UNRISD
UNITED NATIONS RESEARCH INSTITUTE FOR SOCIAL DEVELOPMENT

DRAFT

Social Policy as a Development Tool?

Risk, Distributional Conflict and the Mobilisation of Resources

Juhana Vartiainen

prepared for the UNRISD project on
Social Policy in a Development Context

in the UNRISD programme on
Social Policy and Development

November 2002 ▪ Geneva

The **United Nations Research Institute for Social Development** (**UNRISD**) is an autonomous agency engaging in multidisciplinary research on the social dimensions of contemporary problems affecting development. Its work is guided by the conviction that, for effective development policies to be formulated, an understanding of the social and political context is crucial. The Institute attempts to provide governments, development agencies, grassroots organizations and scholars with a better understanding of how development policies and processes of economic, social and environmental change affect different social groups. Working through an extensive network of national research centres, UNRISD aims to promote original research and strengthen research capacity in developing countries.

Current research programmes include: Civil Society and Social Movements; Democracy, Governance and Human Rights; Identities, Conflict and Cohesion; Social Policy and Development; and Technology, Business and Society.

A list of the Institute's free and priced publications can be obtained by contacting the Reference Centre.

UNRISD, Palais des Nations
1211 Geneva 10, Switzerland

Tel: (41 22) 9173020
Fax: (41 22) 9170650
E-mail: info@unrisd.org
Web: http://www.unrisd.org

Contents

Introduction

Is social policy a necessary ingredient of economic growth and development or its possibly dysfunctional by-product? This is a grand question that does not permit a definitive answer. There are many strands of literature in economics and other social sciences that let one approach this question.

In this paper, I try to use economic theory and the empirical experiences of one Nordic economy to suggest some positive linkages between social policy and economic development. In particular, I will discuss the role of social policies in alleviating the negative effects of risks and uncertainty as well as of distributional conflicts -- both inevitably associated with economic growth and development. I shall outline a couple of economic arguments and show that they can at least shed some light on the experience of such countries as Finland, characterised by small size, corporatist political and economic structures and lateness as to industrialisation and economic development. Whether these lessons on national growth and innovation systems are of any interest for those countries that try to find their niches in the globalised economy of the 2nd millennium is another question.

Growth and Distributional Conflict: Theoretical Models

Stripped to its economic essentials, economic growth and development are about deferring consumption of resources today in order to create more resources in the future. This economic definition consciously abstracts from all other, no less relevant aspects of development, but it is useful if we want to think of the issue in its essential economic terms. Economists tend to think that, provided there are technological opportunities for such profitable investment and the return for these investments exceeds the discount factor, rational economic agents will indeed undertake projects that enhance future consumption at the expense of today's consumption, i.e. economic growth.

Seen in this way, the puzzle for a narrow-minded economist is why some nations do not grow and develop even though it would obviously be in the interest of all or almost all their agents to do so. Now, and continuing this very abstract line of argument, a very general obstacle to these investments occurring is the eventual uncertainty and the eventual externalities associated with the allocation of the costs and returns of investment. Broadly, three kinds of economic mechanisms can lead to a situation, which can hamper even those investments occurring that would be beneficial for the entire economy:

1.Discrepancy between social return and private returns of growth-enhancing investment;

2.Dynamic externality associated with the discrepancy of ex ante and ex post bargaining over distribution;

3.The individual and idiosyncratic uncertainty of investment returns.

The first point is related to what economists call positive externalities. Many investments are such that their rate of return depends on the investment of other economic agents. Being an engineer in a poor country is probably most useful if there are other engineers and accountants around, so that one's education can be used to produce valuable output. Similarly, an individual investment in good health (e.g. via sanitation systems or vaccinations) also confers an advantage to the neighbours of the investors. Such economic environments differ from the most stripped-down assumptions of neoclassical economic models. There is a positive role for government intervention in markets characterised by such positive externalities.

This general point is by now rather obvious to most mainstream economists and scholars of growth and development[1]. It is clear that some economic functions such as education, health care and the provision of infrastructure and a legal framework are better not left to private entrepreneurship. Azariadis and Drazen (1990) provide an interesting application of this idea in the form of "threshold" externalities. Their model suggests that government subsidies of education are important to avoid low-development traps. See Aghion-Howitt (1998: chapter 10) for a survey of theoretical models and empirical research on this issue.

Economic change and the Management of Distributional Conflicts

The second point is concerned with the dynamic externality associated with the division of the returns of productive investment. It is an endemic characteristic of all economies in which some agents are "large" so that the prices of inputs and outputs are not determined competitively and treated as given parametric constants by the concerned economic agents. More concretely, if distributional variables such as wages, are determined in collective bargains, the ex post returns of investment do not in general correspond to the ex ante costs in an optimal way. The paradigmatic examples of this so-called "hold-up" problem include:

1Amartya Sen (1967) has analysed this "isolation paradox" in an abstract and elegant way.

1. The case of investment in productive equipment when there is a trade union which bargains about the wage; once the machinery is installed, the bargained wage probably goes up and the union expropriates a part of the return of the investment;
2. The acceptance by organised workers of a rate of profit that makes possible a rate of investment necessary for adequate economic growth;
3. The case of investment in a country that needs tax revenues; once the investment is in place, there is an incentive for the government to raise taxes on profits;
4. The case of innovation undertaken by the employees of a firm; there is no guarantee that improving the production process leads to an appropriate increase in wages.

These dynamic externalities imply that the incentives for productive investment are in general not optimal and do not lead to an efficient exploitation of investment opportunities. This problem has no easy solution, but it can certainly be alleviated by state action that guarantees certain rules of and principles of equitable distribution. While the state cannot in a market economy directly determine the final allocation of goods, it can with its tax instruments and other instruments create expectations of fair treatment and an atmosphere, which is conducive to mobilisation of the nation's resources. This point has been treated more fully in Vartiainen (1999). In that paper, I argue that the state can be seen as a kind of broker that ensures that the ex post distribution of resources is such that it corresponds to those incentives that were ex ante necessary to induce the necessary investments.

For example, a politically powerful working class may in principle accept a lower level of consumption as of today if this sacrifice can ensure a higher rate of capital accumulation and thereby a higher consumption set in the future. However, in a private market economy, there is probably no contract form that would ensure such a trade off. From the point of view of the working class, the outcome in which the capital-owners either use their extra returns for personal consumption or transfer the profits abroad is a rather plausible scenario as well. In such a situation, the state may be able to intervene in the economy in such a way that high investments become the preferred behaviour of the capital owners. For example, it might ration credit to productive investment and keep interest rates low; or it might tax away a part of these profits and undertake direct public investments into productive capacity; or it might introduce legislation that prevents international transactions of wealth. Such policy measures have been commonplace in the Nordic economic policy regimes after WWII.

Economy wide returns and individual uncertainty

The third aspect that we want to emphasize is the inevitable *individual* uncertainty associated with innovation and new investment projects as well as economic restructuring. In this case, an even more direct relationship between social insurance and investment can be posited. Suppose that there is a large amount of individual investment projects that can be undertaken by future to-be-entrepreneurs and suppose, quite plausibly, that the average return of these projects is high enough to meet the average cost, so that, on average, the projects should be undertaken (supposing that their number is so large that a law of large numbers applies).

However, the return of each individual project is a random variable, and, with risk-averse individuals, the expected utility of the project is less than the utility of the expected return. This implies that the number of realised projects will be less than the optimal one if there is no social security network. The formal interpretation of social security in such a model is that of an insurance pool: by setting an appropriate tax and social insurance system, the state can increase the expected utility associated with failure and thereby increase the amount of investment. This argument is simple but it provides a robust intellectual support for a safety net as a factor that enhances economic growth and development.

To put it simply, you are more likely to become an entrepreneur if you are not drained down the gutter even if you fail. This point turns on its head the conventional wisdom on the detrimental effects of redistribution on innovation and effort incentives. One nice formalisation of this idea is presented in Sinn (1994). In Sinn's model, the welfare state is identified with an insurance device that makes lifetime careers safer. Protected by the welfare state, people engage in productive and risky activities that they would otherwise not undertake. Sinn shows that this innovation-enhancing effect can even become too strong, so that people take too much risk and fail to take such necessary measures that would effectively insure them against adverse conditions. There is consequently an optimal rate of redistributive taxation.

Resistance to economic reform and modernisation

Thus, it can be argued that well designed social insurance can encourage economic innovation and individual risk-taking. On a more macroeconomic level, it can also soften resistance to economic reform. Phases of economic development are also phases of profound structural change. Development requires mobilisation of resources and sacrifices in today's consumption possibilities. Structural change is always associated with uncertainty and the possibility of completely unforeseen contingencies, partly due to changing

bargaining position of different agents. The state, with its multidimensional policy tools, is in principle best equipped to ensure that the final economic outcome is not outrageously disadvantageous for any particular group -- which, in turn means that no particular group need be vehemently opposed to structural change and development.

To fix ideas, suppose that an economy could enhance average productivity by reforming its institutions (say, it might liberalise financial markets, end agricultural subsidies or abolish price rationing in some market). It might be a reasonable guess that such reforms increase the economy's average income. However, the final general equilibrium outcome of a process of structural change cannot be accurately predicted. Even if one might have an idea of what some macroeconomic variables might turn out to be, nobody can predict for sure the changes in individual allocations that will result. Since most individuals are risk-averse, they might consequently adopt a negative attitude towards structural reforms, even if these reforms would beyond reasonable doubt increase average income. Thus, many voters would ex ante want to vote for parties that oppose modernisation and reforms. Such attitudes are commonly ascribed to irrationality and backwardness, but the risk aversion argument suggests that they can be perfectly plausible in the light of the theory of rational choice under uncertainty[2].

Thus, risk aversion can be an obstacle to economic development. A slightly less obvious result of the political economy literature suggests that reforms can be hampered even if all agents are risk-neutral.

This idea has been nicely formalised and analysed by Fernandez and Rodrik (1991). In their sophisticated model, the reform in question is trade liberalisation. Yet the intuitive idea behind their reasoning can be simplified in the following way. Suppose that there are two sectors in the economy, one of which (the "modern" sector) stands to benefit from modernisation (like trade liberalisation) while the other (the "traditional" sector) is going to lose. In the initial state, the majority of the economy's manpower is located in the traditional sector. Moreover, income is originally the same in both sectors (and same across individuals), whereas the modernising reform would increase income in the "winner" sector and shrink it in the "loser" sector.

The crucial but fully plausible assumption, however, is that the modernising reform will also lead to a transfer of people from the traditional sector to the modern sector. Let the economic data of this example be summarised in the following table:

2 In a similar vein, Rodrik (1997: 435) notes that the extension of the market mechanism has in many countries fostered an anti-market, traditionalist reaction on the political arena.

	Before		After	
	Traditional sector	Modern sector	Traditional sector	Modern sector
Size of labour force	60	40	50	50
Income per capita	100	100	90	120
Average income	100		105	

Thus, the modern sector people gain from modernisation, since their income grows from 90 to 120. The reverse is true for the traditional sector individuals, as their income decreases from 100 to 90. Furthermore, 10 people shift from the traditional sector to the modern sector. Yet it is *ex ante* impossible to know who those shifters will be.

How will this economy's people vote if their opinion is asked for in a referendum on trade liberalisation? Suppose that all agents are fully rational and completely aware of the data of the above table. A traditional sector person understands that he or she will have a probability of 1/6 of increasing his or her income from 100 to 120. With probability 5/6, however, income will shrink by 10 units. The expected gain is therefore $(1/6)*(20) - (5/6)(10) = -5 < 0$. Thus, the traditional people will vote against the reform. Since they form ex ante a majority of the voters, the reform will not gather a majority of votes (the modern sector people will obviously vote for the reform, since their expected income change is positive). This is the outcome of the democratic process even if reform increases average income and even increases the income of the *majority* of people.

A salient feature of this model is that if the reform is eventually passed, it will turn out to be popular afterwards: only a minority of voters would want to return to the original state of affairs.

Even in this case, there is an obvious and constructive role for public redistribution of income. If the state can put up an income redistribution scheme that does not waste resources, it can ex ante introduce legislation that will ensure that the losers will be a minority (or even that there are no losers).

Openness and trade as a factor of growth

More can be said on the impact of one specific factor of growth, namely participation in the international division of labour and economic openness. It is generally acknowledged that international division of labour is an important engine of economic growth. Furthermore, developmental success stories are often associated with a bold exploitation of world markets. Wealthy economies tend to be open economies, and this is especially true of small economies.

Many commentators see the correlation between internalisation and social insurance as a negative one: as globalisation proceeds, countries cannot "afford" social insurance systems, so the story goes.

Authors like Dani Rodrik (see Rodrik (1998) in particular), however, have convincingly argued that the relationship between globalisation and the welfare state is a positive one. The empirical regularity certainly corresponds to Rodrik's assertion: the larger the share of foreign trade in a nations output, the higher is the share of government expenditure in output. This conclusion turns out to be quite robust to various statistical tests and alternative specifications of the statistical model.

Rodrik presents a simple theory to explain these facts, based on risk aversion. Open economies are more exposed to the uncertainty generated by volatile export markets. In particular, economies whose export products are concentrated in a few markets (as is typically the case for small and open economies) suffer from greater uncertainty at the individual level. A rational political reaction to this is to build up a welfare state that redistributes income and by these means effectively insures people against uncertainty of factor incomes (see also Rodrik (1997)).

More generally, such reinsurance can take many forms. In any given period, it can entail redistribution from the currently successful to the currently unsuccessful. But a large public sector will also enable insurance from one generation to another. Suppose that an entire economy is largely dependent on the international price of a crop, say. Then, if there are large and long-term swings in this price, a welfare state will also enable a redistribution along the temporal axis.

Counter-arguments: The Overshooting of the Welfare State

The above arguments paint a rather rosy picture of the potential for well-designed social policy in enhancing economic growth and development. A more balanced view must recognise the realities of the political and economic processes that affect economic growth. According to the arguments we have surveyed, the positive role of the welfare state consists in diminishing the uncertainty associated with change, innovation and openness. In a certain sense, the state's action will in this case always amount to some kind of redistribution. This redistribution should not be designed in such a way that the very incentives for change, innovation and openness are taken away. Thus, the question of the proper level and kind of redistribution is a very subtle one and there is no general theory that would predict that democratic political systems would not err on either side.

On the contrary, there are many plausible theories that suggest that redistributive welfare states might expand beyond the point that would be optimal from an efficiency point of view. Perhaps the most convincing of such theories build in one way or another on the notion of *transaction costs* associated with information. If a welfare program is financed by a general tax but benefits a small but well-identifiable group of people, that group of people has a strong incentive to get informed on the project and lobby the political system for its implementation. As the cost of the program is borne for a large number of voters, it might well be too burdensome for the average voter-taxpayer to find out about the deadweight loss that the project imposes on the rest of the economy. Assar Lindbeck (1993) is one representative example of this argument.

Finland as a Nordic Case

The experience of a late industrialised country like Finland can illustrate the interplay of economic agents with the state as a moderator. Finland was still in the middle of the twentieth century a relatively backward country, with a GDP per capita level roughly half of that of central European countries like France and Germany. Beginning from the 1930s and going on through the latter half of the century, the country could generate a remarkable catching up process in which many of the elements outlined above were discernible. This is all the more interesting since the country had in 1918 experienced a bitter civil which divided the nation into two camps, the defeated "red" side and the victorious "white" side. Furthermore, the very existence of Finland as an independent nation was under threat for most of the century, since the country found herself in a contested geopolitical zone, first between Germany and Russia in the interwar years and then between Soviet and NATO after WWII. I have argued elsewhere[3] that the subsequent political will to industrialise may even have benefited from this threat, since it made a free-riding strategy unattractive for all agents: the country could not afford to fail economically.

Anyway, from these premises, the Finnish political system was able to generate a remarkable class compromise in which the powerful working class as represented by the trade union movement and two strong political parties accepted a class compromise that did not put into question the basic mechanisms of property rights, capitalist wealth creation and participation in the international economy, but in which the state would use a large part of the economic surplus to undertake direct productive investment and provide welfare services as soon as the economic wealth of the country would permit.

3 See Vartiainen (1999). I argue there that a similar mechanism may have worked in some Asian tigers like Korea and Taiwan.

Two early political decision that paved the way for the subsequent developments were the "January wedding" of 1940 in which the employers' organisations and the trade unions recognised each other as legitimate and trusted parties, and the fiscal policy measures of the late 1940s in which the high taxes of the war economy were effectively kept unchanged in order to increase the freedom of the state to support economic growth and the growth of welfare services.

The Finnish developmental state had from the early on acquired corporatist characteristics. As such, corporatism was not new. Already in the 1930s, the state and the main economic actors like the banks and the export industry had been working together, in ways not unlike the experience of the Asian late industrialisers. Thus, key economic decisions have been taken in co-operation with organised economic agents. Such corporatist characteristics were enhanced by the war experience.

Anyway, the phase of rapid accumulation of capital from the late 1940s through the 1980s can be seen as a long term class compromise in which the workers abstained from using their full bargaining power while the state guaranteed a high level of investment and capital accumulation as well as the build up of basic public services and social security transfers. The policy tools used to generate this outcome included taxation, credit rationing, selective support for investment and a gradual build up of the welfare state. Thus, the outcome can be interpreted as a long term agreement in which the workers accepted lower wages and got guarantees that the fruits of these sacrifices would benefit not only the capital-owners. Despite its crudeness, this characterisation is quite adequate for the Finnish post-war experience.

One important characteristic of the resulting politics of the welfare state has been its close relationship to the needs of labour markets and worklife. The social partners -- employers' and employees' organisations -- have been closely involved with the state in the design of social policy, and it has then been natural that many social policy programs and measures have been tailored to encourage labour force participation and boost productivity. A typical pattern of political decision-making has been that many initiatives have first been launched by the social partners or voluntary organisations but have later on been adopted by the state.

Key examples of this are:

- *Comprehensive education*; after the war, primary schools were vigorously erected all over the country; free education was first confined to the primary and secondary classes, but in the 1970s a free and universal 12-year schooling scheme was introduced.

- *Day care of children;* in 1973, a comprehensive right to day care at subsidised prices was introduced. This encouraged female labour force participation, which in turn, sustained economic growth through the last decades of the twentieth century. This exemplifies the Finnish and Nordic principle according to which people's entitlements may be either universal or related to work but are in general not tied to marriage or family. Thus, women are treated as independent providers of labour.

- S*ickness insurance*; Finland adopted such a scheme late, in 1964, but at the time of its introduction it was one of the most universal of its kind. It was later complemented by the provision of free health services.

- *Occupational pensions*; In excess of a basic pension provision, the social partners initiated a system of occupational pensions in 1962. Even that scheme made it very attractive to participate in the labour market, in comparison to inactivity.

Is There anything to Learn for the Future?

The growth experience and the associated political regime analysed above was clearly an example of a national solution to the challenge of economic growth. It presupposed that there was a sufficiently well functioning national political system in place, and many of its policy tools made use of economic measures that were available at the time when the global economy was less integrated. At that time, rationing of investment and interest rates, control of the exchange rate and taxation of national subjects were all part of the policymakers' tool kit. In today's world of market-driven rules of the game, there is less scope for such national growth pacts. That there is less scope does not mean that there is no scope, however. As the analyses surveyed in this article have shown, there is a clear case for using the public sector and its social insurance as a way to get the best out of participation into the global economy.

Bibliography

Aghion, Philippe , and Peter Howitt. 1998. *Endogenous Growth Theory*. Cambridge: MIT Press.

Azariadis, C , and A Drazen. 1990. "Threshold Externalities in Economic Development." *Quarterly Journal of Economics* 105: 501-526.

Fernandez, Raquel , and Dani Rodrik. 1991. "Resistance to Reform: Status Quo Bias in the Presence of Individual-Specific Uncertainty." *American Economic Review* 81: 1147-1155.

Lindbeck, Assar. 1993. "Overshooting Reform and Retreat of the Welfare State." in *Seventh Tinbergen Lecture*. Nederlandsche Bank: Institute for International Economic Studies.

Rodrik, Dani. 1997. "The 'paradoxes' of the successful state." *European Economic Review* 41: 411-442.

—. 1998. " Why Do More Open Economies Have Bigger Governments?" *Journal of Political Economy* 106: 997-1032.

Sen, Amartya. 1967. "Isolation, Assurance and the Social Rate of Discount." *Quarterly Journal of Economics* 81: 112-24.

Sinn, Hans-Werner. 1994. "A theory of the Welfare State.". Munich: Centre for Economic Studies, University of Munich.

—. 1995. "A Theory of the Welfare State." *Scandinavian Journal of Economics* 97: 495-526.

Vartiainen, Juhana. 1999. "The Economics of Successful State Intervention in Industrial Intervention." in *The Developmental State*, edited by In Meredith Woo-Cumings: Cornell University Press.