On the Contribution of Economic Analysis to Social Policy

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1. INTRODUCTION: ECONOMICS AND SOCIAL POLICY

This paper examines the contribution of economics to the analysis of social policy. How specifically can economic analysis help us understand and design the welfare state? What do economists bring to the party? I seek to answer this question with particular reference to social transfers and with particular reference to OECD countries. My remit is therefore circumscribed in terms both of the dimensions of social policy and of the geographical coverage.

1.1. Economists and Social Policy

When I first began studying economics in the early 1960s, few economists were interested in social policy. Full employment, rising real wages, and the welfare state were together assumed to have eliminated poverty. Social security was a technical topic left to specialists in social policy, and it was rare for an article on this subject to appear in the Economic Journal or American Economic Review. To check on whether my memory was right, I tried the experiment of interrogating JSTOR, which gives on-line access to past runs of major journals in economics, and asking about the occurrence of the words «social policy», first in the titles, and then in the full text. For the years 1960–1964 there were no titles in the 7 journals I tried, which include the two just mentioned, the Journal of Political Economy, and the Quarterly Journal of Economics. For a similar 5 year period 1986–1990, there were 3 titles containing the words «social policy». This is not a large difference. Nor was there any noticeable difference in the number of articles including in their text the words «social policy», which was 32 for the earlier period and 33 for the later (taking the same 7 journals).

Was my memory wrong? Or were the papers on social policy being published in new journals, not in existence in 1960? In fact the statistics just quoted are misleading. When one looks at the actual content of the articles, then there is a major difference. The subjects of the 32 articles in 1960–1964 containing the words «social policy» include the development of the dual economy, externalities, social decision rules, and the Soviet price system. These are all important subjects but not what I understand here by «social policy». Only 2 of the 32 articles could be said to deal primarily with social policy, whereas this was true for 15 of the 33 in 1986–1990. In the recent period there were articles on

the economics of mandated benefits, on the contribution of transfer payments to poverty prevention, on benefits and labour supply, on cash versus in-kind benefits, and on child support. These are significant aspects of the welfare state. One session of the 1989 American Economic Association (AEA) meeting was indeed devoted explicitly to the question – What Can Economics Contribute to Social Policy? So, empirically at least, economists have started to come to the social policy party.

1.2. The Economics of Social Policy

As Gramlich said in his contribution to the AEA session, "there are an infinite number and variety of questions one could ask about the transfer system" (1989, p. 191). One important set of such questions concerns the effectiveness of social insurance and social assistance in meeting their objectives. These programmes are intended to alleviate poverty, to help people re-allocate income over the lifecycle, to insure against events which cause income loss, and to provide a sense of security to all citizens. Economists have made an important contribution to clarifying these issues: for example, in modelling lifecycle decisions, and in clarifying the concepts of absolute and relative poverty. A second important set of questions concerns the explanation of the historical development of social policy. Why did the institutions of the welfare state come into being? What determined the timing of the introduction of state pensions in different countries? Why do countries differ in the levels of their social spending? Here the contributions of economists have been less extensive than those of other disciplines, but there must be a significant economic element to any answer. Even without subscribing to a purely functionalist explanation, we need to understand the role that social policy can play in different economic contexts.

These questions are important, but here I focus on a third set of questions which concerns the relation between social transfers and the economy. Fifty years ago, the relationship between social policy and the economy was largely viewed as a positive one. From the standpoint of demand management, social transfers, particularly unemployment insurance, were seen as contributing to the degree of automatic stabilisation. The post-Second World War expansion of the welfare state contributed to the avoidance of the mass unemployment of the 1930s, and helped underpin the "Golden Years" of growth. Today, economists are generally of the view that the relationship has changed, and for many it is now seen as competitive, social protection conflicting with economic objectives. Europe's welfare state is charged with being responsible for the persistence of unemployment. Generous social transfers are held to have adverse consequences for competitiveness and growth. My aim here is to examine how economic analysis, both theoretical and empirical, contributes to understanding the relationship between social policy and economic performance, paying particular attention to the impact on employment.
2. A MACRO ANALYSIS: THE WELFARE STATE AS A SYSTEM

In thinking about the relation between social policy and employment, it is helpful to distinguish between the effect on the equilibrium level of employment and the reaction to shocks:

Employment in country \( i \) at time \( t \)

\[
= \text{Equilibrium Employment in country } i \text{ at time } t \\
+ \text{Effect at time } t \text{ of shock to country } i
\]  

(1)

Differences between countries in their employment rates may then be due to (i) differences in the equilibrium employment (which may be time-varying), or (ii) to differences in their response to common shocks, or (iii) to differences in the shocks they have experienced. Social policy seems particularly likely to have affected the first and second channels.

2.1. Social Policy and Stabilisation

The potential role of social policy in reducing the sensitivity of employment to shocks (the second channel) has been well described by Lindbeck (before he goes on to cast doubts on its contemporary relevance):

"the automatic fiscal stabiliser [is] stronger, and hence more favourable, the greater the sensitivity of the budget deficit to variations in macroeconomic activity ... macroeconomic stability could be expected to be favorably influenced by high marginal tax rates and generous income compensation to those who lose their jobs" (Lindbeck 1995, p. 11).

A negative shock to employment would, on this basis, automatically reduce tax receipts and increase transfer payments, both serving to stimulate demand. Conversely, reforms which reduced progression of income taxation, and scaled back unemployment insurance, would increase the sensitivity of employment to shocks, since a downturn would cause a smaller rise in the budget deficit.

However, there are reasons why this stabilising role may not be fulfilled. First, there is a standard argument for the reduced effectiveness of fiscal policy: that interest rates may rise, public borrowing crowding out private, and the interest rate effect offset the expansion in aggregate demand which results from the automatic fiscal stabiliser. The second reason is that current deficits may lead households to expect future tax increases, generating a negative wealth effect on consumer spending. Lindbeck argues that, while automatic budget responses may stabilise employment at modest levels of the budget deficit, the reaction may reverse at higher levels. He suggests that, rather than the automatic responses of tax/transfer programmes acting to moderate macroeconomic fluctuations, a
«huge increase – particularly when starting with an initially large government debt – may well be a destabilizing factor. A macroeconomic vicious circle may then emerge in deep recessions, with a galloping government debt, increased uncertainty, higher interest rates, an increased household saving rate, a further fall in aggregate demand ...» (Lindbeck 1995, p. 12).

Setting the argument out in these explicit terms, we see that the conflict arises not on account of the social transfers per se, but on account of their impact on the government budget. Social transfers can claim no credit for adding automatically to the deficit, but equally a social programme which eschewed deficit funding would not be in conflict with macroeconomic stability. The key issue is the management of the government deficit. Here, and in other contexts, we can see the relevance of distinguishing between (a) the general tax cost of social programmes and (b) the effects on economic decisions which are specific to social spending. The latter arise from the specific form of the expenditure, and would arise even if transfers were (hypothetically) to be financed by an outside donor. The question is one of differential expenditure analysis, to use Musgrave's terminology (Musgrave 1959). Providing a formal framework within which such distinctions become apparent is an important contribution of economic analysis to clarity of thought in this field.

2.2. The Meaning of «Macro» Analysis and «Micro» Foundations

If we concentrate on the specific effects of social policy, then we find that these have typically been studied at the microeconomic, rather than the macroeconomic, level. Writing this paper has caused me to reflect on the use of the term «macro», particularly as a result of reading literature on the welfare state in other disciplines. Whereas the customary usage in economics refers to aggregate variables like total employment or Gross Domestic Product (GDP), as differentiated from individual variables such as a household's hours of work or income, there is a second use of the term «macro», more common in other social science disciplines, which considers social policy «in the large». Such an approach refers to the overall functioning of a system of social institutions, and to the «social climate» that they generate, rather than to specific policies such as unemployment insurance or child benefit.

In empirical terms, the macro-societal approach is illustrated by studies in which indicators of economic performance (such as unemployment rates or rates of GDP growth) have been related to aggregate spending on social programmes (as a percentage of GDP). The findings have been much discussed (see, for example, Atkinson 1999), but here I concentrate on the underlying theoretical justification, which has been the subject of questioning. In the sociology literature, there have been strong calls for more focus on institutional structure:

«The vast majority of studies employ highly aggregative measures such as social spending levels [which] presumably measure welfare effort. [But] no particular attention is given to the more detailed and complex issues within social policy» (Alber, Esping-Andersen and Rainwater 1987, p. 461).
One route forward has been to identify different types of welfare state, such as Esping-Andersen's *Three Worlds of Welfare Capitalism* (1990), where he distinguishes three types of regime: liberal, corporatist, and social democratic. These are characterised by different structural relationships between the state, the family and the market.

The approach adopted in economics has been different, basing macro relationships on the exact aggregation of individual decisions, which are in turn taken to be influenced by individual social policies. Commonly this takes the form of assuming that the economy consists of identical, independent individuals, so that the macro behaviour can be modelled as that of a single agent. Or, only slightly more generally, assumptions are made limiting the differences between people so that we have exact aggregation and aggregate behaviour may be treated as that of a «representative agent» (Deaton and Muellbauer 1980, Chapter 6, and Kirman 1992). For example, identical individuals may have a reservation wage which depends on the level of unemployment benefit (see equation (3) below). This can be aggregated into a horizontal wage-setting curve and combined with an aggregate labour demand curve to yield an equilibrium level of aggregate employment. In this way, a micro-mechanism, explaining a link between a specific instrument of social policy and individual employment decisions, is converted into a macroeconomic prediction that aggregate employment rates vary with benefit levels.

This step from micro- to macro-in analysing social policy involves (a) treatment of the response of the representative individual as predicting the aggregate response and (b) focusing on individual programmes and their parameters. The first of these has been criticised by other social scientists:

«A great difficulty with virtually all economic theory on the subject is that its hypotheses concern microlevel relationships, while it tends towards sweeping macroeconomic generalizations» (Esping-Andersen 1994, p. 712).

The assumption that macroeconomics can be based on the behaviour of a representative utility-maximising agent has also been criticised by economists:

«this reduction of the behavior of a group of heterogeneous agents ... is both unjustified and leads to conclusions which are usually misleading and often wrong» (Kirman 1992, p. 117).

As he brings out, the problems arise both from the heterogeneity of agents and from the neglect of interactions between their behaviour. At the micro level, it is the decision of the unemployed steelworker not to apply for a job in a telephone call centre which adds to unemployment. But individuals are heterogeneous in their circumstances: unemployed steelworkers differ in, for example, their age, their wealth, in the opportunity cost of their time, and in the earnings capacity of their partners. As we know from the study of market demand (Kirman 1992), heterogeneity on its own may mean that the aggregate variables do not inherit the properties of individual behavioural functions. The issue becomes more complex when we recognise that such decisions are subject to manifold, interacting influences. For example, Lindbeck (1995a) has argued that people's willingness to claim benefits is influenced by social norms which evolve over time. He refers to the psychological literature on «learned helplessness» and to the stigma associated with
2.3. The Welfare State as a System

Macroeconomics is not exclusively based on exact aggregation arguments, as is illustrated by the article of Phelps and Zoega (1998) on equilibrium unemployment. While they certainly refer to micro-based mechanisms derived from efficiency wage models of individual behaviour, they also appear to adopt a more macro-societal approach in attributing the rise in equilibrium unemployment to the welfare state in general, going beyond the analysis of specific programmes:

«A domestic shock in most OECD countries has been the expansion of the level and range of benefits offered by the welfare state ... the indictment can be broadened to subsidised public housing, health insurance, income support to aged parents, aid to dependent children and free public housing, all of which can be shared with workers, thus creating a kind of social wealth that workers can fall back on» (1998, p. 786).

On this basis, even policies apparently unrelated to the labour market can be expected to have an impact on employment. One important strand in their argument appears to be the general climate of the welfare state. In this, they are not alone. A number of studies of the welfare state have stressed the need to look at social systems as a whole, including social transfers, labour market institutions, fiscal structure, an idea encapsulated in the title of an article by Freeman called «The Large Welfare State as a System» (1995). Drawing on a study of Sweden (Freeman, Swedensborg and Topel 1997), he concludes that it is «a highly interrelated welfare state and economy in which many parts fit together ... in ways that maintained high employment and wage compression, that offset work disincentives from welfare benefits and high taxes» (1995, p. 18).

Phelps and Zoega (1998) present time-series and cross-country evidence in support of their thesis of a relation between unemployment and welfare state spending. In both cases, there are problems in drawing conclusive inferences. The time series equations for the United Kingdom based on quarterly data from 1966:1 to 1995:3 contain a significant coefficient for the share of welfare spending, but the authors describe it as «probably not as robust» (the t-statistic is 2.5) as those on real interest and oil prices, and which becomes insignificant in magnitude when a variable is added for personal wealth. There is a risk that the welfare spending variable is simply a proxy for rising prosperity. The cross-country evidence is also not without problems. For example, Phelps and Zoega (1998) plot for 15 OECD countries the growth of unemployment from 1965–1973 to 1986–1995 against the share of social expenditures in GDP in 1965–1973. By taking the base year figures for social spending, they seek to deal with simultaneity (that causality may run in the opposite direction), but this does not rule out the possibility that there may be third factors at work. The countries in the Phelps and Zoega diagram (1998, Figure 6) are grouped geographically, with English-speaking countries nearest the origin, then, as
we move outwards, Scandinavia (Finland, Norway and Sweden), France and Italy, and finally northern mainland Europe. This geographical pattern is consistent with a variety of explanations of macro-societal differences. With the exception of Denmark, the groupings correspond broadly to the four «families of nations» identified by CASTLES (1998), in his comparative study of public policy, as having common cultural, historical and geographical features.

The second problem with the macro-societal approach is that there are evident problems in drawing conclusions for the design of policy. If it is the social climate which is responsible, it is not obvious that we should elevate the contribution of one particular policy dimension over others that may be at least as significant. Can we turn Benelux into a Commonwealth country by simply cutting social transfers? Does it really not matter what type of social spending is cut? One response is to seek to model the interactions which underlie the macro-system. FREEMAN (1995) argues that a tight linkage between different elements means that small variations in individual policies may not be beneficial but that a large «jump» is required (see also COE and SNOWER 1997). Another response is to return to modelling the micro-mechanisms, looking at individual instruments of social policy, and I now turn to this approach.

3. ANALYSIS OF INDIVIDUAL SOCIAL POLICIES

How can we relate differences in aggregate economic performance to specific features of social policy? Whereas aggregate indicators of the size of transfers include the whole range of benefits, we are now considering individual programmes, such as unemployment compensation or retirement pensions, and their specific institutional features.

3.1. Unemployment and Unemployment Benefit

In order to examine the underlying mechanisms, we have to ask how exactly the parameters of social policy enter the decisions of individuals. The first example taken here is the relation between unemployment and unemployment benefit. This requires us to specify more fully the working of the labour market. I use, without endorsing, the simple shirking model of SHAPIRO and STIGLITZ (1984). A worker can choose between supplying effort, at cost \( \varepsilon \), and not supplying effort and therefore facing a risk \( \lambda \) of being monitored, in which case the worker is fired. Both \( \varepsilon \) and \( \lambda \) are assumed constant over time. Firms find it profitable to pay a wage premium such that a worker is indifferent between putting in effort and shirking:

\[
 w+g - \varepsilon = \lambda (b+g) + (1-\lambda)(w+g) \tag{2}
\]

where it is assumed that workers who are fired receive unemployment compensation, \( b \), and I have allowed for the benefit, \( g \), per person from general government social spend-
ing. Workers evaluate alternatives in terms solely of their expected value (I return in a moment to the question whether or not risk neutrality is a satisfactory assumption.) Rearranging, we can see that $g$ cancels out, and that

$$w = b + \varepsilon / \lambda$$

(3)

The wage set by employers is a mark-up on the benefit just sufficient to induce workers to supply effort. If everyone is identical, this highly-simplified model generates a horizontal wage setting curve.

From these micro-foundations, there are indeed reasons to expect a rise in unemployment benefit to spur firms to raise wages and so reduce employment, assuming a downward-sloping demand curve for labour. This does of course assume that people are not disqualified from benefit for having been sacked as a result of industrial misconduct, as is provided for in the unemployment insurance legislation of most countries. In reality, the condition may not be fully enforced, but the worker has to allow for the possibility that benefit would be denied. As I have argued elsewhere (ATKINSON 1999), neglect of such institutional features means that economists give a misleading picture of the impact of benefits. It is not however this aspect on which I wish to concentrate here. Rather it is the term which does not appear: the general level of benefits, $g$. Contrary to the argument of PHELPS and ZOEGA (1998), the general level of social provision (for example subsidised housing available whether employed or unemployed) does not enter the efficiency wage. On the other hand, this may reflect the shortcomings of the model. As ZOEGA (1997) has pointed out, with risk aversion there is a wealth effect missing from the simple model just described. If workers are risk averse, with utility an iso-elastic concave function of income (but linear in effort), then a comparison of expected utility leads to the efficiency wage becoming an increasing function of $g$. Where people are better off, then they are more willing to take the gamble involved in shirking, so that the wage premium rises. Seen this way, with the more realistic assumption that workers are risk averse, the effect of increased general social spending is to make people more willing to run the risk of losing their jobs, and hence increases unemployment. Such an argument may be correct, but it is rather different from the standard argument that unemployment benefit causes unemployment. It would happen even if there were no unemployment insurance. As PHELPS and ZOEGA found in their time-series regressions, it may be difficult to separate the effects of benefits from those of general prosperity. Setting out the economic model in full helps bring out this difference.

The reason why general social spending does not enter the efficiency wage equation in the absence of risk aversion is that it is not relevant to that particular margin. Here, it seems to me, is one of the most important contributions of economics, which is to identify the way in which social policy affects the margins relevant to key decisions. It helps us characterise the economically relevant institutional features: the conditions, or parameters, which are crucial to its impact on individual economic decisions.
3.2. The Retirement Decision

The second example is provided by the micro-economics of retirement. In the option value approach, an individual at age t considers the stream of benefits from retiring at age t, compared with the value of remaining at work for a further year, keeping open the option of then retiring or of continuing at work. The implications of a simpler version of this model have been shown for a variety of countries in the project organised by GRUBER and WISE (1998 and 1999). Their calculations show the financial «pressure to retire» in terms of the loss of expected present value of pension from continuing to work, expressed as a fraction of the expected present value of earnings. In a number of OECD countries the implicit tax on working after the early retirement age is in excess of 50 percent.

It appears that there is a powerful financial disincentive to continuing to work. The first point to make about this kind of calculation, however, is that it is not necessarily state pensions that create the disincentive. In the United Kingdom, for example, for many workers the main component in an implicit tax calculation is the occupational pension. Such pensions vary widely, but where the private scheme is integrated with the state pension (the private pension guarantees a total pension after allowing for any state pension paid), then the occupational scheme neutralises any disincentive from the state element: it is purely the private scheme which determines the implicit tax. A cutback in state provision may have no effect on the total amount of replacement income. With a multi-tiered approach, as advocated by the WORLD BANK (1994), this may become very significant.

The second point about this kind of incentive calculation is that the decision to retire is not purely that of the individual worker: the employer may have to give consent to retirement. The role of employers is often missing from economic models of retirement, although there are important exceptions. LAZEAR (1979) has explained mandatory retirement in a model of a long-term employer/worker relationship where the wage exceeds the value marginal product in the final years. According to HANNAH, in his history of occupational pensions in Britain,

«Mandatory retirement, legitimized by more generous pensioning [allowed employers] to buy themselves out of the expensive bias towards overpaying older workers implicit in their reward systems» (1986, pp. 135–136).

There is a risk that important factors will be missed if we apply an economic model which looks at just one side of the market, and this is a common weakness of economic models of social policy. The general equilibrium nature of economic relationships is one of the most important insights which economists can bring to bear, but we do not always remember this.
4. EMPIRICAL STUDIES OF INDIVIDUAL PROGRAMMES

In the past 25 years there has been a large empirical literature on individual social transfer programmes. This literature was much influenced by studies such as that by Feldstein on the relation between state pensions and capital accumulation, in which he reached the striking conclusion that in the United States «the social security program approximately halves the personal savings rate» (1974, p. 922). These conclusions have been challenged, with a wide diversity of subsequent results. The OECD concluded its survey of the evidence regarding public pensions and household savings with the statement that:

«In the light of the evidence, it is difficult to be confident about how public pension programs affect private saving. Both the direction and the magnitude of the effect remain debatable» (OECD 1994, p. 37).

The same is true of the impact of unemployment insurance on unemployment. Earlier, I quoted from the article by Phelps and Zoega (1998). In the same issue of the Economic Journal, there are three articles with empirical results on the impact of unemployment benefits. The first is by Nickell (1998) in which he gives empirical results suggesting, from a mixed cross-country time-series analysis, that a 10% rise in the replacement rate would increase the unemployment rate by 14%. This is a significant but not enormous amount: it is not 14 percentage points. But from a time-series equation for the United Kingdom, he concludes that the same increase in the replacement rate would raise unemployment by 63%. The coefficient from one equation is nearly 4 times that in the other, which may be associated with the fact that the second equation does not include benefit duration, but it would be nice to know. The second article is by Karanassou and Snower (1998) in which they estimate a chain reaction model. One of the by-products of their study is a finding that unemployment benefits have a significant positive effect on wages and that wages enter the employment equation positively. The system is recursive, since employment does not enter the wage equation, so that the impact of higher benefits on long-run unemployment is negative. The third paper is by Madsen (1998) who estimates a pooled time-series cross-country model and finds insignificant coefficients for both benefit level and benefit duration. All this makes it hard to draw conclusions, and it would have been helpful to know how far differing results are due to different choices of variables (real benefit levels versus replacement rates), to differing data (cross-country versus pooled cross-country and time-series), to different functional forms or treatments of dynamics, to the imposition of different sets of parameter restrictions, etc. In order to make progress, we need a more systematic approach to the reconciliation of differences in results. According to the encyclopedia, scientific method involves «new facts being fitted into their places».

Three Empirical Case Studies

There are some individual social policies where the effects appear to stand out very strongly from the data. If we take the case of early retirement, then Gruber and Wise in-
vestigated the relationship between «unused labour capacity from age 55–64» (i.e. years not working) and the implicit tax pressure to retire at 55 rather than 65. They conclude that

«there is a strong relation between social security incentives to quit work and the labor force departure of older workers» (1999, p. 31).

This evidence is based on cross-country comparisons. The second case illustrates time-series evidence. The Allocation Parentale d'Education (APE) in France was paid originally to families with 3 or more children where there is a child under the age of 3 (which is the age at which the child starts Ecole Maternelle), subject to the parent giving up employment. The APE benefit was extended in 1994 to cover 2 child families as well. The participation rate of the mothers affected then fell from just under 70% to little over 50% (ALLAIN and SÉDILLOT 1999). By the standards of observed changes in participation rates, this is a dramatic fall. The third example concerns the impact of unemployment compensation on other household members. If benefits are paid on a wholly individual basis, then there is purely an income effect on the decisions of others. However, if benefit receipt is means-tested on family income, as with social assistance, there may be a marginal tax rate of 100 per cent operating over a range of earnings of other family members. Concern has been expressed in the United Kingdom about this disincentive aspect on account of the much lower labour force participation of the wives of the unemployed. DILNOT and KELL (1987) found that only 1 in 10 of those married to men in receipt of means-tested benefits (with 100 per cent marginal tax rate) were in paid work, compared with nearly half those women married to men on social insurance benefit. This is a large difference.

These three cases suggest that there are situations where the micro-effect of social policy stands out from the data. However, even here there is room for doubt. In the case of early retirement, GRUBER and WISE are careful to point out that their cross-country association is susceptible of more than one interpretation. There is the possibility of reverse causality: that the social security provisions were introduced in order to accommodate to the already expressed preference for early retirement. Here they adduce time-series evidence for individual countries, which they feel provides strong support for the conclusion that causality runs from pension plans to retirement. The case of West Germany is claimed by BÖRSCH-SUPAN and SCHNABEL (1998) to be a «natural experiment». The introduction of a flexible retirement option in 1972, together with expanded use of disability and unemployment benefits for older workers, led to a steady decrease in the retirement age from 1973 to 1981 (GRUBER and WISE 1999, p. 11).

There remains however the possibility that what we are observing is a «macro» relationship between the general social stance of the country and its labour market behaviour. Can we be confident that reducing the pension penalty to continued work will lead to behavioural change as large as that implied by the observed relationship? One reason for doubt is that the tax pressure shown in the diagram is not the tax/benefit position of any actual member of the population or the average of actual positions. The implicit tax
is calculated for a hypothetical person in a set of circumstances specified by the researcher. The United Kingdom variable, for example, is calculated assuming that the person could receive incapacity benefit from age 60–65 if they retired. But there is a medical test of incapacity for work which has to be satisfied for this benefit to be received. If the person does not qualify, then the UK would become an outlier in the Gruber and Wise analysis.

There is indeed a general problem. A major shortcoming of both time-series and cross-country studies is that aggregate indicators of the impact of benefits are too crude. This may be alright where it is a single universal condition, as with entitlement to the APE in France, but in general the impact of social transfers is highly complex and depends on many elements. To attempt to characterise these in terms of a few aggregate variables is a heroic endeavour. The financial incentive to retire depends on past labour market history and levels of earnings, on the inter-relation between state and private pensions, on health status and the availability of health insurance, and on family circumstances. In any population there is a distribution of tax pressures, and they may move differently over time.

This points to the use of micro-data on individuals, and there has been a great expansion of work on micro-data, including the valuable longitudinal data-sets. Here too, however, there are problems. In taking account of the diversity of individual receipt of benefit, it has to be recognised that hypothetical calculations based on a reading of the social security manuals are highly misleading. One cannot assume that the rules apply without modification for individual circumstances. While micro-data from sample surveys or administrative records may record individual benefit receipt, we still have to make assumptions in examining counter-factual situations. Any replacement rate, for example, must make assumptions about either the benefit which would be received if the person did not work, or about the earnings received if they did work.

The use of cross-section data from surveys is also open to the objection that observed relations may be the result of concomitant factors. This is illustrated by the third case study of the participation rate of the partners of the unemployed. The observed pattern may result from the facts that husbands on social assistance (as opposed to social insurance) have been out of work a longer time, reflecting poor job opportunities, and that husbands and wives face similar labour market conditions. In their cross-country study, DEx et al. (1998) seek to control as far as possible for local labour market conditions. They conclude that where unemployment insurance is purely individual, there is no detectable effect on wives’ participation, but that there is a negative effect where insurance is withdrawn if the spouse works and a sizeable negative effect of social assistance. But these conclusions depend crucially on the adequacy of the controls.

Uncontrovertible evidence about the relationship between specific policy instruments and economic outcomes is, therefore, not easy to obtain, even where large effects appear to stand out from the data. We have few natural experiments, and observed variations are susceptible of different interpretations. In my view, the major contribution of the empirical literature has been to identify and quantify the various trade-offs that individuals
face. Simply by calculating the tax pressure to retire, or the distribution of replacement rates in the population, economists are informing public debate. At the very least, we can show ministers how any proposed policy changes will affect the financial incentives and disincentives. This is a major input to clarifying public debate, and something that was previously missing. It is worth remembering that the BEVERIDGE Report (1942), while a remarkable document which had a powerful impact on both popular opinion and government policy, did not concern itself in any systematic way with the impact of social transfers on microeconomic behaviour. BEVERIDGE was certainly aware of the issues, and they are referred to in relation to unemployment insurance, but the Report contained no sustained analysis of the quantitative impact of transfers on individual trade-offs.

5. CONCLUSIONS

My conclusions may be summarised briefly. The economic analysis of social policy has made great strides, but has someway yet to go. As I have tried to show, I do not believe that we are in a position to give definitive answers to questions like – what is the effect of social policy on economic performance? The theoretical models are not sufficiently developed for us to be confident of having included all major elements of the picture. For example, introducing risk aversion changes the conclusions drawn from the shirking model of unemployment, and the analysis of retirement decisions may be changed when we take account of the behaviour of employers. The move from micro-behaviour to macro-aggregates is in urgent need of closer examination. The treatment of the welfare state as a system needs to be developed. Empirical research is far from conclusive, and even apparently large differences in behaviour may be interpreted in different ways. More needs to be done to reconcile conflicting findings.

The main contribution of economics is to provide a rigorous framework for organising our thinking about these important issues. This often points to aspects which otherwise are neglected and distinguishes different arguments which are confounded in public debate. It helps us recognise and quantify the way in which social policy affects the margins relevant to key decisions, and identifies the economically relevant institutional features.

In short, economists should be welcome guests at the party, even if what they bring is rather less useful than they sometimes suggest.
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SUMMARY

This paper examines the contribution of economics to the analysis of social policy. How can economic analysis help us understand and design the welfare state? I seek to answer this question with reference to social transfers in OECD countries. I focus in particular on the relation between social transfers and the economy, notably the impact on employment. I conclude that the economic analysis of social policy has made great strides, but has someway yet to go. Theoretical models are not sufficiently developed for us to be confident of having included all major elements of the picture. The move from micro-behaviour to macro-aggregates is in urgent need of closer examination.

Empirical research is far from conclusive, and even apparently large differences in behaviour may be interpreted in different ways. The main contribution of economics is to provide a rigorous framework for organising our thinking. This often points to aspects which otherwise are neglected and distinguishes different arguments which are confounded in public debate. It helps us recognise and quantify the way in which social policy affects the margins relevant to key decisions.
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RESUME

Cet article examine la contribution de l'économie à l'analyse de la politique sociale. Comment l'analyse économique peut-elle contribuer à comprendre et à former l'État social? J'essaie de répondre à cette question en analysant les prestations sociales des pays de l'OCDE. Plus particulièrement, j'examine la relation entre les prestations sociales et l'économie, c'est-à-dire les répercussions des prestations sociales sur l'emploi. J'en conclus que l'analyse économique de la politique sociale a fait de grands progrès mais ne touche pas encore à sa fin. Les modèles théoriques ne sont pas assez développés pour que nous puissions être certains d'avoir pris en compte tous les éléments essentiels. Le passage du comportement microéconomique aux données macroéconomiques nécessite d'urgence une analyse approfondie.

La recherche empirique est loin d'être terminée; même de grandes divergences dans le comportement sont interprétées de manière différente. La principale contribution de l'économie est de fournir un cadre clair pour le raisonnement. Ceci amène à tenir compte de certains aspects autrement négligés et à différencier entre divers arguments qui sont mélangés dans le débat public. Ceci nous aide à reconnaître et à quantifier la mesure dans laquelle la politique sociale influe sur la marge de manœuvre pour certaines décisions-clés.