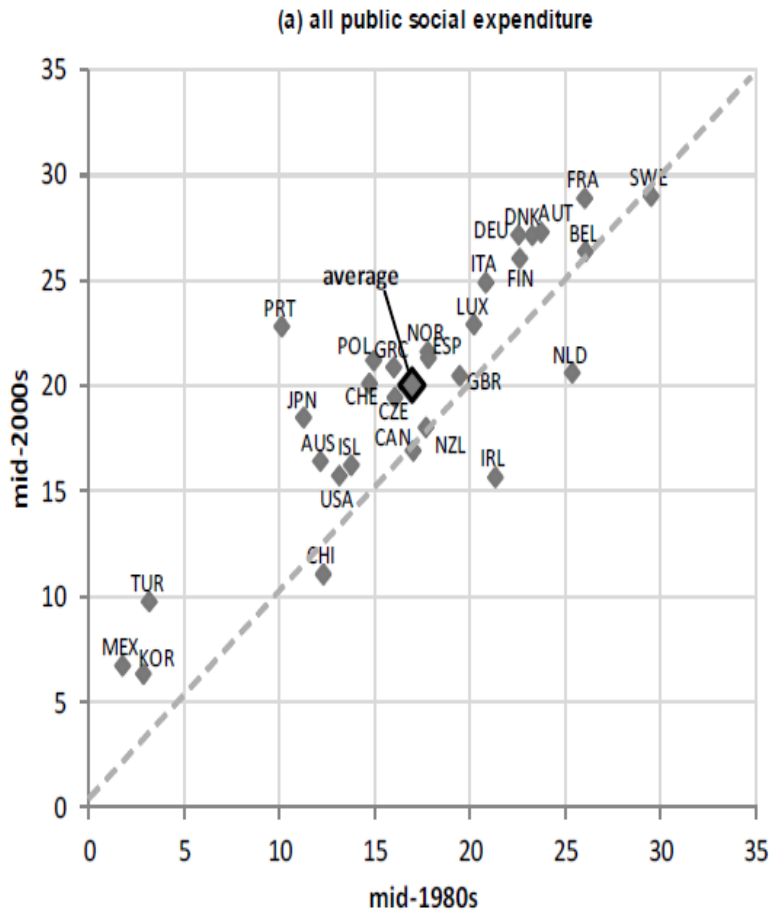


note: Countries are ranked by decreasing order of public social expenditure as a percentage of GDP. Spending on Active Labour Market Programs (ALMPs) cannot be split by cash/services breakdown; they are however included in the total public spending shown in brackets).

source: OECD Social Expenditure Database (SOCX, www.oecd.org/els/social/expenditure).

Figure 4. Total social expenditure levels increased, but cash transfers for the non-elderly often did not.

Entire period: mid-1980s to mid-2000s, in percent of GDP



Welfare expenditures in some EU countries-

Composition %-2003

	Germany	France	Italy	UK	Avg. EU
Pensions	42.9	43.3	61.8	44.9	45.5
Invalidity	7.8	4.8	6.4	9.4	7.9
Unemployment	8.6	7.9	1.87	6.5	6.7
Health	27.7	30.5	25.7	29.6	28.4
Family and Children	10.5	9.0	4.1	6.9	8.0
Social exclusion and housing	2.5	4.5	0.2	6.5	3.5
Total	100	100	100	100	100
% GDP	30.2	30.9	26.4	26.7	28.3

Assistance policies in Italy

- Low social expenditures, apart from pensions which absorb most of Italian welfare expenditures. No safety net
 - Prevalence of cash transfers, only fiscal deductions for children are categorical
 - Low distributive effectiveness, also due to large fiscal evasion which makes it difficult to introduce means tested benefits
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Social Security/1

Features:

- Participation is mandatory
- Eligibility and benefits are a function of contributions
- Benefits are tied to an event and are not means tested

Rationales for public intervention:

- Market failures: missing markets and adverse selection
 - Merit goods (paternalism): people are myopic and underinsure against social risks
 - Externalities (reduction of social conflict, poverty and health risks)
 - Equity and redistributive reasons
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Social security: rationales for public intervention

- **Missing markets and adverse selection:** The market fails to provide insurance against many of the most important social risks facing individuals: unemployment, poverty, bad health, old age. Due to adverse selection only those with higher social risks will be willing to buy an insurance. While market efficiency would require individuals with higher social risks to pay higher premiums, they are the least able to pay for it.
- **High transaction costs** (administrative and monitoring costs) which fall as the insured increase.
- **Moral hazard and merit good** (the cost of supporting those who fail to provide for themselves is borne by others)
- **Externalities:** social conflict, general health and social conditions...

Social security: advantages of public intervention

- **Public social security programmes:**
 - have lower costs, due to scale economies,
 - they can always meet their obligations by rising taxes,
 - they can engage in risk sharing across generations,
 - they are not faced by adverse selection since individuals are obliged to “buy” social insurance, unemployment and retirement (merit goods).
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Social security: limits of public intervention

- **Disincentive effects:** discourage private savings (*crowding out*) and work effort (*unemployment trap, early retirement*), reducing long run growth. However social stability may support growth.
- **Moral hazard:** reduced incentive to provide for bad periods and old age.
- **Increasing costs and risks of fiscal imbalance** with population ageing and increasing administrative costs (as in health care programs) which crowd out other programs (such as programs on children).
- **Low perceived rate of returns** relative to private insurance, especially in the case of retirement funds.
- **Redistribution** among those making similar contributions, not based on assessment of need. How to measure poverty and need?

Social assistance (welfare) programs

Safety net programmes to contrast poverty: housing programmes, health programmes, family and children support, income support during inactivity, disability and invalidity

- These programmes are usually **means tested** and targeted to individuals and/or families below the poverty line

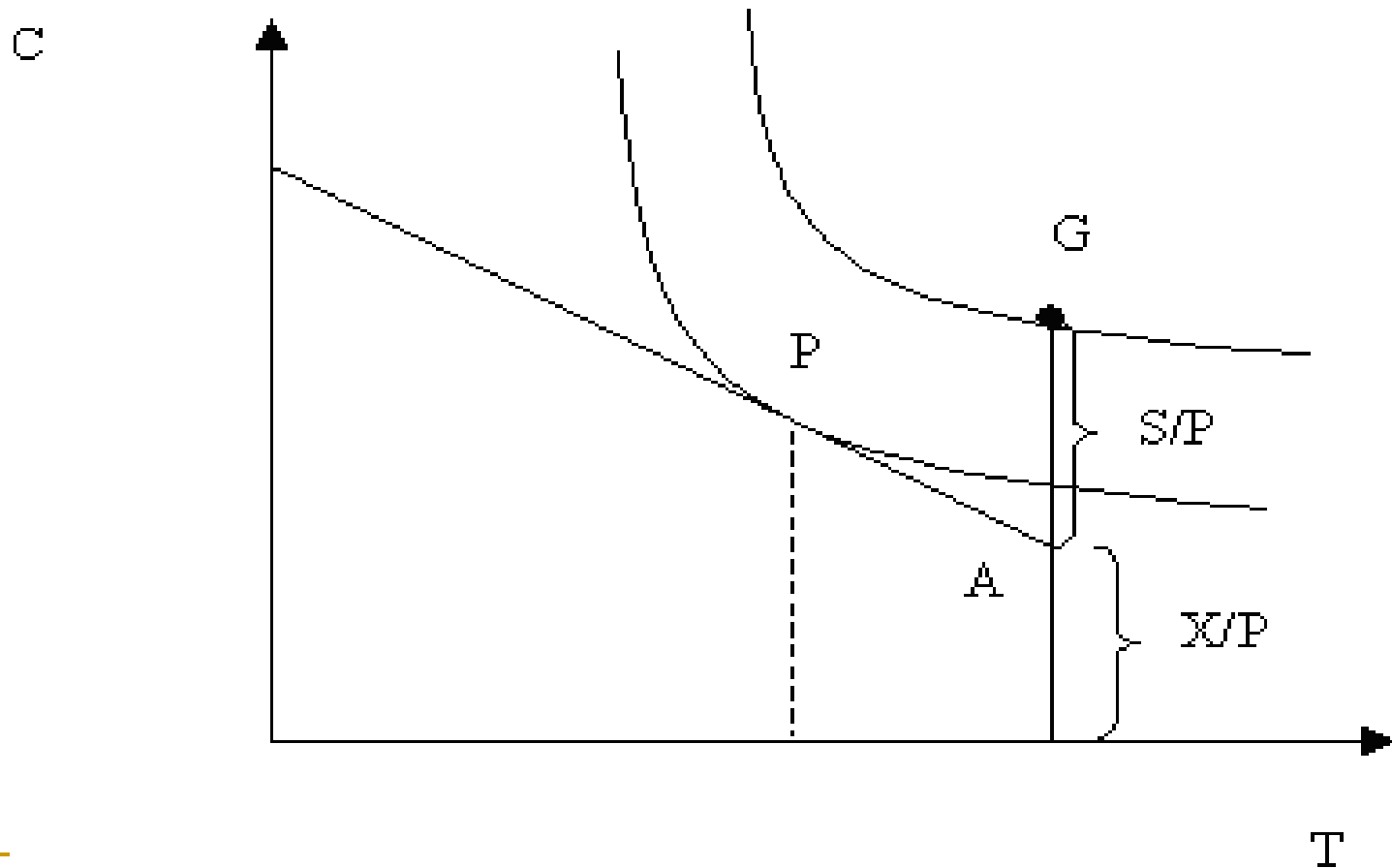
Rationales:

- Positive externalities, especially in the case of programmes aimed at children
 - Equity reasons
 - *problem*: how to define poverty
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Effects of social assistance/1

- **Poverty trap and welfare dependency :**
 - Net of taxes benefits are higher than net wages for low wage individuals and include also in kind benefits (such as housing, free meals in schools, etc.).
 - Since welfare benefits are reduced as income rises, low wage families may be induced to reduce labour supply or to work in the underground economy to receive welfare benefits.
 - When there is a threshold, and benefits go to zero when income exceed a certain level, the disincentive effect is particularly relevant near the cutoff level
 - **Moral hazard:** individuals and families are induced to declare a lower income than the real one.
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Work decision under welfare benefits: welfare dependency and lower labour supply especially for those receiving low net wages in the labour market



The design of benefit systems

- Three broad goals in designing benefit systems:
 - a) **Support living standards** of low income families with children
 - b) **Encourage work** and economic self sufficiency
 - c) **Keep costs low** for the tax payers
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Measures to reduce welfare dependency

a) **target support to the really needy:**

- Categorical vs means-tested
- In kind vs cash transfers

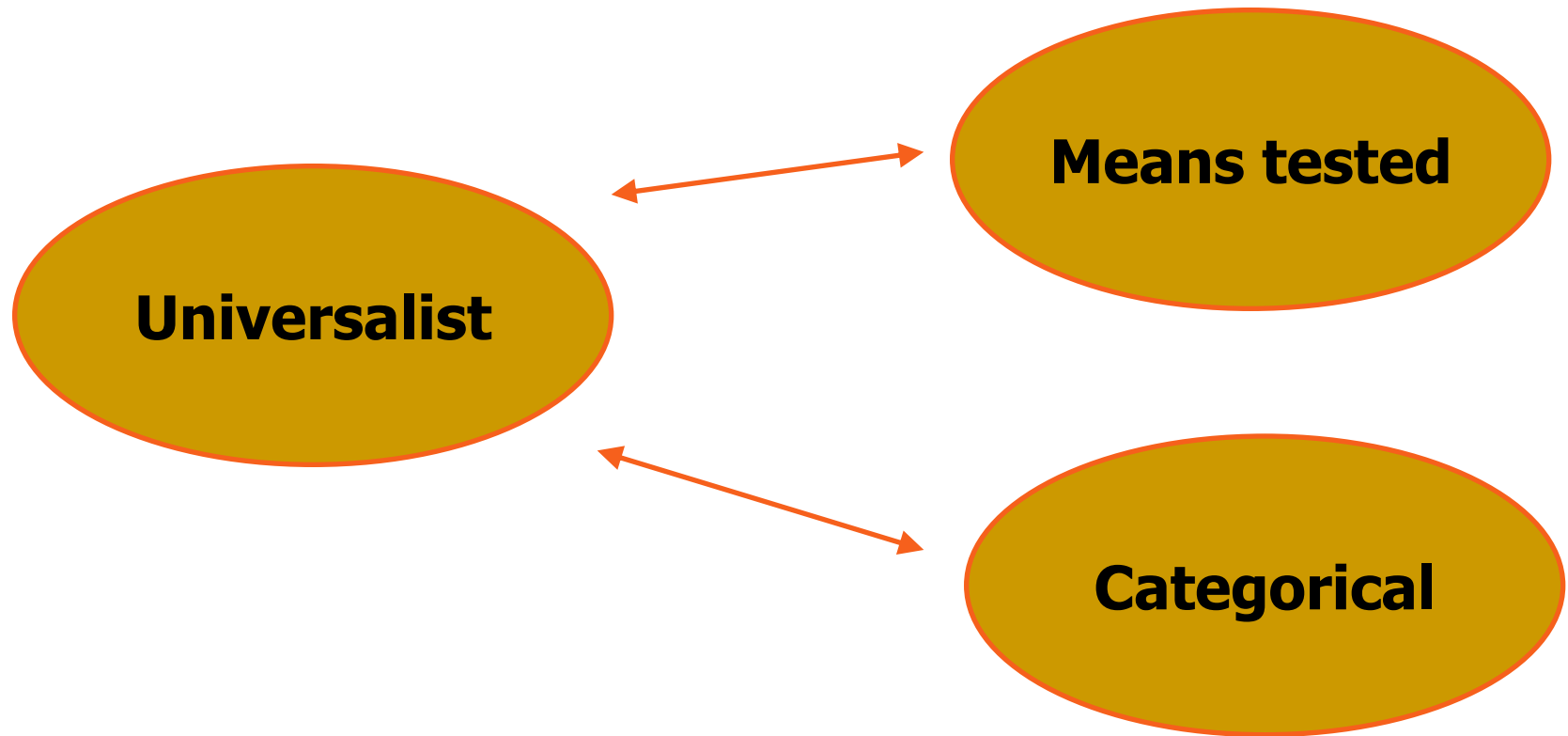
b) Improve outside opportunities: higher net wages (through lower taxation), child support enforcement, etc.

c) Introduce work availability among eligibility conditions (*workfare*).

d) Introduce In Work Benefits: individuals do not lose the benefits if they work .

The optimal system depends on the behavioral response of individuals

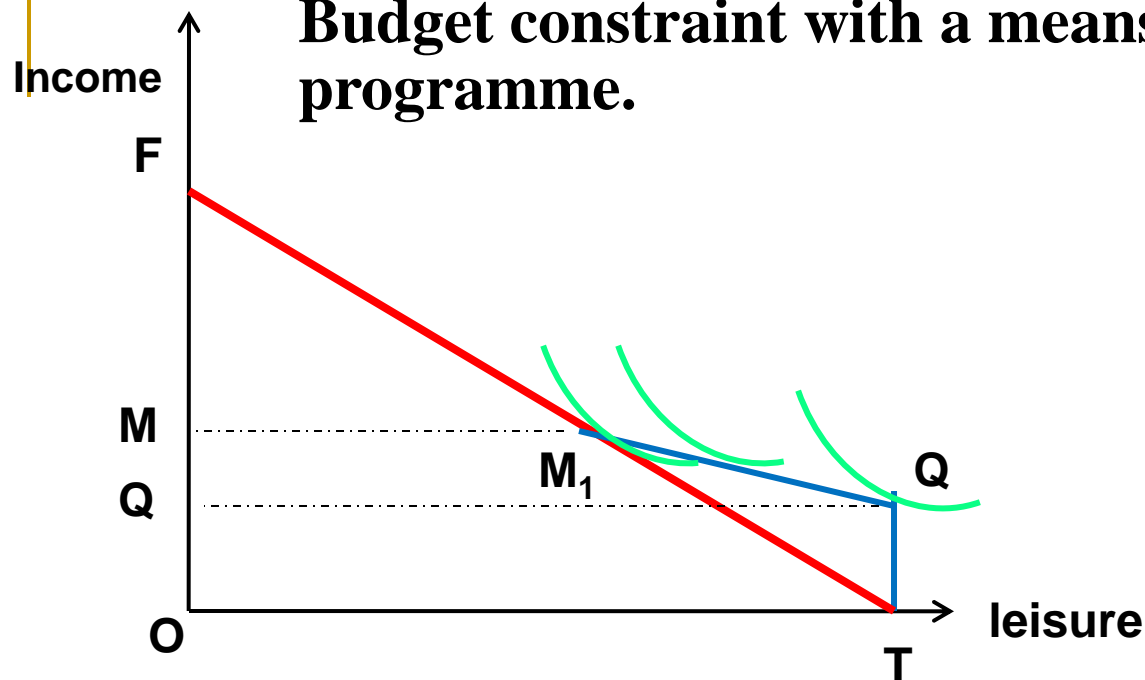
Types of assistance programmes



Means tested programmes

- ***Advantages relative to universal programmes:***
 - Better target efficiency: it is possible to target the program on those (usually families) who most need support
 - Lower expenditure
 - ***Disadvantages:***
 - High administrative costs to assess eligibility
 - Asymmetric information problems (helping those who don't need help, not helping the real needy): it is important the definition of adequate indicators
 - Social stigma which may prevent take up
 - Poverty trap: welfare dependance and disincentive to exit from a poverty condition, especially for benefits based on thresholds (the benefit is lost when income exceed a given level). Example: the Medicaid programme in the US.
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Budget constraint with a means tested assistance programme.

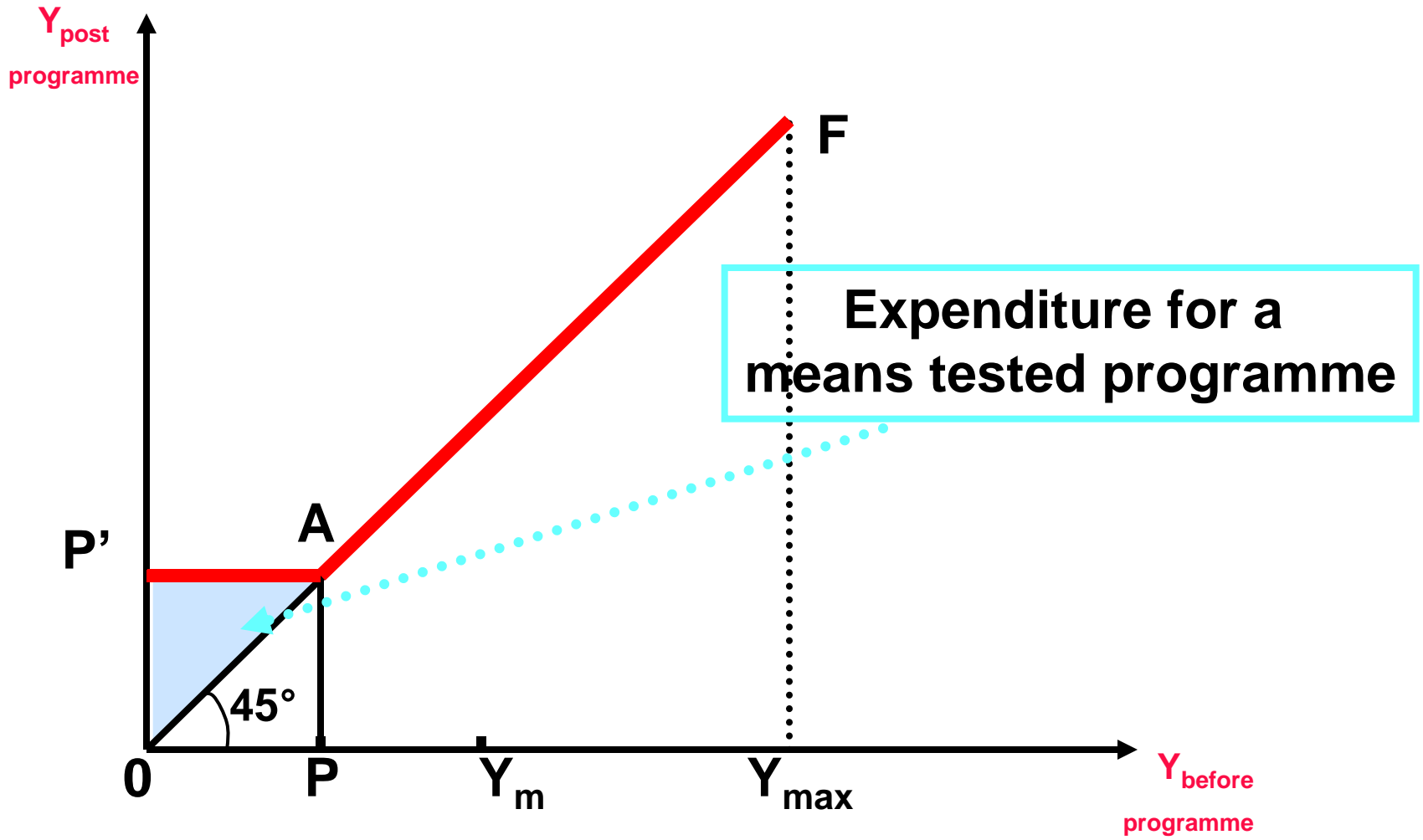


Full subsidy OQ only up to a labour income below Q ,
Partial subsidy (or negative income tax) between Q and M . No subsidy above M .

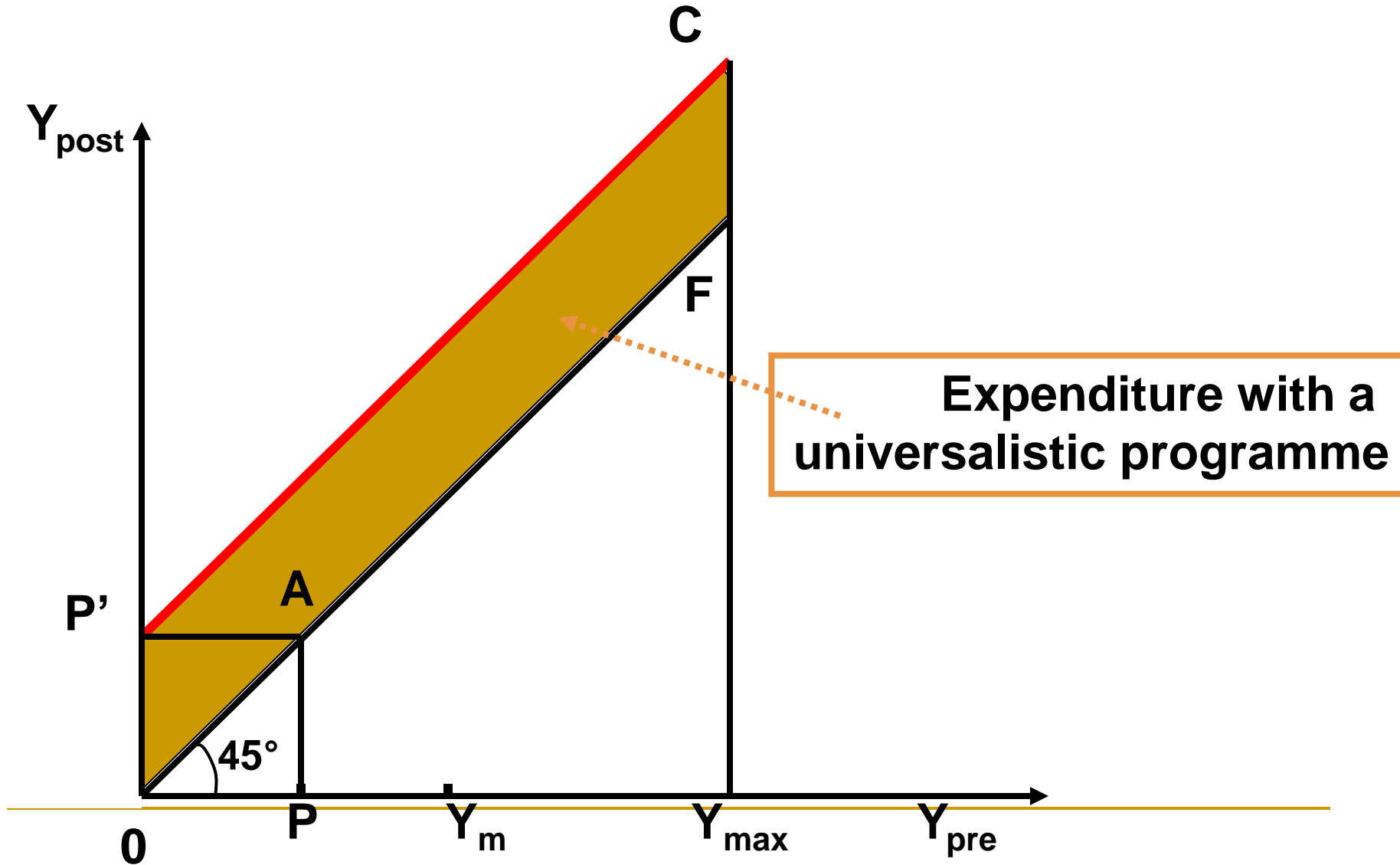
Disincentive effects. The choice is either Q (no work) or the budget constraint QM_1F :

- *Unemployment trap*: Q (no work) is preferred to work
- *Poverty trap*: the subsidy reduces the labour supply relative to the situation without the subsidy for some individuals, especially if they get low wages in the labour market

Means tested programs



Universal programs



Categorical programmes

■ Pros

- Better targeting: not on income, but on categories of need (at individual level): e.g. lone mothers, the disabled, long term unemployed etc.
- Less disincentive effects than means tested programmes
- Easier to detect eligibility

■ Cons

- Unfair to treat different poors differently
- Distortionary effects in meeting eligibility standards (ex: aid to lone mothers may discourage marriages).
- High administrative costs (even if lower than means testing)

In kind programmes

■ Pros

- Increase targeting efficiency (reaching the intended beneficiaries and reducing “impostors”)
- They provide access to basic rights (shelter, food, health care, education), specific egalitarianism view

■ Cons

- Administrative costs
- In some cases they are not efficient:
 - ✓ the gvt could reach the same results with cash benefits at lower costs for the taxpayer)
 - ✓ they distort individuals’ consumption patterns (induce to consume more of the good/service provided, than would otherwise as in the case of food stamps)
- Eligibility standards may produce unintended results (discourage work for example),
- Paternalistic measures.

In kind vs cash transfers

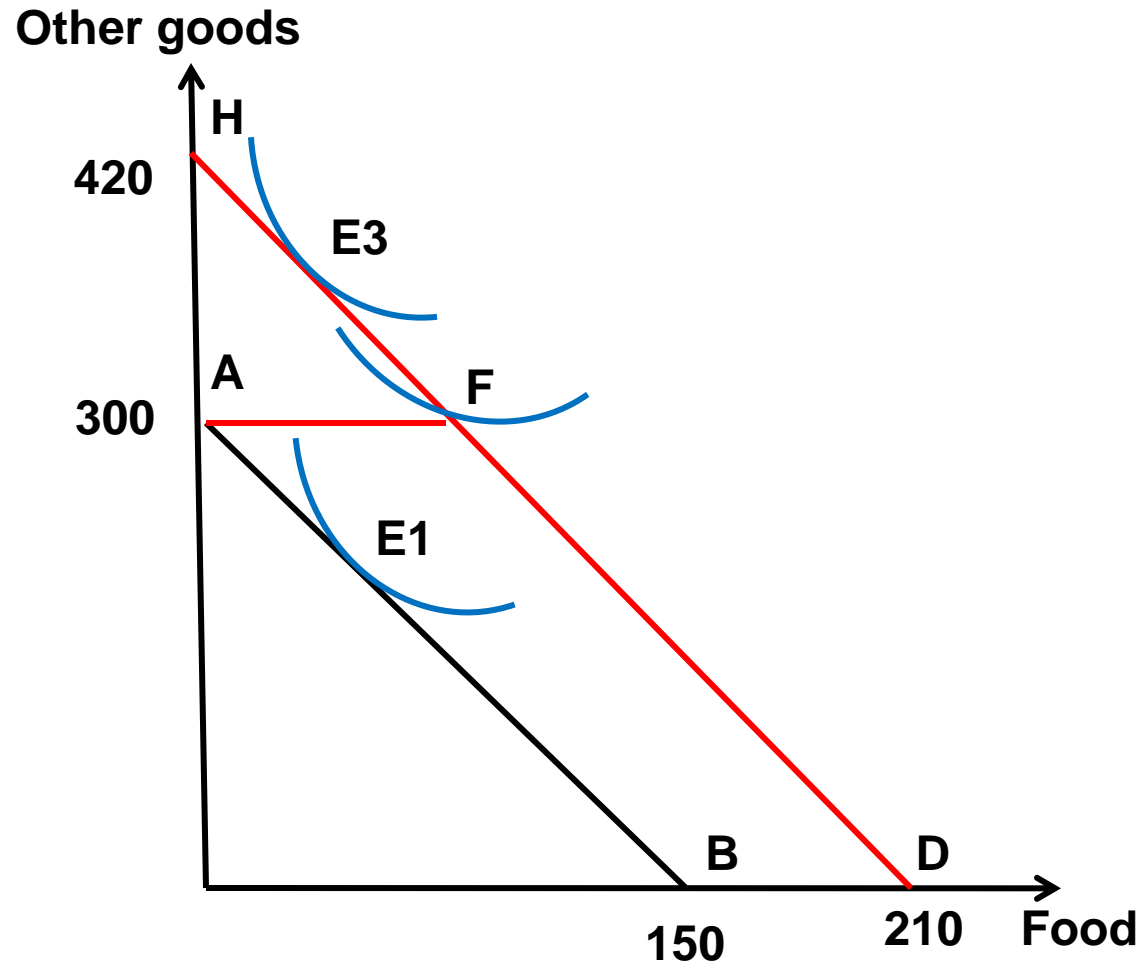
Sam has a monthly income of 300 Euro, the price of food is 2 euro per KG and the unit price of the other goods is 1 euro.

His initial budget constraint is **AB**, given his preferences his choice is point **E1**.

The gvt introduces an **in kind transfer** of 60 Kg more of food, Sam's budget constraint becomes **AFD** and Sam's best choice is now the corner point **F**. If instead the gvt gives Sam a **cash transfer** of the same cost as the in kind transfer ($60\text{kg} \times 2 \text{ euro} = 120 \text{ euro}$), Sam's new budget constraint is **HD** and he will reach a higher indifference curve and choose **E3**.

Note that these results depend on Sam's preferences.

For individuals with different preferences there could be no differences in the effects of in kind vs cash transfers.



An example: unemployment benefits/1

- Unemployment benefits offer replacement income to workers experiencing unemployment spells. In principle should protect *jobseekers* .
- The first UB system was introduced in the UK in 1911.
- Complex design to discourage opportunistic behavior: i.e. people not accepting a new job as long as the UB is available

UBs often operate in connection with other non-employment benefits (other income transfers to non-employed individuals in working age) such as:

- Social assistance of the last resort
 - Early retirement
 - Invalidity pensions
 - Sickness and housing benefits.
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Unemployment Insurance and Unemployment Assistance

UB systems usually include two components:

Unemployment Insurance (UI):

- ❑ Benefit depends on payments during past work experience
- ❑ Offers provisions proportional to past earnings
- ❑ The length of the entitlement period is dependent on the length of the contribution period.
- ❑ Some “experience-rating” (e.g., in the US) with employers paying more if they use it

Unemployment Assistance (UA):

- ❑ Accessible independently of payments during the past working experience
- ❑ Flat subsidy: provisions independent of past earnings
- ❑ Entitlement not conditional on the length of the contribution period.

Unemployment benefits / 2

- Relevant features to assess the generosity of UBs:
 - **replacement rate**: *level* of the UB relative to the previous (future) wage. Replacement rate can be computed *net* or *gross* of taxes, at different unemployment durations, for different household characteristics
 - maximum **duration** of benefits
 - **eligibility** conditions (conditions for access) and **coverage** (fraction of unemployed receiving the benefit): categorical vs. means-tested
 - **entitlement** (rules for provision including sanctions after assessment of search intensity)

Evolution of UBs

- Increasing generosity up to the 1980s, especially in Europe. Levelling off or small decline in the 1990s
 - Net replacement rate on average 2/3 higher than gross
 - Increasing sanctions for refusal of jobs or participation to active labour market policies (ALMP)
 - Relatively low coverage notably in Southern Europe (especially in Italy)
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Net Replacement Rates for four family types at two earnings levels

After tax and including family and housing benefits for *long-term* benefit recipients (1999-2000)

	APW - level				66.7% of APW – level			
	Single	Married couple	Couple 2 children	Lone parent 2 children	Single	Married couple	Couple 2 children	Lone parent 2 children
Canada	24	41	62	60	35	57	81	80
France ¹	30	28	42	43	43	41	59	60
Germany ¹	54	52	65	63	63	61	71	71
Greece ¹	8	8	10	11	8	8	11	12
Ireland ²	31	43	56	56	41	59	66	64
Italy ³	0	4	18	14	0	5	21	17
Luxembourg	50	67	75	59	70	92	93	82
Norway	66	67	74	83	65	67	82	90
Sweden ⁴	54	71	85	59	79	102	110	70
United Kingdom	46	57	80	71	66	80	88	81
United States	7	12	46	38	10	17	59	48

Note:

1. NNRs are based on SA except in France, Germany, Greece, where NNRs are based on unemployment assistance.
2. Housing benefits are not included due to very small number of recipients.
3. Social assistance (*Reddito minimo di inserimento*) is not included in Net Replacement Rates due to its experimental character (on trial in 39 municipalities). NRR are based on family benefits.
4. People in work are not entitled to social assistance.

Source: OECD tax-benefit models

Figure 12. Net replacement rates of unemployment support

Average over a long unemployment spell (60 months of unemployment), in percent

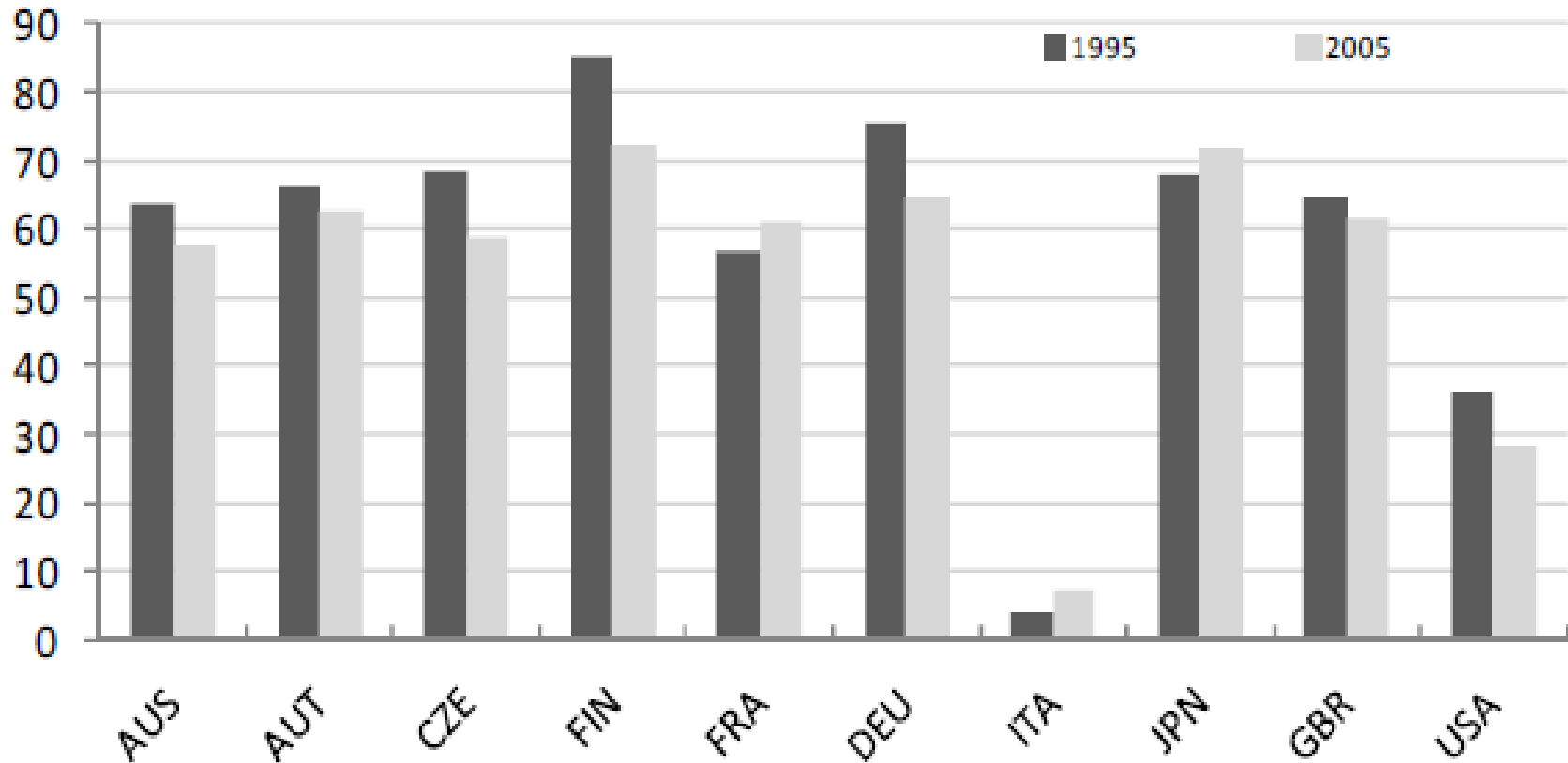
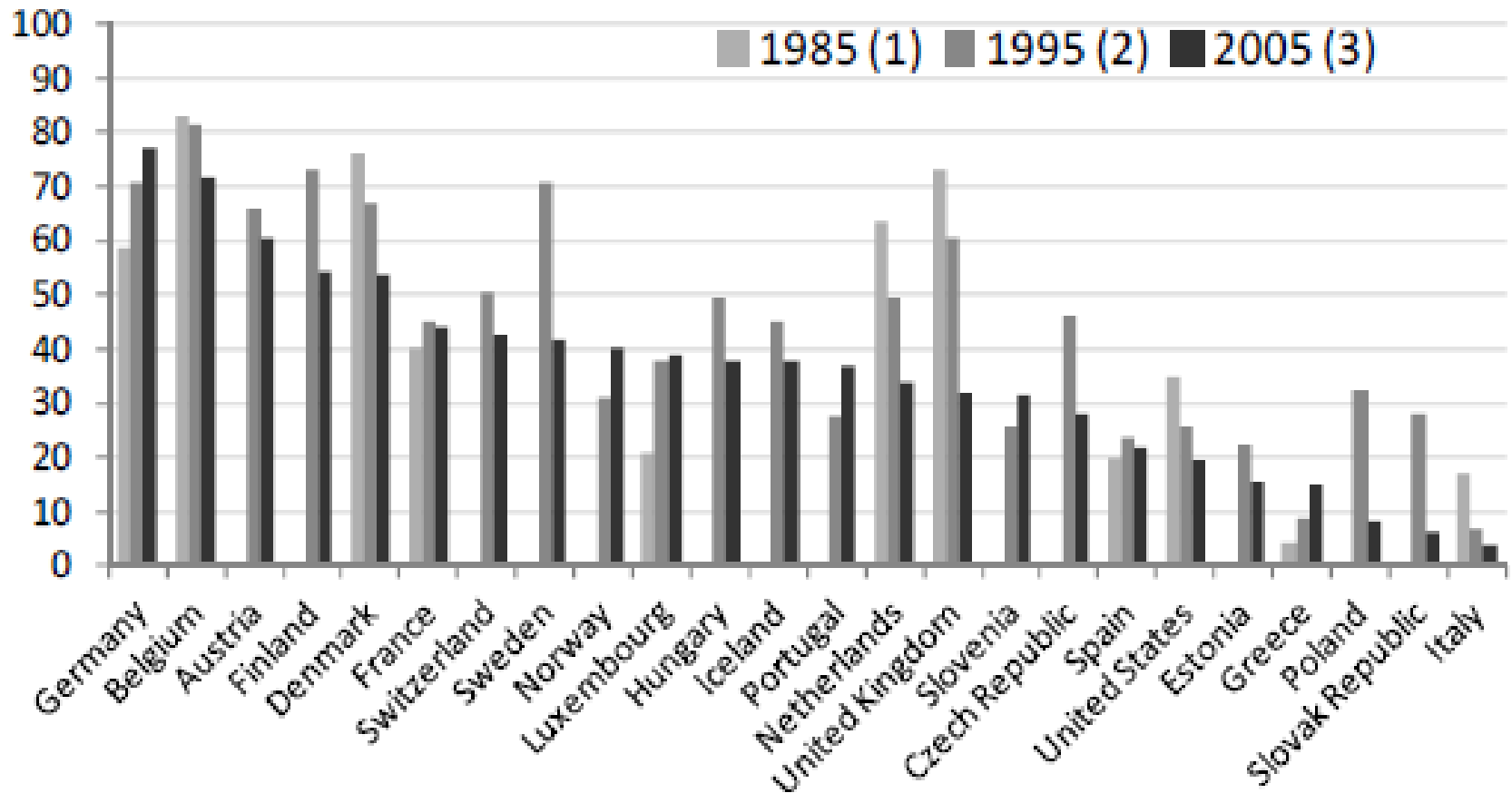


Figure 11. Unemployment benefit coverage

(a) All unemployed, in percent of ILO unemployed



Rationales for public intervention

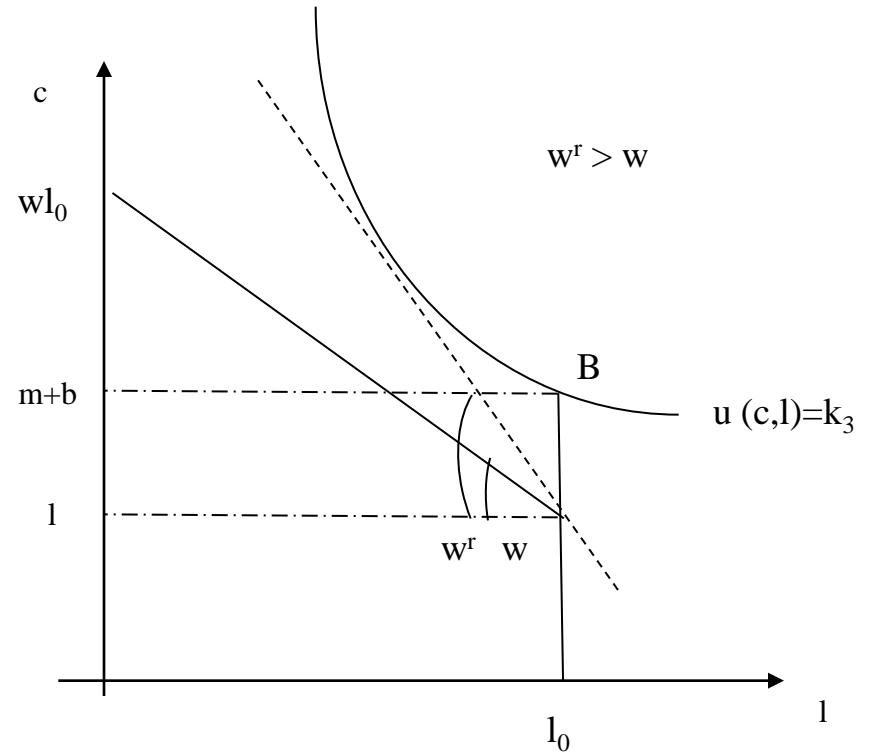
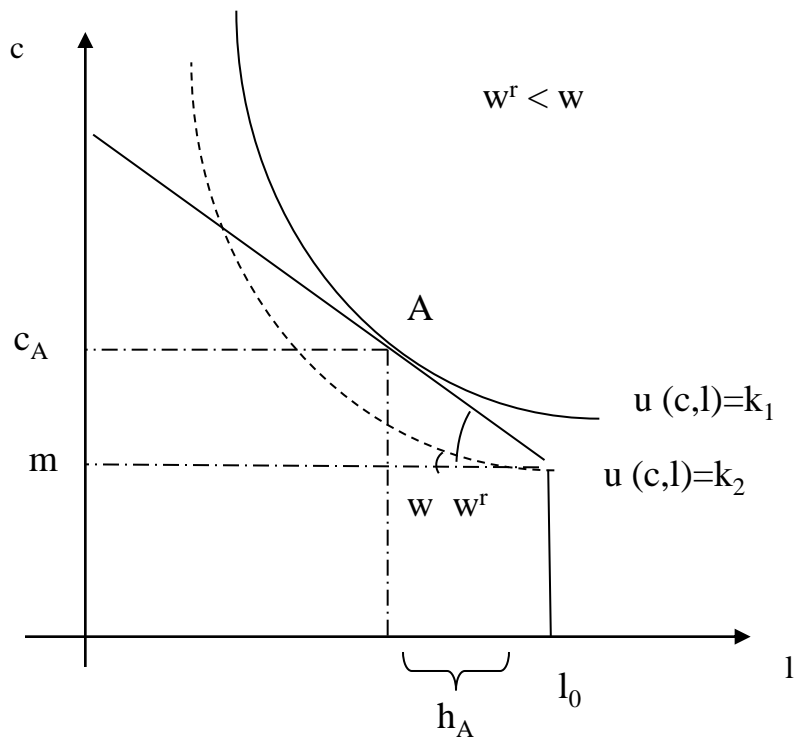
- Market failure: moral hazard and adverse selection
 - Asymmetric information.
 - Risk pooling problem: risks are correlated (e.g., during recession)
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Trade-offs in the provision of UB

- **Reduced incentives to work** (welfare dependence)
 - **Fiscal costs**
 - **Better risk sharing** (with risk-averse workers). Increase in welfare
 - **Spillovers:** workers encouraged to take risky, high-productivity jobs
 - **Subsidy to job search,** matching efficiency
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Expected effects on individual labour supply and reservation wage

- Labor/leisure choice affected by welfare benefits requiring non work
 - Substitution effect discourages work
 - Negative net wage at low working hours
 - Increase in the reservation wage of unemployed benefit *recipients*
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Reservation wage without (Left Panel) and with (Right Panel) unemployment benefits

Expected effects in Labor Markets

- Three main expected effects:
 - *Job search effect* (on the reservation wage)
 - *Wage effect* (on the bargaining outcome)
 - *Entitlement effect* (increase in participation of those not receiving Ubs)

 - Also tax effect related to funding of UBs
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Job search and wage effects

Job search effect

- UB increase the reservation wage of those receiving it: jobseekers become more choosy and only accept job offers involving a higher net wage than the UB
- Longer duration of unemployment among UB recipients.

Wage effect

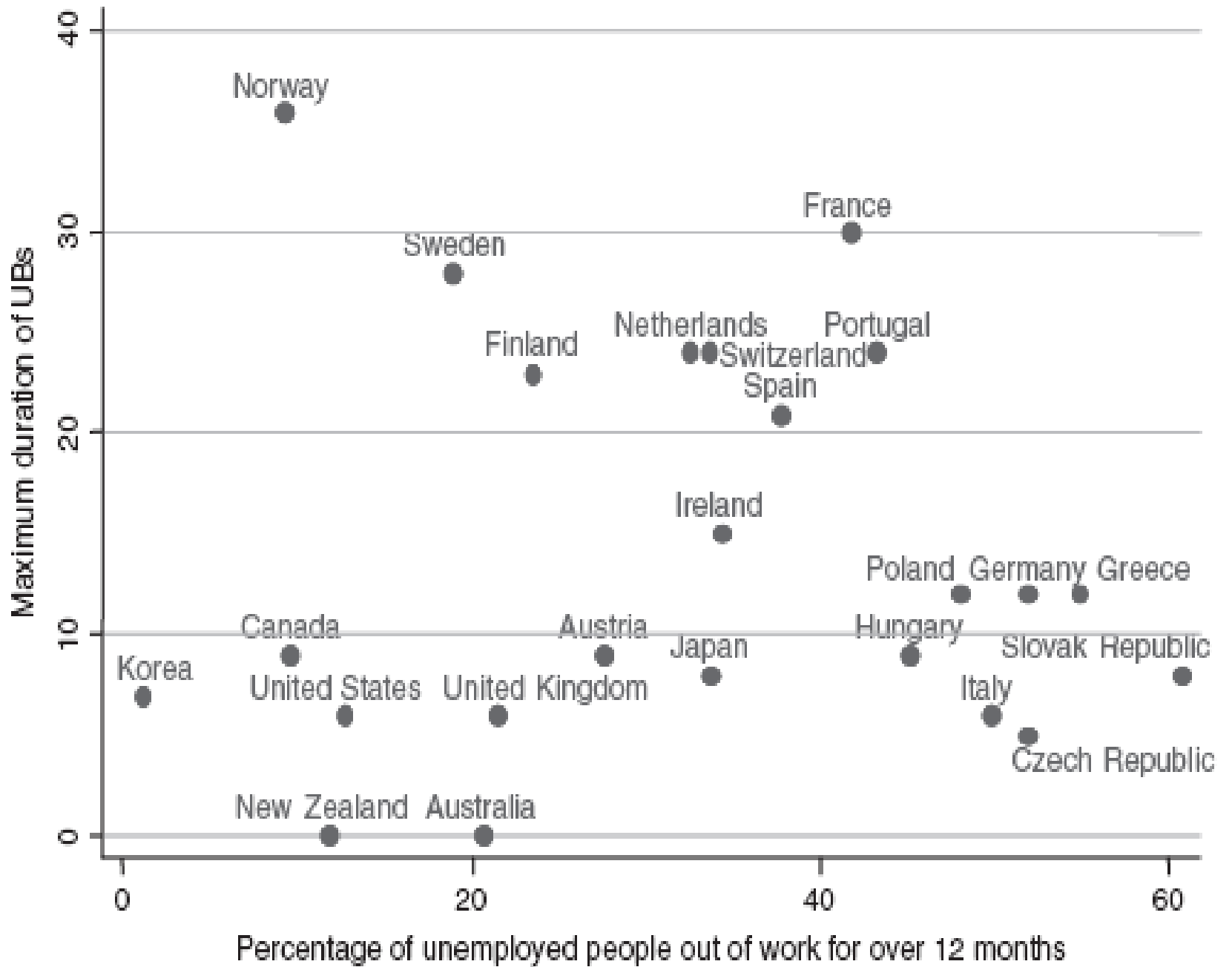
- Higher outside option of workers at the bargaining table (pure bargaining effect)
 - Higher wage is required to deter shirking (efficiency wage effect). The penalty associated with unemployment is reduced in presence of UBs
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Entitlement effect

- **UBs increase the value of employment, and this induces:**
 - Higher participation in the labor market
 - Lower reservation wage of jobseekers not receiving Ubs and higher job finding rates of unemployed not eligible to UBs.
 - Incentives to accept also risky jobs (precarious or with temporary spells) for the outsiders
 - May improve mobility in economies experiencing structural change if in the declining sector there is wage compression

Empirical evidence

- Receipt of benefits increase reported reservation wages
 - Longer duration of benefits correlated with longer duration of unemployment
 - Unemployment outflows increase in proximity of the maximum duration of benefits
 - Presence of spillovers between recipients and non-recipients of UB: also labor supply enhancing effects (as predicted by entitlement effect)
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Why do UBs exist, if they have negative effects?

- Properly designed UBs improve the allocation of human capital and thus, foster economic growth.
 - However, UBs should not be too generous in order not to discourage job search altogether and generate stagnant unemployment pools.
 - The most relevant issues do not concern whether or not a country should have a UB system, but how the system should be designed along its several dimensions. Difficult to reform once in place.
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Optimal design of UBs and agency problem

- Public provider faces the same moral-hazard problems related to the non-verifiability of search effort.
 - Ways to reduce disincentives to seek jobs:
 - Low replacement rates, declining with unemployment duration.
 - Administrative pressure on recipients.
 - Offer of slots in ALMPs as a way to elicit effort
 - Financial incentives to the take-up of jobs: premia in terms of residual benefit claims.
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Politically feasible reforms

- Exploiting the UB/EPL tradeoff, e.g., increasing the degree of experience-rating
 - Change enforcement more than rules
 - Combine benefit cuts with employment conditional benefits or wage subsidies; way to win support by employees and reduce the opposition of the unemployed
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The Trade-off between UB and EPL (late 1990s)

