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..1
Growth and Distributional Conflict: Theoretical Models 1
Economic change and the Management of Distributional Conflicts 2
Social Insurance and Economic Development...4
    Economy wide returns and individual uncertainty...4
    Resistance to economic reform and modernisation 4
    Openness and trade as a factor of growth...6
Counter-arguments: The Overshooting of the Welfare State 7
Finland as a Nordic Case..8
Is There anything to Learn for the Future? 10
Bibliography.. 11

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