THE PUBLIC INTEREST IN SOCIAL SECURITY: AN ECONOMIC PERSPECTIVE

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1 Introduction

In its publication on safeguarding the public interest, the Dutch Scientific Council for Government Policy (WRR) defined the public interest very broadly as any societal interest that has been made the objective of government policy.[1] Applying that definition, social security is one of the domains of societal interests for which the government has taken responsibility. From an economic point of view, the objective of social security policy is basically (a) to provide economic security for citizens against the mishaps in human life, including a basic level of income, (b) while avoiding unnecessary high costs to society. Although it perhaps takes an economist to explicitly mention the latter part, hardly any politician will deny that containment of societal costs is as much in the domain of the public interest as delivering services of good quality. The political challenge is to find the balance between, on the one hand, the benefits of providing security where it is needed and, on the other hand, the sacrifice that is involved.

From an economic perspective, the broad definition the WRR has given to the concept of public interest is not really satisfactory. It fails to provide guidance for demarcating domains. Political decision makers can draw the dividing line wherever they see fit without being criticized because of the absence of criteria. With regard to social security, the broad definition does not give any clues as to when the government should act to further or restrict its provision of social security and when it should not act.

In this chapter we shall look at the public interest in social security from the perspective of economic science. In doing so the first task is to propose criteria for demarcating the public interest domain in social security. The next step is to identify and analyze the problems encountered in furthering that public interest. The chapter on the economic perspective that follows later in the book focuses on the instruments for safeguarding the public interest in social security. Our insights are applied by studying the development of social security in the Netherlands.

This chapter is organized as follows. Section 2 defines the concept of the public interest based on an economic approach. Section 3 analyzes the economic-political life cycle in social security. Section 4 explains what market failures have contributed to the emergence of social

1 WRR, 2000, p. 20-21.

security. Section 5 explains what public sector failures hamper the efficient provision of social security. Conclusions are drawn in section 6.

2 An economic definition of the public interest

Before we define the public interest from an economic perspective, we have to say a few words about what economics actually is and what an economic perspective on social security thus entails. To explain this, it is helpful to understand that the economic system of the Netherlands is of the 'mixed economy' type: basically a market economy with a government stepping in when and where the market fails to provide in the needs of citizens. Economic science teaches us that the market is the most appropriate mechanism to satisfy human needs for private goods; that is, goods that can be individually owned. The agreement to transfer the property of a private good is a matter solely between buyer and seller, who both expect to gain from the transaction. Others remain outsiders to the contract. They have nothing to do with it and they are excluded from using the good. In contrast, the use of collective or public goods has to be shared with others. The Dutch textbook example is a dike to protect a population and its properties against high water. Procurement and maintenance of such a good needs a common decision and an organisation to implement it: the prototype of a government. The basic public goods are the provision of 'law and order', including the rule of law. Without the provision of these essential public goods a thriving market economy could not even exist, since protection of property rights and compliance with contractual commitments are the fundaments on which the market is built. Although in real life the distinction between public and private goods is not a simple matter of black and white, the conceptual difference does provide criteria for delineating the public interest domain from the sphere where the government has no responsibility.

If one accepts that the market is the basic mechanism for providing the goods and services society demands, it follows that a government which intends to pursue the public interest faces a restriction on what can be the objective of government policy. When and where the market functions properly in supplying the goods and services citizens need, the government should abstain. Safeguarding the public interest by providing security against the mishaps of life by way of public sector intervention is in place when and where the market fails in delivering security. Market failure can be due to the fact that a good is not purely private, but to some degree public. Another source of market failure is lack of competition. It will lead to prices that are too high relative to their quality. The market will also fail when consumers are ill-informed and incapable of assessing the value of the product.

To identify and assess market failures, economists investigate the impact of market arrangements on the welfare of society. Citizens have wants they aspire to satisfy. They make sacrifices to get the goods and services they need and which are beneficial to them. Economics brings the sacrifices and the satisfactions under the measuring rod of money. Satisfaction or benefits is expressed as the maximum amount of money a person is willing to pay for the object of desire. The efforts and sacrifices or costs to bring the object forward are also measured in terms of money. What counts are the net benefits or surplus: the benefits obtained minus the costs made. A market failure is a failure because the market arrangement does not bring in the full net benefits. And a public sector arrangement to correct the market failure has to provide higher benefits than costs. Some will win, others may lose as a result of the

intervention; but if the benefits exceed the costs, the losers can be fully compensated without depleting the benefits and net gains will remain some. In that case, economists say, the criteria of 'potential Pareto efficiency' is satisfied, meaning that the winners could, in principle, compensate the losers.[2]

From all this, it follows that the economist will define the public interest as maximizing net benefits to society. Governments should focus on constellations and developments that threaten the maximization of net benefits and look for options to redress them. Government interventions with intentions other than increasing societal welfare cannot be defended from an economic perspective as being in the public interest.
Applied to social security, the economic prescription is that the government should identify the market failures in providing security and create net benefits by designing and implementing a social security policy that corrects the market failures. In the next two sections we shall see whether the government has indeed followed the prescriptions of economic science and focused on intervening where the market failed to provide an adequate level and quality of social security.

Apart from the question whether or not the correction of market failures has been the major reason for drawing social security into the public interest domain, it is evident that the involvement of the national government of the Netherlands in social security insurance and in providing safety nets for the uninsured has expanded immensely. It expanded from next to nothing a hundred years ago to about ten percent of net national income in 1960, to twenty seven percent in 1980 and thirty percent in 2008.[3] Unfortunately, not only markets can fail, but governments can fail too. The ambition is to build and maintain a high quality, efficient and balanced system of social security. However, in this process, inefficiencies and imbalance between the benefits and the costs of social security may turn up. Instead of being the solution to market failure, the public sector then has become (part of) the problem. If this occurs, the public interest in social security has to be redefined as identifying the public sector failures and creating net benefits by redressing them. In the next sections we shall see whether actual developments in the Netherlands correspond with our economic prescription of the public interest. Has the view on what the public interest in social security is changed and have public sector failures been perceived and corrected?

In sum, the economist's view on what the public interest in social security is, has been defined as (a) correcting the market failures in the private provision of security as well as (b) identifying and correcting the public sector failures in the public supply of social security. Our definition of the public interest corresponds with the approach of Teulings et al.,[4] but rather than focusing on externalities and market failures in general, we introduce the concept of so-called 'caring externalities', as we will explain below, and perhaps lean even more heavily on identifying and remedying public sector failures. One could say that our economic approach is the same as that of Teulings et al.[5] But that there are some differences as to how the economic view is worked out, basically since we focus on the development of one specific sector.

2 e.g. Hochman and Rogers 1969.

3 For 1960 and 1980 data see Nentjes 1989. For 2008 calculations are based on CBS data: *sociale beschermingsuitkeringen* as percentage of *netto nationaal inkomen*.

4 Tuelings et al 2003.

5 Tuelings et al 2003.

The task in the next sections is to investigate how suitable this economic interpretation is in presenting and understanding actual developments in social security. Do the decisions taken by the government match the 'idealisation' of economic theory? We shall give our verdict in the final section of this chapter.

3 The economic-political life cycle in social security

The national system of social security in The Netherlands was built up between the year 1900 and the 1970s.[6] In those years the gaps in existing social security supplied voluntarily through the market were one of the major political issues, hand in hand with the political urge to close those gaps through a form of government involvement.[7] Political discussions framed the public interest mainly in terms of the benefits to be reaped from an encompassing framework of social security, replacing the earlier ramshackle private arrangements. In building up the national system of social security, the cost side was not totally neglected. However, the cost burden and its economic repercussions were not perceived as a major bottleneck and hardly as a component of the public interest in need of surveillance.

After completion of the social security structure in the 1970s, the political discussion on social security made a U-turn. In the face of growing evidence that the post-war decades of strong economic growth and full employment were over, most politicians began to accept from the late 1970s onwards that the steady expansion of social security had been and still was a major driving force behind the rise in labour costs with dramatic negative impacts on employment and economic growth. Implicitly the concept of the public interest was redefined: instead of expansion and deepening of social security arrangements, the containment of their costs in order to save employment made the political agenda. The global political trend of the nineteen eighties is best caught in Reagan's words on becoming president of the U.S. in 1981: 'Government is not the solution to our problem; government is the problem'. In the Netherlands, social security provided by the public sector started to be viewed no longer as the solution (to market failure), but as a problem (of rising costs). The public interest was defined now as spotting the public sector failures in providing social security. The public sector failure had two dimensions. The first one was that many entitlements were seen as 'over the top' and no longer affordable. Curtailing the levels, for instance a lowering of employment benefits, was the remedy here: technically simple, but politically extremely difficult. The largest contribution to the reduction of public expenditure did indeed come from this source. The second dimension of public sector failure was inefficiency in the organisation of providing social security. In the effort to eliminate the waste of scarce resources, criteria for eligibility have been made more strict and other changes were enacted, among them the incorporation of market elements in the social security system. Most of the reforms and the motivations given reflect mainstream economic thinking on incentives and other causes of regulatory and organisational inefficiency.

In the first decade of the twenty-first century the government has continued its efforts to improve efficiency and to reassess the balance between the benefits and the costs of the vari-

6 e.g. Nentjes 1989; Postma 1995; Roebroek & Hertogh 1998.

7 e.g. Woerdman 2009.

ous social security services. But one can also observe a reaction of critical journalists, social and legal scientists as well as politicians who fear that cost containment actions have gone too far. The phrase 'paradigm change' was even used: a switch from providing security and income protection to making social security subservient to economic interests, such as a well-functioning labour market.[8] The criticism often tallies with a distrust of - if not aversion against - the infusion of market elements in social security legislation. The critics tend to identify the public interest in social security with quality of service in supporting people in need and prevention of economic insecurity and anxiety. They recommended a caring public sector not driven by profit-making motives, and in particular not in health care, as the best approach to safeguard that public interest. Cost considerations do not seem to be much of an issue for them. Are these the first signals of a new and third stage in the political life cycle of social security? Probably not in the near future. The huge government expenditure made to counter the financial and economic crises from 2007 to 2010 and the consequent increase in public debt will urge a critical review of government tasks. Social security will not escape unnoticed. Looking further ahead one can only say that time will tell which way we are going.

4 Market failure and the emergence of social security

In the Netherlands, provision of social security has evolved from being predominantly a private affair to a public arrangement, along two different routes. Development type 1, discussed in subsection 4.1, deals with mandatory insurance which started and developed as social security for wage-dependent workers, with the government using public regulation to secure insurance. Development type 2, surveyed in subsection 4.2, deals with social security that encompasses all citizens and in particular aims to provide security for people with low income. It appeared later on the national scene, but had a long history at the local level. The economic arguments for government action are very distinct for the two domains. In this section, we shall investigate whether market failure was indeed the major reason for the government to take an interest in the two types of security against the economic mishaps in life.

4.1 Mandatory insurance for wage-dependent workers

Individually unpredictable incidents, which lead to loss of income or extremely high expenditures, are a fact of life. Basically it is possible to protect oneself against the financial consequences of such situations through transactions in private goods. A first line of defence is via building up a capital buffer through saving. When accumulated savings fall short, loans can be taken and be repaid when the tide has turned. Private financial security is for sale in the form of insurance: against costs of health care and loss of income due to illness, invalidity and old age. In extended families or close knit communities, the social network and the social norm of mutual help, can be viewed as a type of insurance in kind: a complement to or an alternative for the individual capital buffer and private insurance bought in the market. Historically, these private mechanisms of providing security have been the way people sought to protect themselves against the misfortunes that life might bestow on them.

8 Asscher-Vonk 2005.

The Dutch national government began to take an interest in social security issues and expanded its involvement during the twentieth century because it took the view that the private mechanisms of security provision fell short of what was required. Looking at the broad spectre of social security as it exists today, the signal seems to be that private provision of security failed in virtually all its various domains. Traditionally the extended family and local communities had provided mutual help. But due to the rise of factory labour and the growth of an urban proletariat - in the Netherlands from about 1870 onwards, the traditional systems of support were crumbling. Insurance provided within trade unions offered only a partial substitute. The intermittence of prosperity and depression in the industry brought new uncertainties about the continuity of employment and income. The suffering of the incapacitated and ill unable to work, of capable workers unable to find work, and of old people living in poverty were visible enough in cities for those of the middle and higher classes who were willing to look. The 'social question' appeared on the political agenda and at the beginning of the twentieth century it had become politically widely accepted that there were serious defects in the provision of security for the wage-dependent part of the population and that the government could not abstain. From a substantial part of the organized workers, the discontent came to the fore as a political outcry against capitalism, that is, against the market economy: a potential political time bomb. The concentration of the labour proletariat in towns and cities had already become a political force well before the extension of the political vote and even more so thereafter.

In the end, the government intervened. But was this a reaction to market failure, or were other considerations involved? For an answer, one has to look at the specific laws that successively came into being in the Netherlands. The very first 'social' law of 1874, on labour by women and children, aimed to protect those deemed unable to protect themselves from abuse. Welfare economics is based on the premise that individuals can make their own choices – and they should have the freedom to do so as long as their choices don't cause damage to others. Not being able or not being allowed to make one's own deliberate choices can therefore be viewed as a market failure. The Accident Law of 1901 made it mandatory for employers to take out insurance against the financial consequences of liability for the incapacity of their workers due to accidents during work. One can view the law as the correction of the market failure consisting of the risk that the employer goes bankrupt, leaving the victim of the accident without financial payment.

The next three social security laws - on Illness (1913), Incapacity (1913) and Old Age (1919) - also involved the employer taking out mandatory insurance for his workers. But here the market failure is far less evident. The major reason why private insurance was often not taken out was most probably a lack of income, if not the sheer poverty of the wage earner. The urgent needs of today had to be met, leaving no money to provide for a future that never might come. An insurance market could thus not develop, since the demand for voluntary, private insurance was absent. Low income is not necessarily a market failure requiring government intervention. Suppose that labourers had been given the choice between mandatory insurance and receiving the equivalent of the insurance premium paid by the employer in cash. If they would have chosen the latter option, the logic of economic theory compels us to conclude that, in this case, social insurance was not a correction of an evident market failure. It appears more like political decision makers expressing their paternalistic preferences in an effort to meet the political demands of trade unions half way. Trade unions could accept mandatory

insurance as an exaction from greedy bosses, but the legislator would never have imposed a mandatory wage increase. To make a case for market failure, considerations other than low income have to be put forward against voluntary private insurance. Well-known bottlenecks in insurance are moral hazard – the insured person takes less care to avoid risks covered by insurance – and adverse selection – only 'bad risks' take out insurance. Commercial insurers counter the bottlenecks by not covering the full damage, by differentiation of premium and by refusing to insure persons with risks that are too. This means that the market can cope with the potential bottlenecks of private insurance. Consequently, from the perspective of economics, those bottlenecks are not a sound argument for public intervention. However, the so-called 'bad risks' unable to find insurance against loss of income due to illness and incapacity will be the ones that are most vulnerable. Socially and politically that is difficult to accept and social security legislation offered a way out. In the name of solidarity, the financial burden of including this high-cost category was distributed over the total number of insured workers in the form of a higher insurance contribution . Nevertheless, the equivalence between the contribution paid and claims on payments - a major feature of private insurance – was maintained in the social insurance arrangements. Of the social insurance arrangements for wage earners that followed in the later decades of the twentieth century, the insurance providing income during unemployment (1949) and the insurance in case of incapacity to work (1966) showed the same equivalence. Insurance providing children's allowances (1939) and insurance covering the costs of health care (1964) are the exception: the insurance contribution was income-dependent, while payments were equal or dependent on health care expenditure.

Given the characteristics of the aforementioned social security laws, it would not be correct to view the development of social insurance wage-dependent workers as an ongoing correction of failing markets for private insurance. Suppose that the government had not intervened, then private insurance on a voluntary basis or as an ingredient of collective labour contracts would probably have developed, following the rather steady increase in income. This is in particular likely for the types of social insurance where the relation between insurance contribution and payments is based on the so-called equivalence principle. Outstanding examples in the Netherlands are insurance of employees against loss of income due to unemployment, illness and labour incapacity. With voluntary instead of mandatory insurance, coverage would of course have been lower and more workers would have taken recourse to the arrangements that will be discussed hereafter.

We conclude that social insurance of wage-dependent workers is not the outcome of ongoing efforts to safeguard the public interest against market failure. So the scheme developed in section 2 does not apply. In our view, a better interpretation is the paternalism of the legislator. Wage-dependent workers were restricted in making their own choices with regard to taking out insurance against risky incidents by a government that intended to protect them against - what it saw as - short-comings in caution. Putting it somewhat more provokingly: it was an exercise in disciplining the wage earning population in its spending pattern.

4.2 Social security through vertical redistribution

Type 2 social security, dealing with vertical redistribution, was built up in the nineteen fifties and sixties. The arrangements cover all citizens. Entitlements to benefits are equal for all,

but insurance premiums are proportional to taxable income up to a maximum. So transfer of income is an inseparable part of the scheme. In the Netherlands, social insurance against loss of income due to old age and the national insurance against the costs of health care fit in this category. Poor relief to provide income support to people with either no income or an income below the poverty line has a similar structure, but that is financed by taxes and not through insurance contributions. This type 2 social security is a more suitable candidate for market failure than type 1 treated above, for reasons to be explained hereafter.

In his *Theory of Moral Sentiments* (1759), Adam Smith noted that normal human beings have the innate capacity of sympathizing, based on the ability to see oneself in the position of the other. As a result, a person is not indifferent to another's suffering. Modern economics has conceptualized the phenomenon as a special type of externality. Positive externalities are the enjoyment of benefits created by others for which one pays less than the costs or for which one pays nothing at all. Negative externalities are the damage and suffering one undergoes without being compensated by those who caused it. Applied to social security issues, the negative externality is, for example, the lamentable state of individual A that makes individual B feel less well. Spending money on help for A will raise the well-being of B. There is a voluntary transfer either in money or in kind that raises the welfare of both receiver and donor. The 'caring externality', as it is called, is 'internalized'.[9] For many decades, care for orphans, poor elderly people, the sick and the invalidated came from private action as a result of the charity of the local aristocracy, churches, religious orders and civil organisations. Donations or provision in kind were voluntary. Only the 'deserving poor' were eligible for support; circumstances and behaviour distinguished them from the undeserving. Although voluntary care worked, it did so imperfectly. Caring citizens could observe that many people in distress remained without adequate help. The major problem undermining the private provision of charity is its public good property. When a public good is supplied, many enjoy the benefits: the persons that made sacrifices for its production, but also those who remained inactive. The same is true for charity. Free-riders can enjoy the fact that needy persons are supported without sharing in the cost. It undermines the incentive to contribute voluntarily. The larger the potential donor group is, the stronger the free-riding effect is and therefore scaling up from differentiated local provision to a uniform national scheme increases the problem. The caring person is willing to pay, but his actual payment will suffer if he sees that the good is supplied anyway and that his personal sacrifice hardly makes a difference. Considering society at large, there is a willingness to pay, but only a part of it can be extracted from the potential donors. As a result, caring externalities are not fully internalised and the supply of care motivated by altruism falls short of the efficient level of full internalisation.

Fundamentally, the problem of a shortfall in the supply of charity is similar to the disincentive for the voluntary production of a classic public good, such as law and order. The solution that emerged in history is also similar. Where gaps in the provision of charity were visible, the public authority stepped in. To prevent the situation in which free-riding undermines social care, citizens accept that contributions to finance its provision are collected from those who are financially able, if necessary by using force. Local governments were the first to do this. Orphanages financed by the local authorities have a history of centuries. In the Netherlands,

9 See e.g. Collard 1978; Culyer 1980; Nentjes 1989.

the first national legislation on poor relief dates from 1800,[10] although national schemes of social security with uniform eligibility criteria entitling individuals to uniform benefits, and financed through income-dependent insurance contributions or taxes, were built up much later, in the second half of the twentieth century. The economic argument for public sector involvement is a threat of market failure if the redistribution of income from rich to poor, based on caring, were left to the market. Active government intervention is required to avoid market failure and to ensure adequate social care. In other words: voluntary redistribution of income meets the economic definition of the public interest.

The big question is whether the above theoretical contemplation is of any use in explaining the real world. First, what do we know about the actual redistribution in the domain of social care? Second, is it plausible that this redistribution is fully based on the caring and voluntariness of those who make the net contributions?

To answer the first question about actual redistribution, the most informative publication is, in our view, Ter Rele.[11] He shows which groups benefit from and pay for diverse public arrangements in the Netherlands. The information in table 1 refers to the arrangements existing in 2003 and 2004. They encompass a broader category than narrowly defined social security and include the benefits from public housing arrangements and benefits in kind from private goods that are provided for free, such as education. The transfer column consists mainly of social security expenditure. As one can see, they are more or less evenly distributed over educational classes. Benefits in kind are dominated by the cost of education. It explains why higher education levels have the highest benefits. In housing arrangements, low incomes benefit from rent subsidies and high incomes and even more from tax exemption for interest on mortgages. In total benefits there is no systematic differentiation between the educational levels. The group with only higher secondary education has the lowest benefits; ten percent less than persons with basic education only and almost thirty percent less than those with university education, who have the highest benefits. The most striking fact is that overall the differences in total benefits between the educational categories are not big.

Table 1. Total lifelong benefits from collective arrangements (present values, in thousand euros)

	Transfers	Benefits in kind	Housing arrangements	Total
Basic education	86.7	167.7	17.8	272.2
Lower secondary	85.1	158.8	14.6	258.5
Higher secondary	85.5	150.5	15.7	251.7
Intermediate vocational	85.6	171.2	14.6	271.4
Higher vocational	88.5	166.2	27.5	282.2
University	88.5	197.9	35.2	321.6

(Ter Rele, 2005, table 4.4, p. 30)

10 Postma, 1995.

11 Ter Rele, 2005.

However, the picture changes if the payments for the public expenditures are included. Income taxes and value-added taxes (VAT) rise with educational level, as is shown in table 2. A relatively equal distribution of benefits in combination with a progressively increasing contribution to the costs of the arrangement leads to vertical redistribution.

Table 2: Lifelong income, benefits and taxes (present values, in thousand euros)

	Net labour income	Total benefits	Taxes	Taxes as percentage of benefits
Basic education	294.1	272.2	155.6	57%
Lower secondary	384.5	258.5	204.5	79%
Higher secondary	554.0	251.7	302.0	120%
Intermediate vocational	569.9	271.4	304.0	112%
Higher vocational	769.6	282.2	421.3	149%
University	1043.7	321.6	569.4	177%

(Based on Ter Rele 2005, tables 3.1, 4.4 and 5.1)

The two lowest levels in education receive on average per person more in benefits over their lifetime than is paid in taxes. They can be supporters of the caring state for selfish reasons. The call on solidarity starts at the level of the middle group: individuals with higher secondary and intermediate vocational education pay over their lifetime ten to twenty percent more in taxes than they receive in benefits. From people with higher education considerably more is expected. They have the highest total benefits, but that is far surpassed by higher taxation. There is a systematic and substantial redistribution from the ‘rich’ to the ‘poor’. The *net lifelong payments* for people with a university degree are 247.800 euro. On the contrary, the group with basic education has positive *net lifelong benefits* of 116.600 euro.

The second question, posed above, was whether all that redistribution is voluntary, based on the caring of the citizens who make the net contributions. If so, the result is a so-called ‘Pareto-efficient’ redistribution, since it leaves some better off and no-one worse off.[12] The figures of table 2 show that a substantial vertical redistribution indeed exists in the Netherlands. Therefore, on the one hand, the hypothesis that government action in the Netherland is solidly based on altruism or caring cannot be falsified. On the other hand, the existence of vertical redistribution is not proof that solidarity really exists to such a degree. Vertical redistribution may be supported by those who pay for it for selfish reasons, I addition they may see the arrangements as an insurance in case either they or their close relatives hit hard times economically. Or vertical redistribution is accepted as the price to be paid for political stability.

However, one should not neglect the option of explaining vertical redistribution more or less as a symptom of social conflict, where the other theories rather see consensus.[13] Vertical redistribution is then supposed to be involuntary. In a democracy, the majority of voters, with

12 Hochman and Rogers 1969.

13 e.g. Nozick 1974.

an income level below the national average income per person, have the political power to exact 'surplus' income from the minority, earning an above average personal income, against their will: the Marxian notion of exploitation turned upside down, if you will.[14] Although constraints such as 'voting with the feet' by emigration of the rich, capital flight and negative economic repercussions will mitigate the degree of exploitation of the 'rich' by the 'poor', involuntary redistribution is a possibility that cannot be excluded *a priori*.
Considering the political economy of redistribution further, one can also think of potential political coalitions. Middle incomes hold the key, since the median voter makes the difference between winning or losing the elections, or the coalition formations. Since the highest 'rents' can be extracted from the 'rich', Tullock predicts a coalition of low and middle incomes taking from the rich where middle incomes benefit proportionally more thanks to their strategic position.[15]

Remarkably, as far as we can see, no empirical research has been done in the Netherlands to test these diverse theories. However, by using the figures of Ter Rele[16], we can give an indication. In Table 3 the educational levels, which correspond with lifelong income levels, have been aggregated to three classes. The same has been done for taxes plus social premiums as a percentage of the lifelong benefits of various arrangements. In the third column our calculation is presented of the percentage of voters in each class (based on CBS data).

Table 3: Tax-benefit ratio per group of voters

Educational and income level	Percentage of all voters	Tax-benefit ratio
Lower	38%	69%
Middle	38%	114%
Higher	24%	158%

(First and third column based on Ter Rele 2005; second column own calculation derived from CBS data for 2004)

From Table 3 one can conclude that a simple political–economy model with a low income group exploiting a high income group is a democratic impossibility. There is no majority of voters which might support that option. A coalition is thus necessary. Neither is Tullock's postulate supported by the evidence of Table 3 that middle incomes will profit excessively from their coalition with the low income group to exploit the rich. Middle incomes rather turn out to be net contributors. The figures suggest that instead of exploiting their median voter position to extract high net benefits through redistribution, the middle income group shows solidarity or, in other words, 'caring' by cofinancing the low income group's consumption of welfare arrangements. It seems a plausible conclusion, since the degree of revealed caring is a modest 14 percent. The call on the high income group is considerably larger: 58 percent. On the one hand, one can have doubts as to whether such a high contribution would be offered on a voluntary basis. On the other hand, the expectation that on further investigation the high income's degree of caring would appear to be above 14 percent seems reasonable to us.

14 Downs 1957.
15 Tullock 1971.
16 Ter Rele 2005.

In conclusion, our reasoned guess is that of a mixed picture: a considerable part of vertical income redistribution is voluntary and another part, in particular a fraction of the net contributions of the high income group, is involuntary.

Involuntary redistribution has benefits for those who receive and costs for those who pay. Economic science offers no criteria to judge whether the transfer in itself is a good or a bad thing. However, it has the conceptual tools to analyse the repercussions on national welfare, conceived as total net benefits. Whether these are positive or negative is a matter for empirical research. In section 5 we come back to the issue.

In sum, it has been argued in this subsection that type 2 social security can be considered to be a welfare enhancing correction of market failure, and therefore meets the economic criteria for being in the public interest domain, in so far as it is based on the caring motive or is accepted as collectively organised self-insurance. Although we found a substantial vertical redistribution in the Netherlands, that alone is insufficient to serve as proof that social security of type 2 meets the criteria and does increase welfare. In so far as income redistribution is forced upon citizens and against their own preferences, economic theory sees it as a government intervention outside the economically demarcated public interest domain. As a participant in the political arena, the economist may support such policies for social reasons. As a professional economist he will see that next to the direct benefits for those who receive and possibly the indirect positive economic impacts there is also reason to worry about the negative impacts on the economic incentives of those who are forced to pay and on the negative repercussions on national income.

The question posed earlier with regard to the extent to which market failure has been a leading motive for the public interest in social security in the Netherlands has received a mixed answer. We have basically identified three driving forces behind social security legislation: paternalistic correction of perceived lack of prudence of wage-dependent workers, politically forced involuntary redistribution and voluntary redistribution either to internalize caring externalities or as self-insurance. Only in so far as the arrangements have been based on voluntary redistribution can they unequivocally be classified as public intervention to correct market failure. And only insofar as social security services can be retraced to this motive, can welfare economics welcome the policy as safeguarding the public interest by increasing national welfare. As for the first two motives, the judgement of whether public intervention has served the public interest depends on one's political views. Economic research can shed light on the distribution of the benefits and costs between groups and may help to inform the general public on its findings.

5 Public sector failures and the reform of social security

Whatever the precise motives of the government may have been in becoming involved in the provision of social security to its citizens, the fact is that in the twentieth century social security has developed as a public sector provision. Throughout its lifetime of about two hundred fifty years, economic science has focused in particular on how markets work and how they may fail, but also on how governments work and how they may fail. Public finance is about as old as general economic theory and in the past four decades an even more specialised branch

of economics has emerged, called public choice, or (new) political economy. Among the other issues investigated is how the public sector can fail in his task of serving the public interest. The public interest is conceived here as maximum net benefits for all citizens. Public sector failure is creating or letting in existence public arrangements of which the net benefits are either lower than what could be achieved or even negative.

The literature has come up with a list of potential failures for organisations in the public sector.[17] In this section, the concept of public sector failures will be introduced and applied to social security to see how suitable they are for explaining the changes that have been made in social security after the U-turn of the nineteen eighties when the focus of politics shifted from expanding and raising the level of social security to revisiting and trimming the system. The public sector failures to be discussed are basically too much production, too much consumption, too little choice for clients, too high costs for the quality provided and too little innovation. We shall investigate whether actual changes made in social security arrangements, and the arguments for them, can be fitted into the scheme of public sector failures or whether they have another origin.

5.1 Overproduction

In the economic literature on public sector failures one can be sure to come across overproduction as a major problem Production is excessive if at the margin the value for its consumers is lower than the cost of providing the output. Net benefits of the redundant part of production are negative: valuable inputs are transformed into output of lower value.

The phenomenon of overproduction has been analyzed using different approaches. Underlying all of them is the view of the public sector as a centrally planned system, suffering from the same economic weaknesses that ultimately led to the collapse of the communist systems at the end of the twentieth century. Applied to social security, one can point out that users of social security services do not directly pay for the service rendered. The finance comes from the government budget or from social insurance contributions. Consequently, which is essential from an economic point of view, consumer preferences are not revealed to the suppliers of the social service. The market's function of signaling the demand for the service is taken over by a national bureaucracy planning the quantity and quality of the service provided as part of the social arrangement. Since market signals are lacking, the planner needs a different clue with regard to how much to provide and of what quality. He has to gather and process relevant information on needs and costs and on the basis of this information he decides. But the capacity of the central organization has its limits. Imperfections in planning may lead to wrong choices. Mistakes alone can cause the planner to err on either side: quantity or quality can be either too much, or too little. However, other forces also have to play a role systematic overproduction.

Niskanen suggested the explanation that the bureaucratic administrator may not be the politician's neutral agent as portrayed by Weber, but has its own objective of maximizing the budget.[18] If true, the bureaucracy tends to produce more public output than the efficient level.

17 e.g. Hanush 1983; Recktenwald 1980; 1984.
18 Niskanen 1971.

Since Niskanen's publication the focus of theoretical analyses has shifted to the role of interest groups lobbying for higher budgets. The theory of rent-seeking analyses the strategies of interest groups trying to extract public expenditures or regulation that serves their special interests.[19] Political decision makers are an attractive target for rent-seekers, since they can provide goods or services for free while the costs will be borne by someone else. Successful rent-seeking feeds overproduction. In social security trade unions are major interest groups, although their pressure is mitigated by having to take into account the negative impacts that rising costs of social security might have on employment. Employers' organisations act rather as a countervailing power by demanding restraint from the politicians . In the past three decades trade unions and other interest groups have acted most manifestly in organizing resistance against government decisions to trim or reform arrangements in social security.

Bureaucrats and interest groups may push for more and better social security arrangements and resist cuts and restrictions, but in the end politicians decide. Ideologies and views on social security differ between parties, yet what is most striking is the broad political consensus in bringing about social security legislation.[20] Over time it resulted in a development characterised by de Swaan as 'a long squib and late explosion'.[21] The squib refers to the comparatively slow growth during the first half of the twentieth century. The explosion came in the period from 1950 to 1980: social security expenditure expanded from hardly 6 percent of the national income to more than 28 percent, following the introduction of the type 2 social legislation.[22] The new social arrangements coming into force in the 1950s and 1960s were carried by a broad political consensus. In those economically booming years there was little attention for the economic cost of maintaining such an all compassing system of collectively provided security. Only in the 1970s, when the international economic tide turned did the full financial and economic consequences become visible and start to become a political worry. The public choice theories of bureaucracy and rent seeking are of little help to explain that turn. We rather think that the story of unforeseen consequences of decisions taken earlier applies here. Part of the explanation is the tendency to extrapolate present favourable developments into the nearby future. However, the 1970s were very different from the two foregoing decades. Once the new safety nets were in place, it turned out that not only did they function to support the victims of social accidents, but they were a potential invitation to make use of the available facilities. As a cause of the fast increase in the number of persons dependent on social security, it went hand in hand with the increase in unemployment due to the slowdown of economic growth and the subsequent deep depression from 1979 to 1983. The combination of social security expenditure going up (the nominator) and a stagnating national income (the denominator) led to a rapid rise in the relative costs of social security as well as a steadily increasing deficit in the government budget. The train of events took the political body by surprise. One additional explanation for the late and hard awakening is that social security financed by insurance contributions was not included in the government budget, but set apart in public social security funds, which were considered as a separate, closed system. Social contributions thus remained outside the norms drafted for the size of the government budget until 1976. In that year the so-called one-percent norm was introduced, stipulating that the sum of taxes and social contributions as a percentage of national income should not grow

19 Tullock 1980.

20 e.g. De Swaan 1989; Postma 1995.

21 De Swaan 1989.

22 Postma 1995.

faster than by one percent point per year.[23] The evident lack of political control of social security expenditure during the 1970's originated initially from a lack of political will, facilitated by the lack of unambiguous signals and norms for public social expenditure, and in the late 1970s the tide could not be turned due to a lack of suitable instruments.

5.2 Overconsumption

From the point of view of the consumer, his use of social security is financed externally, through the public budget or through a social insurance scheme. Having past the eligibility test, the service has no costs, so that an incentive to contain consumption is lacking. For an unemployed person the unemployment benefit or income from poor relief is a subsidy on inactivity that tends to lengthen the period without a job. Wrong incentives for consumers tend to push the consumption of social security services to a level where at the margin the costs of provision exceed the benefits of those who consume it.

Where the service is provided for free, the introduction of a new social security arrangement creates a situation where supply literally generates its own demand. Consumers first have to discover the new product and when it suits them there is an incentive to pass the eligibility test. The strength of the 'supply generates its own demand' effect of new arrangements is difficult to predict, but easily underestimated. An outstanding example of this is the developments under the Invalidity Insurance Act. The level of benefit depended on the diagnosed degree of labour incapacity and in case of full labour incapacity benefits were 80 percent of the former salary and for people with minimum wage 100 percent of the former net wage. After the act came into force in 1967 a steadily increasing number of wage-dependent workers applied for and was granted benefits. In 2002 no less than 13.5 percent of the working population was receiving payments under the arrangement. By international standards an incredibly high level of full or partial labour incapacity.[24]

An almost similar story can be told about the Social Assistance Act, which came into force in 1965 to replace the Poor Law of 1912. Individuals from the age of 18 years without income of their own were eligible for income support, fixed at 70 percent of the net minimum wage. Income support was a right and no longer a favour, as it had been under the old law. Again the inflow was high and the number of people receiving support was increasing.

5.3 Lack of choice

As one can see in table 1, throughout the lifetime of a Dutch citizen an enormous amount of money is spent on social policy arrangements, principally social security services. For transfers only it amounts to roughly 6,000 euros per year (undiscounted value). From an economic perspective, this is money that cannot be spent freely according to a person's or household's own preferences, perceptions of risk and willingness to bear that risk. Instead the state decides on the destination of the tax payer's primary income and regulates for what and under which circumstances the tax payer is eligible for consumption of social services and what criteria will be applied to assess his or her eligibility. The regulations are very much of the

23 Postma 1995.

24 Calculation based on CBS data.

type 'one size fits all'. The discrepancies between the diversity of private preferences, on the one hand, and on the other hand the uniform type of service and security provided by the arrangements imply a national welfare loss.
In social insurance the lack of choice shows up in the standards for eligibility, insurance coverage and level of benefits. Traditionally the client has no choice between insurers and between suppliers of the social services. There are signs that recent governments have understood the economic lesson that uniformity is a real bottleneck. Politicians have started to search for solutions that allow choice and consequently more diversity. The chapter on instruments for safeguarding the public interest in social security will give some examples.

5.4 X-inefficiency

Public sector suppliers of social security traditionally have a monopoly in administrating and delivering the service. The relaxed existence of a monopolist, free from the pressure of competition, makes surveillance and containment of costs less urgent. Costs will tend to creep up to a level higher than necessary. The excess of costs above the necessary minimum has received the label X-inefficiency.[25] It can take many forms. The traditional jokes about the short working day and slow working pace of the civil servant reveal that a low work load is a longstanding and widely observed form in which X-inefficiency has appeared. In social security, X-inefficiency can take the form of relaxing the criteria for being admitted as eligible for a specific arrangement, by applying the criteria less strictly than is formally required. It was considered to be one more cause, next to the overconsumption incentive, of the fast increase in the number of people receiving benefits under the Invalidity Insurance Act.

A more recent case, that has received much attention in the media, is the practice of non-profit firms supplying care-at–home to employ more highly qualified personnel than is strictly necessary - and charge for it. The practice was facilitated by the commissions that decided on eligibility and type of care, but they had no responsibility for the public budget spent on home care. Many journalists were enthralled about such good care for the needy old and sick, but from the economic point of view, it is a clear-cut piece of X-inefficiency.

X-inefficiency can thrive were competition is lacking. Monopolists in the private for-profit sector are not free of it. However, the owners of stock that want to see profits are a countervailing power. Or the managers have to fear a take-over and shake out when their incapacity to show good profits is reflected in a low price of equity. In public (including non-profit) organisations such feed-back is lacking and consequently the scope for X-inefficiency is larger. Since financial (budget) surpluses cannot be paid out, the incumbents have an incentive to consume the potential surplus within the organisation under the guise of costs. From this perspective, X-inefficiency is more than simple neglect; it is a well-considered choice to use revenues for objectives other than the efficient delivery of services, including high salaries and wages, low workloads and expenditure on 'pet projects'.

For the Netherlands a striking illustration of pet projects is the merger wave between non-profit providers of home care in the first decade of the twenty-first century. A belief in the advantages of large scale in home care paired remarkably well with managers' ambitions and

25 Leibenstein 1966; 1978.

their perspective of a higher salary. In many cases the mergers resulted in big losses. A critical study on the bankruptcy of the Mediavita conglomerate concluded that the managers and board of supervisors had been totally absorbed by the merger frenzy and had seriously neglected the firm's primary task of delivering home care services of good quality at a cost that is covered by revenue. An example of a type of pet project that is well-known in the literature was provided by Newhouse.[26] Drawing his inspiration from health care, he pointed out that organisations with a strong position of professionals have a predilection for using the newest technology, which will show up in excess costs.

5.5 Lack of innovation

Innovation is the mainspring of economic progress. In social security, new ways of doing things can improve quality of service, raise the productivity of workers in the sector and lower costs. However, a large bureaucratic organisation that has a monopoly in its field is not a stimulating place for innovation. When life is easy the necessity to change is not felt. Moreover, most workers have no or hardly any space to diverge from the prescribed routines. When there is such space, the effort to innovate may fail, leaving the instigator with the blame; and if successful, what does he gain? A lack of incentives for innovation has the same background as X-inefficiency, but in the long run the resulting stagnation is far more serious. When there is innovation in a bureaucratic environment, it may even have adverse effects on cost and quality as the failures of realizing economies of scale through mergers in home care seem to suggest.

In this section the public interest in social security has been defined in terms of redressing the identified public sector failures. In the chapter on instruments we shall discuss the efforts to contain overproduction and overconsumption as well as the reforms to counter X-inefficiency, lack of choice for consumers and failure to innovate in social security.

6 Conclusion

The economist's view on what the public interest in social security is, has been defined as (a) correcting the market failures in the private provision of social security as well as (b) identifying and correcting the public sector failures in the public supply of social security. The government's task in safeguarding the public interest in social security can broadly be defined as finding the balance between the benefits of economic security for citizens and the costs of providing it. In a mixed economy, it is not evident that the public interest requires economic existential security to be provided through the public sector. On the contrary, economists in principle find that needs are to be satisfied in the private sector, where the market coordinates economic decisions. From an economic point of view, the public interest in constructing an economic safety net of social security lies there where the private sector fails to satisfy the essential needs. This is the domain where the government should intervene and regulate private activity or undertake production and distribution activities of its own.

26 Newhouse 1970.

We have investigated how far the development of social security in the Netherlands corresponds with this blueprint of the public interest in a mixed economy. It turned out that the correspondence was partial. The only case of correction of market failure that could be identified was voluntary redistribution through social security with the aim to internalise caring externalities. The transfer of income is supported by the willingness of those who are taxed to pay for it. Empirical data are lacking on the degree of voluntary vertical redistribution as opposed to politically forced involuntary redistribution, imposed by the political majority on the unwilling minority. As a second force, apart from evident market failure moving the public sector into regulation and the provision of social security, the paternalistic correction of a perceived lack of prudence of wage-dependent workers stands out. One can conclude that in building up social security as a public sector activity, political decision makers had a broader conception of the public interest in social security than the more narrow definition of welfare economics. Clearly, more political objectives were involved than raising national welfare through a correction of market failures in providing security for citizens.

Mixed as the motives may have been, the fact is that in the twentieth century social security has developed as a public sector provision. It is in the public interest that public sector failures in social security are prevented and, if detected, that they are remedied. The build-up and completion of the welfare state in the 1950s and 1960s led to an unforeseen increase in the cost of social security when the international economic tide turned. The ongoing growth of unemployment in the 1970s and early 1980s convinced the government that social security had over-expanded to an economically unsustainable level. The decades that followed were clearly characterized by an ongoing struggle against the public sector failures of overproduction and overconsumption. It went hand in hand with the detection of other public sector failures: lack of choice for clients, too high costs for the quality provided (X-inefficiency), and too little innovation. Efforts have been undertaken to mend them, as we shall see in the chapter on instruments. In doing so, political decision makers have indeed conceived the public interest in the way economic science suggests. And in their actions they have also followed the prescriptions derived from economic theory more closely than they did in the foregoing decades of building up the national system of social security.

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