Beyond Redistribution: Binary Economics and the Crisis of the Welfare State

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Abstract: This paper addresses two major problems of contemporary welfare states. The first concerns the increases in income inequality that have occurred over the past 10 to 15 years despite redistributive tax and spending programs. Conventional policy options to reverse this trend, including increases in taxing and spending, are constrained by popular resistance to higher taxes and retreat of leftist parties from socialist or social democratic egalitarian principles. The second problem is related to the financing of old-age pension programs in the 21st century. The immediate source of the problem is demographic, stemming from the sharp rise in the ratio of retirees to workers that all advanced societies will face over the next 10 to 30 years. Options to deal with this looming crisis include raising taxes, cutting benefit levels, or raising the age of retirement. Such measures are both politically unpalatable and may well exacerbate the problem of income inequality. Binary economics holds the potential to help solve or lessen the severity of both these crises. Expanded opportunities for capital ownership holds the potential to (1) supplement (or in some cases to eventually replace) state-funded retirement benefits; and (2) to reverse growing income inequality by providing net benefits to lower-income strata that are proportionally greater than benefits that will accrue to upper-income strata.

Introduction

The phrase "crisis of the welfare state" has been used over the past 25 years or so to describe various problems that modern societies have faced in managing the social and economic security of their populations. While perhaps overused, the term *crisis* is nonetheless appropriate to characterize the gravity of the challenges that have beset the welfare state. In some cases, such as the "fiscal crisis of the state" (O'Connor, 1973) that threatened the economic stability of mature welfare states in the 1970s, predictions of imminent economic collapse have not been borne out. In other cases, such as the "unemployment crisis" of the 1990s, the damage has been distributed unevenly, with some nations continuing to struggle with unemployment at record high levels (e.g., France, Germany, Sweden, Italy, and Finland), while other nations are either experiencing some of the lowest unemployment levels in years (e.g., United States, Denmark, and the Netherlands) or appear to be succeeding in bringing unemployment down to levels that are manageable (e.g., United Kingdom).

The welfare state is a large and complex phenomenon, and this complexity is naturally reflected in the range of problems that confronts it or will confront it in the future. In this paper I will limit attention to only two problems. The first is the rising levels of income inequality that have afflicted modern societies despite decades of redistributive welfare state taxing and spending programs. The second problem is the acute pressure that state-sponsored old-age pension programs are beginning to feel and which will become more severe over the next two to three decades as a consequence of the inexorable rise in the size of the aged population and corresponding large increases in the ratio of retirees to workers. Both these problems, I will argue, are serious enough to merit the use of the term *crisis*.

I will begin with a brief review of the origins and implications of these two problems. I will then move on to a discussion of the potential for a program of expanded capital ownership along the lines suggested by Louis Kelso's binary economics (e.g., Kelso and Hetter, 1967) to provide remedies that might solve or lessen the severity of both these conditions.

Increasing Inequality

Historically the welfare state has had two main purposes: (1) to provide protection against the risks of loss of income (due to retirement, disability, unemployment, or the death of a breadwinner); and (2) to redistribute income downward.[1] While societies have varied in the degree to which they have pursued these goals, particularly the extent of income redistribution they have sought to achieve (Esping-Andersen, 1990), all nations have put into place state-sponsored welfare programs to mitigate the effects of market forces on individuals and families. From the late 19th to the mid-20th century, these interventionist policies succeeded in reducing social and economic insecurity and in achieving a greater degree of income equality than before—although the impact of the policies varied substantially across nations, as did their pre- and post-tax and transfer levels of income inequality.

Beginning in the 1970s, however, the capacity of the welfare state to fulfill the twin purposes of social protection and income redistribution began to weaken. The causes are multiple, including: (1) the increasing pressures on national labor markets exerted by the globalization of the economy; (2) growing tax resistance among the population and the emergence in some places of radical anti-tax movements; (3) a general move to the right on the part of socialist and social democratic parties in the wake of the collapse of communism in Eastern Europe; and (4) the difficulties in fulfilling commitments to existing social programs under conditions of relatively low rates of economic growth. Thus, in the 1980s the welfare state was described as having grown to its upper limits (Flora, 1986), while the 1990s has been characterized as "after the Golden

Age." Without going into detail here, the key point is that there is an emerging consensus that the future of the welfare state will not be one of bold new initiatives, nor even more of the same policies that marked the past half century. Instead, most scholars see the welfare state as having entered a period of retrenchment, marked by defensive measures to guard against wholesale efforts to dismantle the welfare state (cf. Pierson, 1994) and generally lowered expectations. Indeed, for most OECD nations, the period from 1980 to 1994 saw only modest increases in the percentage of GDP spent on social security transfer programs. The exceptions to this trend are Sweden and Finland, which saw social security spending undergo a sharp increase in the early 1990s as a result of the nations' deepest recessions since the 1930s.

A retrenchment of the welfare state might be acceptable if it represented a stable equilibrium. But, in fact, the status quo does not appear to be stable: in terms of income inequality and the projected capacity of modern societies to live up to long-term social security commitments, movement over the past decade has been in the wrong direction, and more trouble lies ahead. The situation of the welfare state is, in short, a crisis.

The most compelling evidence of the problem of growing income inequality comes from the United States, a nation that both historically and currently is the preeminent welfare-state laggard. Consider the following indicators:

- Average hourly wages of men have declined in real terms since 1979 in all but the upper decile of earning, with the largest decreases located in the bottom quintile.

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[1] These are not the only functions the welfare state has performed. See Coughlin and Armour (1985) for a discussion of social control functions. See also Furniss and Tilton (1977) and Esping-Andersen (1990) for a discussion of the different models of the welfare state.

- The top quintile's share of aggregate household income increased steadily from 1976 through 1996, while the bottom *80 percent* of households all saw their share of income decrease.
- From the late 1970s to the mid-1990s family income increased in real terms by almost 30 percent among the top quintile but less than 10 percent for the fourth quintile; income actually decreased in real terms among the bottom half of households, with the biggest losses concentrated among the poorest 20 percent.
- From 1980 to 1996, average wages in the U.S. increased at a rate about 30 percent less than corporate profits, with the gap widening sharply since 1992.
- Although the lowest-paid workers have clearly fared badly in the United States, the situation in other nations is not encouraging. Both Canada and Australia saw low wage workers actually lose ground during the 1980s, while gains in the welfare states of Western Europe were only modest—with wage increases of low-paid workers typically averaging 1.5 percent or less in real terms per annum, except for Germany.
- The minimum wage has decreased in real terms since the 1970s throughout the industrialized world, with the possible exception of France, where it increased through the mid-1980s before leveling off.
- The distribution of wealth is even more skewed than the distribution of income. Even in a society such as Sweden, with one of the world's most egalitarian post-tax/transfer distributions of income, it is estimated that 90 percent of securities are owned by less than 10 percent of the population.

In sum, the recent history of the welfare state has the reemergence of a growing gap between the rich and poor, even in the face of total welfare spending that has been increasing (albeit by a modest amount). In terms of economic equality, the welfare state seems to be caught on a treadmill where it has to run ever faster just to keep up—and there are clears signs that it is falling behind. Conventional remedies to combat levels of inequality judged to be excessive, such as expanded benefit programs or more steeply progressive taxation, are thwarted by economic reality on one side and political forces on the other. Modern welfare states can ill afford to increase social benefits for the most vulnerable segments of the population (indeed, the trend seems to be in the opposite direction) without either cutting other types of spending (such as old-age pensions and health care, which everywhere are the two biggest social spending categories), or raising taxes, or both. There is nowhere to be found within the conventional framework of social and economic policy an obvious way out of this dilemma. Below I will discuss how binary economics may hold the key to opening an innovative and workable solution. But before doing so, I would like to turn to the second problem confronting the welfare state, namely, the growing population of the elderly and the enormous pressures that state pension systems are beginning to feel.

Rising Aged-Dependency Ratios

Since the 1960s there has been a decline in fertility rates in all industrial societies. The reductions in fertility are the result of a combination of factors, including: (1) in most nations, a rise in fertility rates after World War II that produced the famous "baby boom" generation; (2) the increased availability of reliable birth control methods (and, in many nations, increased access to abortion); and (3) the changing status of women, including not least of all increased participation in paid work outside the home. The declines in fertility have been gradual in some nations such as France and Sweden, which already had relatively low fertility rates before World War II (and which, consequently, had instituted consciously pro-natalist family policies as early as the 1930s). In other nations, such as Italy and Japan, the drop in fertility has been abrupt, falling from levels higher than average in the 1950s to among the world's lowest in the 1990s.

The decline in fertility rates has produced an unprecedented demographic imbalance in the ratio of retirees to workers. This imbalance is already beginning to place enormous pressure on public retirement systems. For example, in 1990 France already had fewer than three people of working age (defined as 20 through 60 years, the latter the age of eligibility for pensions for both men and women in France) per retiree. The United Kingdom, Austria, and Sweden were all at levels only fractionally higher than three workers per retiree—with the statutory retirement age varying from 60 to 65 across these nations.

But even those nations with relatively healthy ratios of workers to retirees in 1990 will shortly run into problems early in the next century. By 2030 Germany and Japan are projected to have only two people of working age (even applying the generous definition of workers as individuals 15 to 64 years old) for every person over 65—not even half the number they have today. The United States and Britain are in only slightly better shape, with worker to retiree ratios stable through the year 2010 before experiencing a sharp rise in the proportion of elderly through the year 2030. The latter date is also approximately the time when the United States old-age pension trust fund is projected to be depleted—although rosy (and likely unrealistic) assumptions of continuing uninterrupted economic growth may push back the latter date several years.

The impact of the "graying" of the population will be further exacerbated by another demographic trend, the increasing life expectancies in modern societies (with the exception of post-Soviet Russia, where life expectancies for males have fallen precipitously). For health care and social service systems, the increasing numbers of the "old old" will pose further important challenges to welfare states, further exacerbating the demands on government budgets to fund pension benefits.

Finally, there has been a trend, particularly notable among males, to opt for early retirement. The average retirement age in the United States for men is now approximately 62 years--a figure which is all the more remarkable when one considers that one-half of the male population retires before 62 years of age. In some nations, particularly in Western Europe, the problem of growing demands on public retirement systems has been aggravated by policies that have built in incentives for retirement at ages as young as the mid-40s or early 50s (Esping-Andersen, 1996).

Conventional Solutions?

Within the conventional framework of current political economy, initiatives that would deal effectively with the two problems outlined above—increasing income inequality and overburdened public pension systems—are regarded as either politically unpalatable or economically unacceptable.

The growing gap between the rich and the middle class and poor, while hardly a secret, can hardly be said to be at the forefront of political and popular attention. In part this is because the poor, working or not, have tended to suffer in silence real declines in their standards of living. The problem of low-wage employment is, furthermore, not amenable to easy amelioration: it has deep roots in the global economy, and poses extraordinary difficulty for policymakers at the national level. In those nations where unemployment is at dangerously high levels, the primary political concern is to create job opportunities. Attempts to prop up wages only make this task, *ceteris paribus*, more difficult. Indeed, job security and high wages in well-developed welfare states is typically the focal point of criticism by neo-classical economists, who argue that such conditions rigidify labor markets, discouraging both employment mobility and job creation. Even where unemployment levels are currently at politically manageable levels, many new jobs are in low-wage employment, which will if anything tend to increase income inequality over time. Efforts to prop up minimum wage levels will only slow, not reverse, this market-driven trend. Short of a radical restructuring of the economy—something not under serious discussion—the future will likely bring more of the same. And, as noted above, increases in the gap between high-wage and low-wage employment (and, more generally, inequality in household incomes) has occurred over the past two decades at a time when social security spending has actually increased as a proportion of national GDPs.

The problems facing pension systems have received more public discussion than the growing gap between rich and poor in large part because the looming pension crisis is of such immense potential impact that it cannot be ignored. Proposals to remedy the problem include cutting benefits, raising taxes, or raising the age of retirement. These approaches inflict pain with no immediate prospects for gain, and so are understandably politically unpopular—a situation that will hardly improve over time. Another perspective on reform looks to privatization as the solution. Specific proposals range from diverting a small amount of taxes into privately managed retirement accounts to wholesale scrapping of public pension schemes. While abolition of public pension schemes is virtually impossible, the incrementalist approach of diverting some taxes into private investments holds some promise. However, if proposals to privatize all old-age pensions offer too much, too soon, most reforms currently under discussion to earmark some payroll taxes for private annuities are too little for all but the youngest of current workers. As I argue below, however, the principle of supplementing state pension systems with private capital investment is extremely attractive, and with the addition of some binary economic elements could potentially be leveraged into a significant reform of social security.

How Binary Economics Can Help

The basic principle of binary economics is to make access to capital investments available to people who would not otherwise have the means to do so. The various specific mechanisms for achieving this goal are described elsewhere (e.g., Kelso and Hetter, 1967 and 1991; also see Ashford 1996), and I will not go into detail here. Instead, I will focus on the unique advantages for an approach based on binary economics to make significant progress toward reducing income inequality and helping to stabilize pension schemes.

A policy aimed at significantly broadening the base of capital ownership would, first of all, be of greater proportional benefit to those at the lower end of the income distribution, which is composed of households without significant assets and whose "wealth" may consist of some equity in a house (but often not even this). Underwriting access to capital acquisition would allow persons in low-wage employment to build up significant assets over time, and serve as a countervailing force against the declining real value of the income they derive from paid employment. The question of how much difference ownership of capital will make in the long-term welfare of the poor and near poor is, of course, dependent on the specifics and scope of the policy undertaken. Such measures would undoubtedly hold out the greatest promise for those who are currently managing to make ends meets, by providing them with realistic hope that their economic circumstances will improve significantly over the mid- to long term. This latter group, however, is not small, comprising a broad segment of the population—a rough estimate would include the middle 50 to 60 percent of households. Whether or not capital assets generated through a Kelso-type plan would eventually replace reliance on various forms of public assistance for the poorest segments of the population is another question, which I will not attempt to address here. But whatever the magnitude of the wealth effect realized through a policy of expanded capital ownership, it would represent a positive step toward reversing a trend toward ever more severe economic inequality—a problem for which the welfare state currently offers little or no effective remedies.

Expanding the base of capital ownership would also serve to relieve pressure on overburdened state pension schemes. To the extent that workers are able to build up significant private capital holdings, it will be feasible to reduce to some extent their reliance on state pensions as a source of retirement income. Here the logic of a Kelso-type approach is similar to many proposals currently under study to add a privatized component to state-sponsored social security. The important difference, however, is that the binary economics strategy would allow individual contributions to be leveraged, thus multiplying several fold the potential for building wealth. Conventional proposals to privatize social security either require contributions up front (e.g., the Chilean and

Singapore approaches), or divert only a small amount of individual taxes to individual retirement account (IRA) investments. The result is either too much individual savings or not enough. The binary economics approach, in contrast, allows for individual contributions to be based in whole or part on the extension of credit to purchase capital assets. Underwriting credit for the purchase of individual capital assets is either a radical proposal or quite a modest one, depending on one's ideological perspective (more about this below). The economic question of how much additional wealth could be created by providing the means for people who would otherwise not be able to purchase capital assets on their own is, of course, a central concern for ongoing study.

The binary economics approach is a politically attractive means of reducing inequality and buttressing public pension systems, since it would not necessitate either increasing the level or progressivity of taxes to be implemented. Its immediate beneficiaries would include a large majority of the population—essentially everyone who presently does not possess significant capital assets (roughly 80 to 95 percent of the population). But what of those who are already doing well: the successful entrepreneurs, business executives, and professionals who have seen their incomes rise and their stock portfolios swell over the past decade? These groups, who admittedly wield political power disproportionate to their numbers, may view a Kelso-type plan as of little benefit to themselves and potentially a threat. This is a potential obstacle that should not be ignored, and which will require skillful political packaging. Such an effort might begin by emphasizing that in the same way that government subsidized home mortgages have not diluted the value of real estate holdings over the years--indeed, they have helped the real estate market by propping up demand, especially at the bottom where conventional financing is routinely denied to low-income people defined as "poor credit risks." A broadly based strategy to expand capital asset holdings does not pose a necessary threat to those who already hold significant assets. The binary economics approach would certainly be more palatable to the affluent segment of the population compared to higher and/or more steeply progressive taxes. Here I make the somewhat controversial assumption that absent fundamental changes in the economy or social welfare systems of advanced nations, the tax reforms of recent years lowering the top marginal rates of income tax and giving preferential treatment to capital gains income cannot be sustained indefinitely, and will eventually need to be reversed if modern democratic societies are to avoid the massive income inequalities typically found in Third World nations.

Economically, the impact of expanding capital ownership is also potentially beneficial. If successful, an approach based on principles of binary economics will stimulate demand where it is most needed (i.e., the middle to low end of the income distribution) and lead to higher and more stable rates of economic growth. A possible downside, of course, would be increased demand that would spur inflation. These are all important questions that merit serious consideration and further study. Here I would like to stake a more modest claim: that binary economics offers an approach that is less radical than most of the alternative proposed means under consideration to address the twin crises of growing inequality and increasingly burdened public pension schemes. Indeed, on reflection, the Kelso solution seems benign compared to such moves as the abrupt abandonment of public pension systems (as some radical measures for privatization would propose) or the seemingly endless taxing-and-spending cycle in which modern welfare states have become entangled in their well-intentioned but

Sisyphusian task of attempting to moderate growing economic inequality and providing some measure of income security for their populations.

Related to this point, approach to reforming social security based on principles of binary economics would embrace a wide range of the political spectrum. Only the extremes of the ideological spectrum would likely see a proactive policy of broadening the base of capital ownership as undesirable. Although hard-line neo-liberals (whom George Soros has referred to as "market fundamentalists") and unreconstructed socialists may object, albeit on quite different grounds, the broad center—ranging from moderate social democrats, "new democrats," and "third way" politicians of various stripes—to pragmatic conservatives will likely find significant appeal in pension reform policies based on binary economic principles.

In conclusion, binary economics offers an innovative approach to reducing economic inequality and easing growing demands on public retirement systems. Moreover, it could be phased in gradually, does not require increases in taxes, and would likely enjoy broad political support. Binary economics thus deserves serious consideration as a way out of the current, and more importantly future, crisis of the welfare state in western democratic societies.

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