LABOR MARKET INSURANCE AND SOCIAL SAFETY NETS IN DEVELOPING COUNTRIES

by

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EPIGRAPH

I am deeply convinced that any permanent, regular, administrative system whose aim will be to provide for the needs of the poor, will breed more miseries than it can cure, will deprave the population that it wants to help and comfort, will in time reduce the rich to being no more than tenant-farmers of the poor, will dry up the source of savings, will stop the accumulation of capital, will retard the development of trade, will benumb human industry and activity, and will culminate by bringing about a violent revolution in the State, when the number of those who receive alms will have become as great as those who give it, and the indigent, no longer being able to take from the impoverished rich the means of providing for his needs, will find it easier to plunder them of all their property at one stroke than to ask for their help.

(De Tocqueville, Memoir on Pauperism, pp. 24-25)

I conceive it to be highly desirable, that the certainty of subsistence should be held out by law to the destitute able-bodied, rather than that their relief should depend on voluntary charity. In the first place, charity almost always does too much or too little: it lavishes its bounty in one place, and allows people to starve in another. Secondly, since the state must necessarily provide subsistence for the criminal poor while undergoing punishment, not to do the same for the poor who have not offended is to give a premium on crime. And lastly if the poor are left to individual charity, a vast amount of mendacity is inevitable. What the state may and should abandon to private charity, is the task of distinguishing between one case of real necessity and another. Private charity can give more to the more deserving. The state must act by general rules. It cannot undertake to discriminate between the deserving and undeserving indigent. It owes no more than subsistence to the first, and can give no less to the last. ...The dispensers of public relief have no business to be inquisitors. Guardians and overseers are not fit to be trusted to give or withhold other people's money according to their verdict on the morality of the person soliciting it. ...Private charity can make these distinctions; and in bestowing its own money, is entitled to do so according to its own judgment. It should understand that this is its peculiar and appropriate province, and that it is commendable or the contrary, as it exercises the function with more or less discernment.

(Mill, Principles of Political Economy, Bk V, Ch. XI, pp. 335-6).

INTRODUCTION

The purpose of this paper is to examine the design of social safety nets that are fiscally and politically sustainable. Various components of proposed safety nets: the provision of merit goods, direct transfers to alleviate poverty, insurable labor market risks, unemployment benefits and severance payments are distinguished, and discussed.

To anchor the discussion, it is necessary to briefly outline the difference between a "welfare state" and a "social safety net" and to provide a typology by stage of development of the type of labor market risks faced by workers in different developing countries which requires some collective action. This is done in Section I. Even if a social safety net embodying such collective action is required, there is the open question whether this should be left to individuals to organize through private institutions or should be imposed on them through the coercive power of the State -- including its power to tax. This question is discussed along with the available empirical evidence in Section II. This then allows us to set up some general principles for the design of social safety nets in line with classical liberalism, in Section III. The fourth and final section then applies these principles to provide some operational guidelines for the individual components of the safety net distinguished above.

I. LABOR MARKET RISKS IN THE PROCESS OF DEVELOPMENT

(A) Safety Nets and Welfare States: The subject of this paper are transfers -- which allow the income/consumption of an individual to be higher than it would otherwise be. The distinction between the "welfare state" and a "social safety net" then turns essentially upon the universality of coverage of transfers under a welfare state as opposed to the restriction of collectively provided benefits under a social safety net to "those among the poor who are unlikely to benefit from economic growth or human resource development. The safety net includes income transfers for those chronically unable to work -- because of age or handicap -- and those temporarily affected by natural disasters or economic recession" (World Bank, Poverty Reduction Handbook, [PH] 4-4). The same handbook also then notes two essential elements in any design of a social safety net: "The issues concerning transfers and safety nets include identifying the groups in need of assistance, and the means of targeting assistance to those groups cost-effectively. Are these questions for public policy, or are they adequately addressed by the traditional family network?" (ibid., pp. 2-13)

By contrast, welfare state advocates (e.g., see the recent World Bank conference papers on "targeting") favor universality as it alone in their view provides a feasible means to achieve the ends sought to be subserved by a social safety net. Some (e.g., Barr (1992)) have argued that, because of the ubiquitousness of imperfect information, markets for risk will be inherently imperfect. Hence, universal welfare states are required as part of an efficient solution to deal with "market failure". This last argument was dealt with in Lal (1993a). Suffice it to say that this "nirvana economics" provides no credible justification for a welfare state.

An implicit objective of those who argue against targeting and in favor of universal welfare states is distributivist. This is not surprising as they are by and large socialists who subscribe to the common socialist end of egalitarianism. But as set out in Lal (1993) classical liberalism necessarily eschews egalitarianism.[1] Nor is egalitarianism a universally accepted moral code that can be used to justify the universalized public transfers of a welfare state on ethical grounds.

The need for a social safety net -- to be found in most economies -- is not necessarily a reflection of morality, nor of public action seeking to correct "market failures", but is due to the ubiquitousness of risk in men's lives and the possibility of reducing its individual burden through various forms of mutual assurance. This could take various forms: through market processes such as insurance, as well as social institutions like the family. The term "social" needs to be clarified in this context. Though it has become coterminous with public (state) action, in its original sense it refers only to co-operative action -- private or public. In this sense to say that there is a need for a "social safety net" does not prejudge whether this should be provided through private or public action.

(B) Labor Market Risks: So what are the risks in labor markets against which mankind has sought some form of insurance through social cooperation and how have these changed with different stages in economic development? As most economies were agrarian organic economies, in which (until fairly recently) labor was scarce relative to land, there were two major types of risks that were endemic.

The first, which was a form of systemic risk was related to the need to tie labor down to land where various forms of intensive agriculture were feasible and profitable (largely in alluvial plains, e.g., the Indo-Gangetic plain in India). Without this tied labor, less intensive and productive forms of agriculture would have had to be adopted. Various institutions -- feudalism in Europe (see Bloch), the caste system in India (see Lal (1988)) -- evolved to deal with this systemic risk.

More ubiquitous were the cyclical risks associated with changing climate. Various institutional arrangements like the jajmani system in India (see Lal (1988)), sharecropping (see Bardhan (ed)), interlinked contracts in other factor markets (see Bardhan), provided the ways to cope with these risks. Moreover, in these traditional societies, unemployment and destitution as "normal" states were virtually unknown (see Garraty). Feudal societies were designed to provide a place for every member, and the local "society" -- village, clan or tribe provided the requisite social safety net. The main risk, as in a famine, was of not being able to spread highly covariant risks across the local group. In traditional Indian village society, for instance, this risk was partly dealt with by acquiring relatives through marriage in geographically distant areas whose climatic risks would not be correlated with their own. They could then expect the necessary transfers from their spatially distant relatives when they were suffering climatically induced falls in their income (see Roseznzwig for the continuing relevance of this feature in modern Indian village life).

In other parts of the world: "Among tribes, no doubt, a rough and ready concern for the sick and old marked most peoples. In settled communities, an essential part was the role played by the lord. A typical feudal provision was that of the Prussian code of 1795: the lord had to see to it that poor peasants were given education, that a livelihood for such of his vassals as had no land must be provided and, if they were reduced to poverty, he had to come to their aid" (Thomas, p. 577). In Europe, the breakdown of medieval society,and the subsequent agrarian and industrial revolutions led to major changes. Not least, because population expansion led ,in addition to the destitution of those without any labor power (the handicapped and the old without any families) to: "the poverty of the able-bodied who lacked land, work, or wages adequate to support the dependents who were partly responsible for their poverty" (Illife, p. 5). They were the paupers , and altruism apart, it was the danger to civil order from vagrancy which lent urgency to the alleviation of their poverty once the link between poverty, crime, and vice was perceived. Their numbers being swelled by another form of conjunctural poverty arising from the Industrial Revolution's trade cycle and the unemployment that ensues in its downturns.

Finally, in most pre-industrial economies self-employment was and remains the dominant form of employment. A self-employed worker combines in his person and personal enterprise (or household) all those characteristics which, due to the division of labor, are separated in industrial firms. These are labor, entrepreneurship, and capital. A variation in the demand for the output produced by these factors of production will be reflected in an instantaneous change in the implicit value marginal products of the various "factors". There cannot be any "involuntary" unemployment, therefore of the self-employed, and hence no question of unemployment insurance for them. Only the income transfers to alleviate conjunctural poverty and those that maybe deemed necessary to provide merit goods as part of the social safety net, will be relevant for them.

(C) <u>A Typology of Risks and Stages of Development</u>: This suggests that we can combine these differing structural features of labor markets, as countries move from being rural organic economies to industrial ones, with the three fold categorization of poverty into: destitution, conjunctural poverty, and mass structural poverty, due to Illife and outlined in Lal (1993a). This can provide a typography of the differing components of the social safety net that will be relevant at different stages in development.

<u>First</u>, are those countries (mainly in sub-Saharan Africa), which are still largely pre-industrial and where labor is still scarce relative to land. There maybe a great deal of mass structural poverty, but no social

safety net can deal with it. Its only cure is rapid efficient growth, following the classical liberal recipe.

The causes of destitution are likely to be a lack of labor power (because of physical handicaps, age, and the lack of any able bodied family members). Direct transfers to alleviate such destitution are unavoidable. Whether these should be public or private is taken up in the next section.

The major causes of conjunctural poverty are likely to be climatic crises or political turmoil. Its most dramatic manifestation is a famine. Since the Indian Famine Code was devised by the British Raj in the late 19th century, the remedy for a famine is also well known. Because of the common fall in output and income over a geographical area encompassing private transfer networks, the purchasing power which is required to ward of the famine will have to provided by state action (through food for work schemes for instance). As the Indian example shows, apart from one wartime exception this administrative solution has eliminated famines. But this solution does require political stability and a relatively competent administration. Thus in post-colonial Africa, apart from climatic factors which have periodically put some Africans (particularly pastoralists) at risk, political violence in a series of civil wars has created an army of destitutes. These African civil wars have created 12 million "mass distress migrants" between 1964-84 (Oliver's review of Ilife). Since then, the Sudanese and Eritriean famines were due to civil wars in which famine was a political weapon used by the State against secessionists; and the Somali famine which resulted from the collapse of that country into a Hobbesian state of nature. Similarly the worst famine in human history, occurred in China as a result of the politically determined Great Leap Forward. It cost 63 million lives (actual and prospective -- through lost or postponed births) (see Lin (1990)). In all these cases the State rather than being the solution has been the problem.

Second, are those countries (mainly in South Asia), where labor is abundant relative to land. There in addition to mass structural poverty, destitution is likely to be due not to a shortage but an excess of labor power. Its alleviation most often merges with that of mass poverty, for which the only long term solution is efficient growth. But there will now be a group -- landless labor -- which is able-bodied but may not be able to find enough work throughout the year. This creates a risk of seasonal unemployment, for which many agrarian institutions such as tied farm workers have evolved (see Lal (1989)). Whether some public action can provide an alternative and better form of insurance will be discussed in the last section. The risks of conjunctural poverty will be similar in these primarily agrarian economies to those discussed above.

Third, are those countries in which non farm employment is predominant in either industrial or mining enterprises or in plantations (mainly in Latin America and parts of East Asia). The main additional source of labor market risk in these economies where the division of labor has gone much further than the primarily agrarian economies of Africa and South Asia, is linked to the industrial trade cycle and the accompanying unemployment in its downturns. As the process of industrialization also often entails a constantly changing pattern of industrial output, and hence industrial structure, frictional unemployment as workers move from declining to rising industries will also appear. Questions of unemployment insurance and severance payments will be relevant in promoting flexibility and thence efficiency in these more "formal" labor markets. It is these aspects of a form of conjunctural poverty, and of destitution which are likely to be most relevant in thinking about social safety nets for such economies.

Finally, in a class by themselves are the former socialist economies now attempting to transform themselves into market economies. Their problem is not the creation of social safety nets, but the efficient dismantlement of the system of publicly guaranteed entitlements that their full scale socialist, universal welfare states had created. Their problems are shared by those countries (e.g., India, Sri Lanka) whose flirtation with socialism created inefficient public sector enterprises, offering their workers politically determined entitlements, which they now want to rescind. For some socialist countries, as large parts of their existing industrial capital stock is nearly worthless at world market prices, economic liberalization also entails at least a temporary drop in industrial output. This raises the scepter of mass structural poverty, whose cure again is efficient growth. However, unlike the agrarian economies where "the poor have always been with us", this incipient structural poverty involves a massive frustration of existing expectations (however economically unviable) which could be politically explosive. Unlike the other set of countries, therefore, for ex-socialist countries, designing some transitional arrangement of public transfers to deal with structural poverty maybe a political imperative. We deal with these issues in the final section.

II. PRIVATE VERSUS PUBLIC TRANSFERS IN SOCIAL SAFETY NETS

As the risk of income shortfalls over an individual's lifecycle is ubiquitous, it would be extraordinary if most societies had not found means of insurance against these risks. Historically, destitution and conjunctural poverty were dealt with through five means. The first was through institutions like the Church, which took one of its primary tasks to be the care of the poor. Individual charity most often through interhousehold transfers from an extended family provided a second means. A third was through organizations of the poor themselves: through self-help organizations (e.g., rotating credit associations like the contemporary Grameen bank), and the mutual friendly societies of 18th and 19th century Britain discussed in Lal (1993a). Fourth, were various underworld organizations engaged in crime. Finally, various forms of insurance embodied in interlinked contracts in factor markets, have historically been the major way of dealing with conjunctural poverty in traditional village economies (see Platteau).

(A) Private Transfers: Of these the role of private inter-household transfers is particularly relevant. For though transfers through religious channels have probably been significant, I have not been able to find any scholarly analysis of their size or effectiveness. This is surely an area for profitable future research. Kin based transfers, reciprocity arrangements and interlinked factor market contracts have been the major way that traditional societies have dealt with income risk. As Platteau concludes:

> Even though empirical evidence is scanty (but not altogether absent), the case can reasonably be made that, barring exceptionally unfavorable circumstances (such as repeated crop failures or crop diseases affecting entire communities), traditional methods for controlling the risk of falling into distress have usually enabled the people to counter natural and other hazards in a rather effective way. (p. 156).

With the inevitable erosion of village communities it is feared that these private insurance arrangements will break down and that no private alternative will be available to counter destitution and conjunctural poverty in increasingly industrial economies.

It is in this context that the role of private interhousehold transfers is of great importance. Cox and Jiminez (1990) provide evidence to show that they are of considerable quantitative importance.

> For example, among a sample of urban poor in El Salvador, 33% reported having received private transfers, and income form private transfers accounted for 39% of total income among recipients. Ninety-three percent of a rural south Indian sample received transfers from other households. In Malaysia, private transfers accounted for almost half the income of the poorest households. Nearly three quarters of rural households in Java, Indonesia, gave private transfers to other households. About half of a sample of Filipino households received private cash transfers. (p. 206).

(Also see Rempel and Lobdell, Knowles and Anker, Collier and Lal, Oberai et. al., Lucas and Stark on the significant size and effects of remittances within the rural and between the rural and urban sectors in Ghana, Liberia, Nigeria, Pakistan, Tanzania, Kenya,India and Botswana.) Moreover since the oil price rise of the early 1970s the poor in South Asia and parts of Southeast Asia have found remunerative employment in the newly rich oil states and their remittances to their Third World relatives has helped to alleviate their poverty (see G. Swamy).

The motivation for these transfers is of some interest. If they were purely altruistically determined (as in Becker's famous "rotten kid" theorem),[2] then it would imply that with intergenerational transfers between parents and children there would be dynastic families which would behave as though they were a single infinite lived individual. Barro's famous Ricardian equivalence would then hold, with public policies such as debt financing and social security being completely neutralized by countervailing private action. Warr, and Bernheim and Bagwell, went further and showed that as "propagation requires the participation of two traditionally unrelated individuals, ...there will be a proliferation of linkages between families." This gives rise to even stronger neutrality results.

> In particular, no government transfer (including those between unrelated members of the same generation) has any real effect, and all tax instruments (including so-called distortionary taxes) are equivalent to lump sum taxes. In essence, the government can affect the allocation of real resources only by altering real

> expenditures. The efficiency role of government is thus severely limited, and the distributional role is entirely eliminated. More generally, ...if all linkages between parents and children are truly operative, then market prices play no role in the resource allocation process: the distribution of goods is determined by the nature of intergenerational altruism.
> (Bernheim & Bagwell, pp. 309-10)

As these implications seem to be highly unrealistic, attempts have been made to explain private transfers as part of an exchange process involving an implicit mutually beneficial contract say between parents and children, who in exchange for their educational expenditure, say, are committed to looking after their parents in their old age (see Kotlikoff and Spivak, and Bernheim et. al.) Lucas and Stark have developed an intermediate model in which both altruism and self-interested exchange are the motives for transfers, and found that it applies satisfactorily to Botswana. They found that the prediction of the pure altruism model that lower income households will receive higher transfers is not borne out, and that instead as the exchange model predicts there is "a positive association between amount remitted and per capita income of the household from other sources" (p. 910). For in the exchange model the "greater wealth of the family should increase its relative bargaining strength" (p. 906), and thus leads to a higher demand on its "migrants".

But as Lucas & Stark recognize, their data -- which is cross-sectional -- does not allow the altruistic motive for transfers to be tested in a dynamic context. Rosenzweig does so. In a longitudinal study of 6 villages in three different agro-climatic regions in the semi-arid tropics of India he found that

> kinship in a risky world not only tends to bond family members in a single location (in a particular way) but kinship ties are able to be sustained over time and space in implicit insurance-based transfer schemes which contribute to consumption smoothing in the face of covariant income risks. (p. 1167)

> It is kinship, and common (family) experiences [which] induce trust, knowledge and altruism among family members,[hence] such income pooling implicit contracts maybe feasible even if spread across wide areas. (p. 1152)

Thus the empirical evidence on the motives for private transfers is mixed. As Cox and Jimenez summarize it:

> Some studies find an inverse relation between recipients' resources and transfer amounts received (for instance Kaufman and Lindauer for El Salvador, Kaufman for the Philippines, Ravaillon and Dearden for rural households in Java, and Tomes for bequests in the U.S.) But others (Lucas and Stark for Botswana, Cox for [inter vivos transfers in] the U.S., Ravaillon and Dearden for urban households in Java, and Cox and Jimenez for Peru) find a positive relation, which contradicts the altruism hypothesis. (p. 216)

There are some empirical studies which directly estimate the crowding out effect of public on private transfers. Most of these have been done for the U.S. (see Lampman and Smeeding, Cox and Jakubson, Rosenzweig and Wolpin and Gale, Maritato and Scholtz), and find some small crowding out effect. For developing countries there are only two available studies. For Peru, Cox and Jimenez (1992) found that in the absence of social security in urban Peru, private inter household old age support would have been higher by 20%. So there is considerable but not complete crowding out of private by public transfers. A study of the Philippines by Cox and Jimenez (1993) is probably more relevant. As they state:

> part of the reason for the low estimates of the degree of crowding out of private transfers by public ones might be due to the fact that the estimates discussed above are derived in environments [in OECD countries] where public transfers are already substantial. These transfers may have already crowded out private transfers to a large extent, rendering the small samples of private -- recipients uninformative. In contrast, the Philippines has almost no public welfare payments, which makes it an ideal case study for gauging the strength of private transfers. (p. 6)

They found that transfers were widespread and large. They used the available data to simulate the effects on these private transfers of three public policies; unemployment insurance, social security and income grants targeted to the poor. For unemployment insurance they find: "the reduction in private transfers is nearly as large as the boost in income that unemployment insurance gives to households. Ninety-one percent of the increase in household income from unemployment insurance is offset by reductions in private transfers" (p. 19). For retirement income they find that "private transfers would be 37% higher" if retirement income did not exist. On a program to completely eliminate poverty by giving each household the difference between its actual income and poverty line income, they find that after private transfers adjust: 46% of urban and 94% of rural households below the poverty line before the program would still be below the line after the program! Moreover they give reasons to believe that their estimates of crowding out are biased downwards. This study should certainly give anyone seeking the public transfer route to deal with labor market risks considerable cause to pause.

These doubts are further strengthened when we consider that, private transfers by relying on locally held information (see Hayek), and in part on extra economic motivations like trust and altruism, can overcome many of the problems of adverse selection, moral hazard etc., which have so exercised the "nirvana" economics market-failure school. For as Cox and Jimenez summarizing the empirical evidence conclude "private transfers equalize income; private transfers are directed toward the poor, the young, the old, women, the disabled and the unemployed" (p. 216).

(B) <u>Public Transfers</u>: Perhaps public transfers can do even better, so that we should not worry if they crowd out private transfers? Public subsidization of the two merit goods -- health and education -- are the major public transfers in nearly all developing countries. In addition social security is important in many Latin American countries.

One question on which there is some empirical evidence is the incidence of the benefits from subsidies for merit goods. Beginning with the pioneering studies of Meerman for Malaysia, and Selowsky for Colombia, a number of other studies have addressed this issue. Jimenez (1989) summarizing the studies done till 1987, concluded:

> students from the highest quartile of the income distribution profile in Chile, Colombia, Indonesia, and Malaysia receive between 51 and 83% of all public expenditures on higher education, whereas those from the lowest 40% receive between 6 and 15%. The effect is only partly counterbalanced by the concentration of primary education subsidies among poor families, which have most of a country's younger school children. The net result is a distribution of overall educational subsidies roughly proportional to each income group's population share, with the exception of the Dominican Republic where the poor's share is still less. The income bias is less for health. Health subsidies for Colombia and Malaysia are roughly proportional to each income group's population share. But in Indonesia, the poorest 40% capture only about 19% from public health centers and hospitals. (p. 114)

More recent studies of the effects of health subsidies in Indonesia (see Deolalikar, van de Walle) find that:

> with the sole exception of reported morbidity, all the evidence points to the children of high-expenditure households benefitting more (in terms of the marginal effects on both health utilization and health outcomes) from government health spending than the children of low expenditure households. Even in the case of reported morbidity, the greater benefits derived by the poor relative to the non-poor from government health spending is quite small.

Moreover,

> if government health spending largely improves publicly-provided health care opportunities for the non-poor but also crowds out private providers (say, traditional healers) that are used typically by the poor, it could reduce the total amount of medical care opportunities available to the poor. If the health outcomes of the poor are highly responsive to medical care inputs, this could have a detrimental effect on their health.
>
> (Deolalikar, pp. 26, 28)

Jee Peng Tan (<u>Poverty Handbook</u>, [PH] Box 3.9) cites the conclusion from a 1990 Bank study of Asian government's spending on health that:

> The findings on targeting of public expenditure on health to the poor in Asian countries are not encouraging. ...For the countries for which data could be assembled, there is little evidence of such targeting, either by income group or geographical area. The data suggest that the same infections and parasitic diseases that have been killing people in Asia for centuries continue to do so.

For Brazil (PH, Box A3.2) McGreevey concludes from a 1988 Bank report

> the poorest 19% of the population receives only about 6% of social benefits. A large share of social expenditure benefits higher-income groups. Regional inequalities are also severe.
> (Also see Maddison et. al.)

For Costa Rica Riboud (PH, Box A3.3) concludes on the basis of a 1990 Bank report:

> Total benefits are fairly evenly distributed among income groups. This is the result of two opposing and compensating forces: the regressiveness of the distribution of education benefits and the progressiveness of the distribution of health benefits. ...Taking account of state pensions, however, social program benefits per capita are 62% higher for the richest 20% than for the poorest 20% of the population.

On social security in Latin America Meso Lago (1983) noted that a stratification of social security had occurred with each occupational group seeking its own arrangements.

> Generally, the most powerful groups (militarymen, civil servants, the labor aristocracy) exercised pressure to obtain the best systems so that social security became a pyramid in which the higher strata enjoyed better systems than the lower strata, while the base of the pyramid was made up of the non-insured. The more powerful the pressure group, the earlier in time it received protection, the greater the degree of its coverage, the less its financial cost, and the more generous its benefits. (p. 89)

The net result is that:

> the distributive objective of social security (on behalf of the needy) is rarely fulfilled in Latin America, since in the majority of countries social security plays either a regressive or null role. The extreme poverty group is deprived of protection (except for public health and social welfare programs) and, to add salt to injury, it contributes through taxes and prices, to the welfare of those insured. Within the latter, especially in stratified systems, the lower income groups generally receive a net social security transference inferior to that accrued by the higher income groups. (p. 95)

Nor are the various public transfers indirectly targeted to help the poor such as agricultural and food subsidies any more effective in achieving their objectives. Thus Pamela Cox (PH Box 3.7) summarizing the findings of a 1991 Bank report on the incidence of agricultural subsidies in India found that: "benefits from agricultural input subsidies have gone overwhelmingly to wealthier and agriculturally advanced regions and to larger farmers." Whilst Liberman summarizing a 1989 Bank report's findings on India's safety net programs concluded: "The public distribution system has high costs and weak targeting, including a strong urban bias. The national employment schemes have a small positive impact on the income of poor households , but with relatively low coverage in some very poor states".

Next, what have been the effects of social expenditures on health and education on various social indicators? The evidence again is mixed. But there are two revealing pieces of evidence that suggest that the common presumption that a rise in these social expenditures will improve literacy and life expectancy and reduce infant mortality is not secure. Thus Grosh (PH Box 3.4) summarizing a 1990 World Bank study which

> traced public social sector expenditures for nine Latin American countries in the 1980s...found that real per capita public social spending on health, education, and social security fell during some part of the 1980s in every country in the study. The share of health and education expenditures in total government expenditures also fell, even as that of social security rose. In spite of lower funding , and no apparent increases in equity and efficiency, social indicators generally improved in the 1980s.

Apart from obvious statistical and other biases which might explain this anomaly, the most plausible explanation provided is that, it might be due to "the growing role of non-governmental organizations, and the response of the market oriented private sector to enhanced expectations and demand". That is there was probably a "crowding in" of more equitable and more efficient private transfers to replace the decline in public ones!

The second is a simple regression we ran on the State level data on per capita public expenditure on health and education between 1976 and 1986 and the changes in literacy rates and life expectancy and infant mortality rates for India, given in Ravallion and Subbarow (1992).[3] In these cross-sections, we found there was no statistically significant relationship between changes in state level health expenditures and health outcomes, and a statistically significant negative relationship between changes in educational expenditure and literacy!

(C) Political Economy of Transfer States: And so we could go on. But enough has been said to suggest that public transfers are clearly not the panacea being touted by socialists of various hues (see Ahmad for a representative sample of this type of viewpoint). Their efficacy in achieving ends like improved educational and health outcomes are dubious and the incidence of their benefits tends to be regressive, certainly as compared with the evidence on private transfers summarized earlier. The general conclusion about these transfers is a repetition of a Bank report's conclusion for Honduras: "most social programs benefit primarily the middle class and rich, through spending on curative hospital care, pension benefits and higher education. Social spending pays for services that might be financed by the private sector" (PH. Box A3.5).

This "middle class capture" of the benefits of social expenditure is not confined to developing countries. It has also been documented for the welfare states of the OECD (see Goodin and Le Grand). A systemic process is clearly at work. The new political economy is useful in understanding it. It is most clearly seen in terms of the political economy of redistribution in majoritarian democracies. In a two party majoritarian democracy, politicians will bid for votes by offering transfers of income from some sections of the populace at the expense of others. Models of this political process (which do not require democracy, but rather the interplay of different pressure/interest groups -- see Stigler, Meltzer and Richard, Peltzman -- show that there will be a tendency for income to be transferred from both the rich and the poor to the middle classes -- the so-called "median voter". Even if social expenditures are initially intended to benefit only the needy, in democracies such programs have inevitably been "universalized" through the political process, leading to what are properly called transfer rather than welfare states, which primarily benefit the middle classes.

The poverty alleviation that may occur as a by product of the expansion of the transfer state is moreover bought at a rising dynamic cost. With the universalization of various welfare schemes, political entitlements are created whose fiscal burden is governed more by demography than the conjunctural state of the economy. With the costs of entitlements rising faster than the revenues needed to finance them, the transfer state finds itself in a fiscal crisis. This process is discernible both in developing and developed countries.

For developing countries Lal-Myint show how this process is clearly visible in those countries in their sample (Uruguay, Costa Rica, Sri Lanka, and Jamaica) that under the factional pressures of majoritarian democracies have created and expanded welfare states. All four welfare states were financed by taxing the rents from their major primary products. With the expansion of revenues during upturns in the primary product cycle, political pressures led to their commitment to entitlements, which could not be repudiated when revenues fell during the downturn in the price cycle. The ensuing increase in the tax burden on the productive primary sector (to close the fiscal gap) led to a retardation of its growth and productivity, and in some cases to the "killing of the goose that laid the golden egg". Thus whilst there was undoubtedly some poverty redressal as a result of the expansion of these welfare states, over the long run the entitlements created damaged economic growth on which they were predicated, and hence eventually became unsustainable. Similar processes leading to the fiscal crisis of the state are to be found in many other developing countries (see Mesa-Lago (1983, 1990) for Latin America). Not surprisingly, many of these countries with over extended welfare states are now seeking to rein them back. The most dramatic being the case of Chile (see Castaneda).

Very similar problems are also visible in the more mature welfare states of the OECD. For though the public provision of transfers to the "deserving poor" in the U.K. goes back to the Elizabethan Poor Law, it was not till the late 19th century that, beginning with Bismarck's introduction of social insurance against sickness, accident and old age, and soon followed in the U.K. by Lloyd George's 1911 introduction of national insurance (which in addition covered unemployment), that public transfers began to expand in all industrial countries (in the U.S., the New Deal was the watershed). In the post second world war period these public transfers exploded -- as in the 1960s and 1970s the coverage of health and pensions benefits was made universal and their levels increased. The share of social expenditures in total public expenditure rose from 44 to 60% between 1960 and 1980, and the share of social expenditures in GDP rose from under 14% to nearly 25% over the same period (see Hakim and Wallich (1986)). In an earlier study (see Lal and Wolf) the deleterious effects of this expansion of the welfare state on the public finances, and on the economy's productivity had been charted (see Lindbeck for a discussion of the productivity damaging effects of the Swedish welfare state, which ultimately brought it to its knees). With the stagflation of the 1970s in part flowing from these trends, and with growing uneasiness about the unintended social consequences of the welfare state (on which more below) many OECD governments took measures to stem the growth of transfers. In some countries which had gone furthest down the public welfare route, the late 1980s and 1990s saw a growing questioning of the welfare state in the West, and in some cases its partial or virtual dismantling.

One final aspect of the welfare state is its effects on what De Tocqueville in his Democracy in America called the "habits of the heart" -- the cultural underpinnings for both a democratic society and the market economy. The most sustained though controversial critique of the decadence in private habits engendered by the transfer state is in Murray's examination of the results of the U.S. war on poverty. The cultural consequences of the welfare state maybe as momentous as the economic or political ones. This is a very large subject beyond the scope of this paper. But as Lee Kwan Yew has pointed out the Western welfare state has sapped the family bonds which provide the safety nets in East Asia.

This is of relevance because of the oft repeated claim that "ageing populations, growing urbanization and the rising number of nuclear families have weakened the traditional support provided by the family and increased the need for formal provision" (Ahmad, p. 106). But are extended families in the Third World necessarily likely to be extinguished? And is the decline of not only extended but even nuclear families in the West due to some inevitable process associated with economic growth, or as Murray and many others maintain, it is the unintended consequence of well intentioned welfare policies which subsidize teenage mothers, promote single parent families, and make the type of reciprocal exchange relationships -- outlined in our discussion of private transfers- more and more redundant.[4] If the family has been an institution which has to some extent been created and preserved as a form of mutual insurance against life's risks, is the transfer of these insurance functions to the State not likely to undermine the very institution whose decline politicians in all the Western welfare states are currently bemoaning? Nor can one assume that the type of individualistic as opposed to dynastic motivation for marriage which seems to predominate in the West is a universal human characteristic, nor that it is a necessary accompaniment of growth. Many Third world cultures e.g., Indian and Chinese, seem to be relatively immune to these Western cultural norms. As Lee Kwan Yew suggests, the family in many Third World cultures may be <u>relatively</u> immune to the specifically Western social developments which have undermined it in the West. But of course, as economic incentives matter, as in the West, Third World families <u>could</u> be undermined by similar welfare state policies.

Thus, seeking ways to strengthen traditional methods of dealing with destitution and conjunctural poverty, and finding new ways to foster the civic virtues and the growth of civil associations, on which (for classical liberals) the health of sustainable democracies as well as market economies depends, is likely to serve the Third World better than finding arguments for a vast expansion of State provision/financing of social expenditures. For as sociologists (e.g., Nisbet) have noted, the conversion of welfare into transfer states in the West (and some developing countries), has led to an attack on civil society from both above and below. From above the intermediate institutions of civil society are forced to surrender their functions and authority to professional elites and the bureaucrats of centralizing states. From below "rights chatter " -- the clamor for numerous and newly discovered individual rights (see Lal (1993)) -- undermines the authority of those traditional civil institutions -- family, church, school, neighborhood -- which in the past have promoted both private benevolence and the lower order "vigorous virtues". The acceptance of claims to various welfare rights, substitutes public for private benevolence -- sapping the latter, which for classical liberals is the highest (though scarce) virtue (see Lal (1993)).

It is these longer run, unintended, social and fiscal consequences of the welfare state, which are now leading to its partial dismantlement in many OECD countries -- of which the most dramatic example is the virtual abandonment of the New Zealand welfare state by its chastened socialist party, and the most poignant is the growing reversal of that social democratic beacon of hope the Swedish "middle way". It is then particularly ironical that, at a time when the welfare state is coming to be repudiated by its progenitors, international institutions such as UNDP, UNICEF and WIDER are seeking their extension in the Third World.

III. CLASSICAL LIBERAL PRINCIPLES AND LABOR MARKET INSURANCE

The refurbished classical liberal principles ,for public action in insuring labor market risks, then follow naturally from the above discussion.

The <u>first</u> is that nothing should be done which would damage the existing private institutions and channels which provide for private transfers to deal with destitution and conjunctural poverty. "Forbear" should be the watchword for every proposed scheme which seeks to alleviate poverty through public transfers.

The <u>second</u> is that, if for whatever reason, public money is sought to be transferred to the "needy", this is best done through private agencies.

In particular for the merit goods of primary health care and primary education, whatever the case for public financing there is none for public production. As the Bolivia Public sector expenditure review noted:

> in the health sector, NGOs deliver the most effective service. In education, several communities have asked the largest NGO to manage their public schooling, indicating the perceived better quality education offered, even with much higher student: teacher ratios in NGO schools. ...The public education system spends more than 10 times more per child than the largest NGO, which provides high-quality education.
>
> (PH, Box A3.1; also see Jimenez et. al. (1991))

The third, is that the very problems of moral hazard, adverse selection and monitoring cited by "nirvana economics" for public insurance, in fact argue for fostering the alternative private route which capitalizes on the comparative informational advantage of private agents with local knowledge (see for instance the evidence on the relative efficacy of private credit agents over centralized public agencies in rural credit markets, Binswanger et. al., Braverman and Guasch; von Pischke et. al.) These private welfare channels can be promoted by various methods of co-financing them with public funds. (Though some of the pitfalls in this public embrace of private NGOs outlined in Lal (1993) should be borne in mind.)

For the Bank it maybe worth considering a radical proposal for channeling of all its IDA aid for "safety nets" for alleviating destitution and conjunctural poverty through a Bank sponsored consortium of international charities. This could be modelled on the highly successful Bank CIGAR initiative for agricultural research.

Fourth, in cases where for political reasons public responsibility for the needy has to be accepted, public policy should be concerned with alleviating real hardship and not with equalizing people. The socialist distributivist end must be forsworn. State help should be concentrated on the minority in absolute need, and the categories of prospective beneficiaries should not be allowed to multiply as "'need' assumes an elastic dimension in the name of 'relative poverty'" (Harris, p. 18).

Fifth, universal provision of welfare and social security benefits should be eschewed. For particularly in majoritarian democracies, such "universalization" will corrupt the polity with competing politicians showing their compassion by indiscriminately buying votes with other people's money. This in turn will lead to the likely "middle class" capture of the transfer state, and could lead to endemic growth and fiscal crises.

IV. GUIDELINES FOR PUBLIC ACTION ON SOCIAL SAFETY NETS

If public action is considered desirable to deal with various labor market risks, what are the guidelines for specific types of risks that the application of the above principles can provide. For the political reasons mentioned earlier, the dismantling of the universalist welfare states in former socialist countries will necessarily involve some continuing public provision of the "safety net". Moreover in those countries (e.g., the Soviet Union) where socialism has completely extinguished or greatly weakened those channels of private insurance through the family or mutual aid agencies, it maybe a long time before private substitutes for public welfare become feasible. Hence the following discussion maybe of particular relevance for such "economies in transition". We deal with the various elements of the safety net in sequence.

For the merit goods of education and health, as noted in the last section there maybe a case for financing the poor but none for public production. As J.S. Mill put it: "If the country contains a sufficient number of persons qualified to provide education under government auspices. the same persons would be willing to give an equally good education on the voluntary principle, under the assurance of remuneration afforded by a law rendering education compulsory, combined with state aid to those unable to defray the expense" (p. 161). For health we have argued (see Lal (1993a)) that the poor are best helped by various means to allow them to purchase private care. These means include mutual aid societies, as well as private charities and NGO's. Matching public funds to the private funds raised by these charitable institutions would be the method of channeling public funds to the poor. For both type of merit goods, if the country has an adequate administrative capacity, vouchers earmarked for purchasing these merit goods given to the preferred purchasers will be more efficient than subsidies to producers. If, faut mieux, public provision of these merit goods is undertaken then differential pricing to recover the costs of provision, whilst subsidizing the poor on the lines developed and recommended by the World Bank,in the past, is desirable (see Jimenez (1989) for a powerful restatement of the case for social sector pricing against the universalist welfarists).

Social security pensions form the other major component of social expenditures, at least in the more advanced developing and former socialist countries. As in most Western welfare states, they are pay-as-you-go schemes. In the light of demographic trends in most ex-socialist countries, they are as in the West an economic time bomb (see Lapidus and Swanson,and IMF et. al., for socialist countries, and Lal and Wolf, and Boskin for the West). In countries where the welfare ethos has become widespread, there is the danger that, it maybe rational to be feckless in providing for one's old age as "the rotten kid meets the good samaritan" (see Bruce and Waldeman (1990)). Hence, some state compulsion in ensuring everyone provides for a basic pension maybe desirable. As in Chile (see Castaneda) this could be done through earmarked taxes that are put into fully funded and actuarily fair, private pension funds.

This leaves various forms of <u>income support programs</u> -- including disability and unemployment insurance, and transfers to alleviate low end poverty -- which are common in many Western welfare states, and which are being recommended for the transitional socialist economies (see Barr (1992a), Paull). These schemes involve unavoidable "tax-cum-subsidy distortions" because lump sum taxation and subsidization is normally not feasible. The econometric attempts to provide quantitative evidence of the effects on labor supply, consumption and savings of these distortions has been inconclusive (see Atkinson) -- another example of the emerging law that "all econometric evidence is equivocal"!

<u>Unemployment insurance</u> is of little relevance for the majority of developing countries in which self-employment predominates over wage employment. Even in the so-called modern sectors of these economies where wage employment is the norm, measured open unemployment rates are relatively low, and the unemployed are typically highly educated relatively wealthy urban youth. Their unemployment reflects, in part, the availability of "reserves" (from their relatively better off families) to finance job search in the high wage modern sector and, in part, the over expansion of higher and secondary education because of economically unjustifiable public subsidies (see Squire). In addition, relatively high institutional wages in the modern sector encourage what can be termed Harris-Todaro type unemployment. Given these "typical" features of developing country labor markets, unemployment insurance is only feasible for wage employees in the modern sector.

In an excellent overview of the literature on unemployment insurance, Hammermesh argues that the only rationale for unemployment insurance programs is the "individual based goal of consumption stabilization. ...For this goal to be valid it must be true that workers either estimate the probability of becoming unemployed correctly, but are so myopic that they do not save for the eventuality; or they underestimate the probability and thus have insufficient precautionary savings" (p. 3). But this still does not establish whether such programs should be private or public. Beenstock and Brasse have argued that general private unemployment insurance would be feasible. (But see Barr (1992) who again uses "nirvana economics" arguments to counter this claim.) But as Hamermesh notes:

> Before the British unemployment insurance program was introduced in 1911, several private firms offered UI as an insurance option. ...The early British companies went bankrupt, and the classic argument in favor of social insurance for unemployment is that private carriers cannot insure against the common risk of a nationwide recession. A compulsory privately operated program, with very large carriers that have sufficient reserves or borrowing capacity to weather a recession, might not have such problems. (p. 13)

If however, for whatever reason a publicly funded program of unemployment insurance is introduced for the urban employees in the formal sector, what should be its features? We need to minimize the side-effects in terms of the higher urban unemployment/expansion of the urban informal sector, and increased rural-urban migration that maybe induced. These effects will depend upon how the "tax" to finance the benefits is raised. If the tax is levied on modern sector employers, whilst their wage employees receive the benefits, the net effect will be to raise the "effective" wage of such employees and this will through the familiar Harris-Todaro type dynamic process lead to a reduction in modern sector employment, increase the size of the urban "informal" sector, and also rural-urban migration. If, instead, the "tax is assessed on worker's earnings, there is no effect on the size of the urban sector, just as there is no impact on the employment or the unemployment rate. [Hence] to the extent we believe that labor-market dualism characterizes developing economies, UI benefits should be financed by taxes on the earnings of workers in the modern sector" (Hammermesh, p. 35).

From a poverty viewpoint, the seasonal unemployment of landless labor in rural areas is likely to be of greater importance than urban unemployment. Rural public works schemes like the Maharashtra Employment Guarantee scheme (see Ravallion (1991)),have been effective both in preventing famines and in dealing with problems of short run income variability. But their success lies in the self-targeting that is made possible by offering a wage that only the truly needy will accept.

Severance Payments: In many ex-socialist economies as well as those developing countries which created over-extended and inefficient public sectors, an important part of structural adjustment is the privatization of such enterprises. In addition many bureaucracies which were set up to manage controlled economies need to be slimmed as they move towards market economies. Such structural adjustment programs, typically face political resistance from the public sector workers who face retrenchment and/or cuts in their real wages. Such workers can exert political pressure to prevent the rescinding of their politically determined entitlements to future income streams which are above what they would be able to obtain in the free market. The capitalized value of the difference between their expected public sector earnings (including pension and other benefits), and those they could get in the private sector (adjusted for the probabilities of being hired and fired in the market), represent the rents, public sector workers are currently receiving. If their resistance is to be overcome they might need to be compensated for these rents. This is a political rather than an economic argument for severance payments, over and above those that might already exist in the contractual arrangements that maybe in force in the respective labor markets (see Rosen for a survey of the reasons why many labor market contracts will have various forms of severance terms built into them for efficiency reasons). How to deal with this problem will differ from country-to-country, depending upon the particular labor laws and the government's ability to rescind these unviable rents. If the method of adjustment is to be voluntary, however, certain common problems will be faced. The most important of these is that, given the heterogeneity of the labor force, the rents derived from public sector jobs will differ for different workers, being highest for the "bad" workers whose market opportunities relative to their entitlements in the public sector are the worst. With imperfect knowledge of each worker's rents, and the difficulty in devising perfectly discriminating severance payment schemes, if the severance compensation is set to persuade the last "bad" worker to leave the public sector, the intra-marginal workers will be receiving more compensation than the capitalized value of their public sector rents. This could mean a very high cost to the fisc. But in some cases (e.g., where the public enterprise is producing negative value added at world prices), shutting down the enterprise even with this high cost may lead to a gain in net GDP. In others where the enterprise might still be viable after restructuring and privatization, which involves retrenchment, the problem of tailoring a severance package remains. Papers by Fiszbein and Diwan provide detailed analyses of the various options, as well as discussions of severance payment schemes in a number of countries.

The most attractive plan which would meet both the objectives of limiting political opposition and reducing the fiscal burden would be one limited to workers not hired by the newly privatized enterprise. This tackles the adverse selection problem whereby the "good" workers take the severance package and the "lemons" are left with the new firm. The severance package for those made redundant should be based on the principle of tailoring the benefits to the median redundant worker's public sector rents. This would imply that, if the severance package offered uniform compensation at the level of the rents to the median retrenched worker, all those with lower rents would be better off, and they would provide the political support for the scheme to override those workers whose rents were greater than the median and would be worse off. Little more can be said in principle about the specific terms of these programs which need to be tailored to local conditions, and in particular the relative bargaining power of public sector workers vis a vis the state.

Transfers to alleviate poverty: We have already discussed the reasons for preferring the strengthening of private channels and institutions for the alleviation of low end poverty (destitution and conjunctural poverty), in countries where the welfare state ethos has not become widespread. This is best done by the public co-financing of local and international charities, as well as local mutual self-help associations. But there are a number of countries, mainly the ex-socialist, where either because they already have universalist welfare states, and/or the institutions for the private sector option are not present, some form of public provision for income support of the low end poor may be necessary. How can this best be done? A large part of the relevant group is likely to consist of people who for identifiable reasons are incapable of earning a living (the handicapped, the mentally ill, the old and infirm without any families or savings). Their inability to finance their basic needs is genuinely involuntary, and hence the problems of perverse incentives which bedevil so many social insurance type programs is not likely to arise. This is the category of people the Victorians labelled the "deserving poor". In the absence of private charity, public assistance to provide them some basic minimum income maybe justifiable. But again, for the reasons discussed in previous sections, this public assistance is probably best channeled through local voluntary associations.

The problems of disincentives and the creation of a dependency culture is particularly acute for the able-bodied poor (see Murray). No completely satisfactory scheme is available on the basis of Western experience to alleviate their poverty without the perversion of incentives. Negative income tax, or basic income schemes (e.g., those recommended by Friedman, and in the Meade committee report) involve unacceptable tax burdens. Thus Brittan and Webb estimate that such a scheme which guaranteed a minimum income for all U.K. families at the current income support level would require a uniform income tax rate of 40%, much higher than the current basic income tax rate of 25%. However, the alternative of targeted means-tested benefits, which are withdrawn when the unemployed find work or the poor move up the income ladder, lead to well known disincentives associated with unemployment and poverty traps. There is no obvious remedy. Decentralization to local communities of the administration and monitoring of these programs to help the able-bodied poor -- as is done in Sweden and Switzerland -- may be part of the answer (see Lindbeck, Segalman). An income maintenance scheme that distinguishes between the able-bodied poor and the deserving poor has recently been proposed for Eastern Europe by an IMF economist (see Paull). It has much to commend it. The deserving poor are means tested and publicly assisted to bring them up to a minimum income level. The able-bodied poor are assisted through a series of training, job-search and workfare programs to enter or re-enter employment. The proposals are costed for Poland and do not seem to imply unreasonable shares of GNP as compared with Polish social expenditures for 1990, or similar expenditures in developed countries. If the programs can be decentralized so that they are administered and monitored locally, they might provide the best that can be done to deal with an intractable problem.

But in the long run, even in these ex-socialist countries the hope must lie in the creation of a civil society where private transfers and institutions arise to take care of the needy. Besides promoting the supreme moral virtue -- private benevolence-extolled by classical liberalism, it would also prevent that corruption of the polity that the creation of universal welfare states has invariably caused.

ENDNOTES

*The paper was written for the Vice President, Human Resources Development and Operation Policy, The World bank. Comments by members of a seminar at the World Bank and the National Council of Applied Economic Research are gratefully acknowledged.

[1]The technocratic approach to public policy has been based on the welfare economics pioneered by Bergson and Samuelson and which Sen has labelled "welfarism". But the trouble with this has always been: how are the judgments about the social good which form the social welfare function to be derived? As Sugden notes: "most welfarists think of social welfare judgments as being made by a particular individual, but from a neutral standpoint. This basic idea can be found, for example, in Arrow's (1963, p. 107) ethically neutral "public official...it can be traced back to Adam Smith's 'impartial spectator'" (p. 1949). In classical utilitarianism, pleasure provided the measure of goodness. But this view flounders on the impossibility of finding a metric for pleasure, in particular one which is interpersonally comparable. Nor, as Sen (1982) has shown in his penetrating critique of "welfarism", is the revealed preference version any more coherent. He has then attempted to argue for his own conception of the social good based on "capabilities" and "functionings", which unlike revealed preference welfarism "does not automatically assert that whatever the individual chooses is good for him Then, by aggregating in some way the good of all individuals, we can arrive at a conception of the social good" (Sugden, p. 1951). But as Sugden notes "given the rich array of functionings that Sen takes to be relevant, given the extent of disagreement

among reasonable people about the nature of the good life, and given the unresolved problem of how to value sets" it is not operational, and provides no alternative to the measurements of real national income and practical cost-benefit analysis based on Marshallian consumer theory that is the bread and butter of applied economics.

The alternative to this attempt to define the social good -- which Platonic Guardians then maximize -- is an alternative vision of public policy where "society is seen as a system of cooperation among individuals for their mutual advantage. On this view, the primary role of government is not to maximize the social good, but rather to maintain a framework of rules within which individuals are left free to pursue their own ends" (Sugden p. 1948). This is the classical liberal vision of the state as a civil association in Oakeshott's terms (see Lal (1993)). Its contemporary exponents are the Virginia public choice school and the neo-Austrians like Hayek. Amongst philosophers it is reflected in the contractarian tradition of the American liberal Rawls, and the libertarian Nozick. It is the viewpoint from which these series of papers have been written. But it should be noted that Sen (1992) has claimed that even this tradition can be subsumed into his own and that its proponents are also egalitarians -- with respect to the good "liberty". But as Sugden argues convincingly, this is a misreading of this contractarian and classical liberal position which cannot be subsumed, as Sen suggests, into a theory of the social good.

[2]The rotten kid theorem states that:

> when one member [of a family] cares sufficiently about other members to be the head, all members have the same motivation as the head to maximize family opportunities and to internalize fully all within-family "externalities", regardless of how selfish (or, indeed, how envious) these members are. Even a selfish child receiving transfers from his parents would automatically consider the effects of his actions on other siblings as well as his

> parents. Put still differently, sufficient "love" by one member guarantees that all members act as if they loved other members as much as themselves. (Becker, p. 270)

[3]The regressions estimated on the Ravaillon-Subbarow data were OLS regressions of the percentage changes (increases) in life expectancy (LIFEXPTN); literacy rates (LITRCY) and (decreases) in infant mortality (INFMORT) in different states in India between 1976 and 1986, as the dependent variables and the rate of growth of per capita expenditure on health (HLTH), and the percent change in per capita public expenditure on education (EDTN) as the independent variable. As there was no infant mortality data for West Bengal and Bihar, the relevant health expenditures were dropped from the regression with the restricted variable HLTH1. Given the weakness in the underlying debt set, not too much should be read into this regression. The only purpose is to compute the "evidence" usually advanced on the basis of similar ??? cross-sectional regressions by "the other side"! It should also be noted that as pointed out by Bhalla, since there is a "physical limit" to some of the social indicators (life expectancy, infant mortality), linking percentage changes in the social indicators to changes in the relevant expenditures in the regression will be untenable. A logit form for the indicators is more appealing but difficult to implement, because we do not have knowledge of the ceiling or floor for the relevant social indicators for its estimation. But as Bhalla notes the logit curve is approximately linear in the middle (and for the Indian states the data is in the middle of the possible span of most of the indicators) the percentage form "may represent useful approximations" (Bhalla, p. 103). The estimated equations with the t-ratios in parentheses are as follows:,

$$\text{(I)}\quad \text{LIFEXPTN} = \underset{(2.98)}{4.16} + \underset{(1.62)}{0.44}\ \text{HLTH}$$

Adj R sq = 0.11
No. obs. = 14
F stat. = 2.61

(II)	EDTN =	14.15 - 0.18 EDTN	Adj.R sq = 0.27	
		(3.02) (2.39)	No. obs. = 14	
			F stats = 5.71	
(III)	INFMORT =	43.78 - 2.08 HLTH1	Adj R sq = -0.02	
		(3.50) (0.88)	No. obs. = 12	
			F stats. = 0.77	

[4] The evidence from the US on the effects of the welfare system on incentives is summarized in Danziger et. al., and Moffitt. The latter also incorporates many of the findings of the former. Moffits's general conclusion is:

> The literature on the incentive effects of the U.S. welfare system...has shown unequivocal evidence of effects on labor supply, participation in the welfare system and on some aspects of family structure. ...Yet the review has also shown that the importance of these effects is limited in many respects. The labor supply effects, whilst statistically significant, are not large enough to explain the high rates of poverty among female heads. ...In addition, the econometric estimates of family structure effects are not large enough to explain long-run declines in marriage rates and, in any case, are incapable of explaining recent upward trends in female headship because welfare benefits have been declining. ...Some of the evidence assembled in the review suggests that family- structure issues appear to be at least as important in understanding the economic status of low income female heads as labor supply issues. ... Unfortunately, the research on family structure remains in its infancy compared to the voluminous research on labor supply.
>
> (Moffitt, pp. 56-7)

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