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The welfare state is a piggy bank for life

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Distribution of income over lifetimes matters at least as much as among individuals

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How is the “welfare state” to be justified? The usual answer is that it is a way for the well-off to help the less well-off. But this is not its only role. It is also a “piggy bank”, as Nicholas Barr of the London School of Economics has argued. More precisely, it is a substitute for markets that the private sector does not offer.

Put aside spending on services, such as education or health; focus on benefits paid to individuals, such as housing benefits, tax credits paid to those in work and pensions. In the UK, such benefits amount to a huge sum: 33 per cent of current spending (and 12.5 per cent of gross domestic product) in 2014-15.

In the short run, spending on benefits is largely redistributive. This role of the state is undoubtedly important at all times. But it is particularly significant in the aftermath of a crisis that has left the economy as a whole far smaller than everybody had expected. The Institute for Fiscal Studies, a London-based think-tank, has concluded that changes in taxes and benefits between May 2015 and April 2019 will fall proportionately most heavily on the poorest parts the population. The relatively well-off could have borne more of this burden. The government chose otherwise. Everybody should decide for themselves whether they think this was right.

Such decisions can themselves have significant long-term implications. If, for example, a cut in benefits were to re­duce parents’ ability to support their children, the longer-term economic and social impacts could be highly damaging. But it is when one looks at the welfare state’s impact over the course of a life that something perhaps even more profound emerges: its role is, it seems, as much about distribution of income over lifetimes as among people.

Evidence for this comes from another IFS study, published last year. This examined the effects of the tax and benefit systems on people born between 1945 and 1954 — the baby boomers. It reached four big conclusions.

First, income is far less unequal over lifetimes than in any given year. This is because a big proportion of inequality is temporary, a result either of changing needs as people age or transitory shocks.

Second, largely as a result, more than half of the redistribution achieved by taxes and benefits is over lifetimes rather than among different people,

Third, in the course of adult life, only 7 per cent of individuals receive more in benefits than they pay in taxes, even though 36 per cent of people receive more in benefits than they pay in taxes in any given year.

Finally, in-work benefits are just as good as out-of-work benefits at helping people who remain poor throughout their lives but they do less damage to incentives to work. Higher rates of income tax, meanwhile, target the “lifetime rich” relatively well because mobility at the top is relatively modest.

The finding that taxes and benefits distribute incomes over individuals’ lifetimes even more than among individuals should be seen not as a bug but as a feature of the welfare state.

The argument here is that a necessary condition for economic efficiency is “complete markets”: that is, a market for every asset in all possible states. Evidently — because of pervasive uncertainty, asymmetric information, transaction costs and so forth — complete markets do not and cannot exist. This is not some theoretical curiosity. As a result of these failings, private insurance against unemployment or big temporary loss of income, and borrowing against earnings in the distant future, are difficult if not impossible.

The state is in a good position to rectify these failings, partly because it can monitor behaviour and avoid adverse selection (that is, ending up stuck with only bad risks) by insisting that everyone joins the insurance pool. Of course, the state may design such programmes very badly. Insurance also creates “moral hazard”. But one can limit such damage while helping people through temporary difficulties or the exceptional demands of some stages of life.

The 2015 IFS study suggests this is precisely what the UK’s tax and benefit system does. Publicly financed education and health services strongly reinforce such effects: people gain the biggest benefits from the former when young and from the latter when old.

In designing the structure of taxes and benefits, such lifetime effects are at least as important as those at any moment. These effects include the role of the welfare state as both insurer and bank. Government plays these roles in all high-income nations, including even the US. It is a desirable one. Yet careful design is also needed. The starting point must be with greater awareness of this truth.