

**Comment on Agnar Sandmo:
The welfare state:
a theoretical framework for justification and criticism**

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Being the discussant of Agnar Sandmo's clear and well-balanced paper is a difficult task; there is hardly any point where I disagree. It is also hard to point out important questions that are missing—or at least that have not been touched upon in his brief but nevertheless comprehensive exposition.

Nevertheless, I will do my best to be critical. First, although I do not object to Agnar Sandmo's discussion of the theoretical arguments for and against public intervention, the theoretical arguments tell us but little more than that the public sector should be greater than zero and less than one-hundred percent of the economy. I think some more quantitative precision would be interesting. Of course, there is no simple way to tell what is the optimal size of the public sector, but it would still be interesting to hear Agnar Sandmo's view on this. Maybe a broad question like that is meaningless, and one should instead discuss specific programs, but even such a discussion would add quantitative substance to the paper.

Another way of phrasing the same question is to ask how large a public sector is required to perform the classical tasks (externalities, public goods, increasing returns, and redistribution). In 1960, government spending in Sweden was less than 30 percent of GDP, a figure that had increased to 40 percent in 1970. Today, Swedish government spending amounts to between 60 and 65 percent of GDP. Does this mean that the public sector was too small in the 1960s to perform its classical tasks? Or is it too large today, spending resources on programs that are hard to justify on efficiency grounds? If so, can the rest of government spending be defended as desired redistribution, or is there a large redistribution taking place that cannot be justified on equity grounds? For example, some of the effects of agricultural policy seem to imply a redistribution from workers to (presumably wealthy) landowners. Similarly, the subsidies to the

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housing sector are regressive, distributing income from persons with incomes below the average to those above the average.¹ This was at least true in the 1980s; no recent study of the redistributive properties of the housing subsidies has been made. The same has been shown to hold for the system of supplementary pensions (ATP) that was introduced in 1960; being highly non-actuarial, the system has redistributed income in a fashion that seems strangely at odds with the official rhetoric of the politicians.²

I admit that our empirical knowledge is not sufficient to yield a very precise answer to the question of the optimal size of the public sector. Still, this is a relevant question for actual economic policy, and as such I think it should be addressed at this conference. Here Agnar Sandmo might argue that it is not a task for the academic economist to provide an answer to such a political question. But who should then do it? After all, the academic economist is a specialist on weighing marginal costs against marginal benefits, who knows the pitfalls of available data sets, and whose judgment is not biased by running for a political office. If Agnar Sandmo is not the best person to answer the difficult questions relating to the size of the public sector, then who is?

After this grand question—which might not have an answer, but which is nevertheless “the” relevant question for economic policy—I would like to raise a few minor questions. The first one deals with the view of progressive taxation as social insurance that Sandmo discusses in Section 2 of his paper. He points at a problem with this approach, namely that most of us are not behind the veil of ignorance presumed by Vickrey, Harsanyi, Rawls and the other writers in that tradition. Quite the contrary, most of us have a fairly good knowledge of our earnings capacity, and thus the veil-of-ignorance argument for progressive taxation is not relevant. However, Sandmo tries to save the argument by conjecturing that “...it gives more meaning to ask what kind of society you would like your grandchildren or great-grandchildren to grow up in.”

I wonder if this is a good analogy. I do not find it very convincing that we, by voting for progressive taxes *today*, would provide social insurance against the income uncertainty of our grandchildren and great-grandchildren. Today’s tax system does not imply any commit-

¹ Cf. Ministry of Housing (1989).

² Cf. Ståhlberg (1990, 1995).

ment to the tax system thirty or forty years from now. In fact, there are other ways of providing for our grandchildren that impose less distortions on today's economy, and that contain a stronger element of commitment. Bequests would be such a possibility, as would education.

Another minor question deals with private provision of compulsory social insurance. I fully agree with Sandmo that the theoretical arguments for social insurance do not lead to the conclusion that it should be provided by a government agency; a compulsory system, run by private insurance companies, would satisfy the theoretical criteria just as well. Reasons for having the system run by the government—which is often the case in reality—thus have to be based on transactions costs and on the possibility that competing insurance companies will spend excessive amounts on marketing. This is the argument put forth by Sandmo, as by other scholars discussing the issue.³

Now, I do not have any firm view on this, and neither has Sandmo (who only points out that "... it is far from clear that the benefits of competition would, on the whole, be positive"). But the kind of insurance we are talking of here must, almost by definition, be a very homogenous product, and most of the marketing expenditure of the insurance companies today is related to highly differentiated insurance policies that are not compulsory. We are thus talking about a true mass market, and it seems fair to assume that this particular market will conform reasonably well to the textbook case of price competition. Thus one would assume that competition, as opposed to a government monopoly, would drive down administration costs. But there is of course a difficult trade-off involved; the more freedom we allow the consumer regarding fund management, the more differentiated is the product and the greater the risk of high marketing costs.

Finally, there is one more argument in favor of privately run (but mandatory) social security systems. While there are many temptations for the political sector to interfere with the systems, and make them non-actuarial, competition will drive the private systems in the direction of increased actuarial fairness. One could argue that the main problem of most social security systems today is *not* that they are pay-as-you-go rather than funded, and *not* that the demographic struc-

³ See, for example, Diamond (1998).

tures are changing into rapidly ageing populations, but rather that the systems are non-actuarial.⁴ In such a case, actuarially fair systems would solve, or at least alleviate, most of the problems that are commonly attributed to, e.g., an ageing population. Thus competition between private insurance companies, and private contracts between the insurer and the insured, might lead to more stable and reliable systems than would state monopoly provision, based on political contracts between the insured and the government.

References

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⁴ Cf. Persson (1998) and the references cited therein.