NISKANEN
CENTER

Policy Essay

THE FREE-MARKET WELFARE STATE: Preserving Dynamism in a Volatile World

Samuel Hammond[1]
Poverty and Welfare Policy Analyst
Niskanen Center

May 2018

INTRODUCTION

"The perennial gale of creative destruction…" wrote the economist Joseph Schumpeter, "…is the essential fact of capitalism." For new industries to rise and flourish, old industries must fail. Yet creative destruction is a process that is rarely—if ever—politically neutral; even one-off economic shocks can have lasting political-economic consequences. From his vantage point in 1942, Schumpeter believed that capitalism would become the ultimate victim of its own success, inspiring reactionary and populist movements against its destructive side that would inadvertently strangle any potential for future creativity.[2]

This paper argues that the countries that have eluded Schumpeter's dreary prediction have done so by combining free-markets with robust systems of universal social insurance. As one survey of national elections across Europe found, "the universal welfare state" directly depresses the vote for reactionary political parties.[3] Conversely, I argue that the contemporary rise of anti-market populism in America should be taken as an indictment of our inadequate social-insurance system,[4] and a refutation of the prevailing "small government" view that regulation and social spending are equally corrosive to economic freedom. The universal welfare state, far from being at odds with innovation and economic freedom, may end up being their ultimate guarantor.

The fallout from China's entry to the World Trade Organization (WTO) in 2001 is a clear case in point. Cheaper imports benefited millions of Americans through lower consumer prices. At the same time, Chinese import competition destroyed nearly two million jobs in manufacturing and associated services—a classic case of creative destruction.[5] Yet rather than help those workers adjust, our social insurance system left them to languish. In the regions of the United States most exposed to import

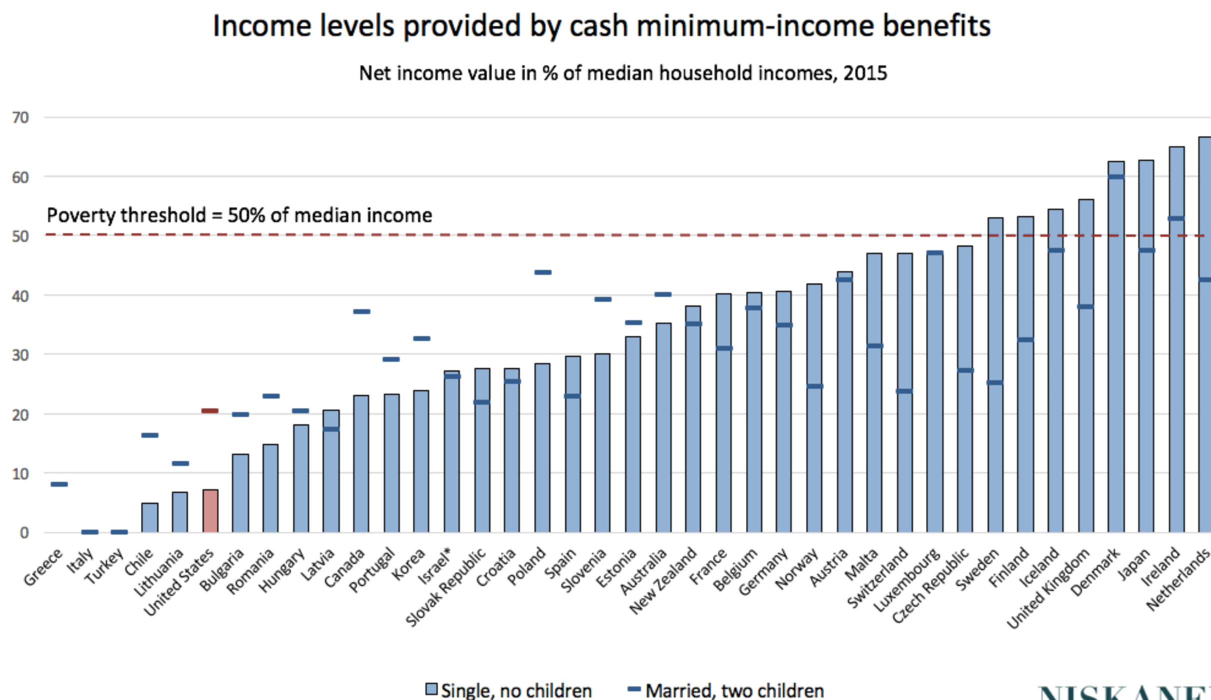
competition, Social Security Disability Insurance (SSDI) was more than twice as responsive to the economic shock as unemployment insurance and Trade Adjustment Assistance (TAA) combined, even though it is one of the most restrictive disability programs in the developed world. Indeed, while critics of the welfare state often argue the United States spends a trillion dollars a year on social programs, only about a quarter of this comes close to anything resembling cash or quasi-cash income support—about the same annual amount spent subsidizing employer-based health insurance.

As shown in **Figure 1**, this has made the U.S. income security system one of the stingiest in the developed world. As a result, the "China Shock"[6] fueled a subsequent growth in anti-trade and nativist sentiment that, researchers have since shown, directly contributed to increasing political polarization, the election of nativists to Congress,[7] and the populist presidential candidacies of Bernie Sanders and Donald Trump .[8]

While the impact of the China Shock is easy to see thanks to its discrete timing and regional concentration, creative destruction of a similar magnitude is a continuous fact in any growing economy. In fact, in the decade after 1999, nearly four times as many American manufacturing jobs were sacrificed to automation and productivity growth as to Chinese trade—despite being a period with historically sluggish productivity growth and job destruction rates.[10]

With far bigger technological disruptions on the horizon, from robotics to revolutions in artificial intelligence, preserving the full dynamism of the U.S. economy will require transforming the current patchwork of means-tested programs into a system premised on the fundamental complementarity of free-markets and universal social insurance—a true "free-market welfare state." This paper defends that basic proposition, while leaving detailed reform proposals for future research. My starting point is a rejection of the prevailing view of social welfare, shared by policy makers on both the left and right, as simply a tool for addressing poverty or income

Figure 1: America's Missing Income Security System



inequality. While all insurance programs are redistributive *ex post*, what separates social insurance from a purely zero-sum redistribution is the *ex ante* economic security created by risk-pooling. And much like the market itself, risk-pooling arrangements represent a positive-sum, cooperative institution.[11] With this in mind, I argue that well-designed social insurance programs are ones that:

- Promote entrepreneurial risk-taking and ease credit constraints in low-income households;
- Address the "adjustment costs" associated with globalization and rapid technological change;
- Substitute for (and justify abolishing) more interventionist approaches to providing economic security;
- Prioritize cash transfers over in-kind benefits to preserve individual choice and flexibility;
- Link working-age benefits to prior employment and social contributions;
- Detach important social benefits, like retirement security and health insurance, from any particular employer or market structure.

Part 1:
THE FREEDOM THAT MATTERS

In the classical liberal conception, liberty is about being the author of one's own life, free from domination. The market advances freedom by providing individuals with a mechanism to harmonize their values and interests with those of others, and to execute their plans according to their own ends. In this sense, a regulatory intervention or statute that actively precludes a particular life course or mutually beneficial exchange, like rent control or occupational licensing, impinges on personal autonomy (and, often, economic efficiency) in a way that a universal social insurance program, financed by a general system of taxation, does not. This difference allows us to define two different approaches to addressing issues of economic insecurity: "the interventionist state" and "the social insurance state."

The libertarian economist F.A. Hayek made a similar point in a coda to his famous book, *The Road to Serfdom*. At the time of its original publication in 1944, Hayek noted that

> socialism meant unambiguously the nationalization of the means of production, and the central economic planning which this made possible and necessary. In this sense Sweden, for instance, is today very much less socialistically organized than Great Britain or Austria, though Sweden is commonly regarded as much more socialistic.[12]

While Hayek didn't advocate for the adoption of Swedish-style welfare policies, his distinction between a state engaged in central economic planning and a state that provides social insurance according to general rules forced him to admit the latter was fully consistent with a free society:

> Where, as in the case of sickness and accident, neither the desire to avoid such calamities nor the efforts to overcome their consequences are as a rule weakened by the provision of assistance—where, in short, we deal with genuinely insurable risks—the case for the state's helping to organize a

> comprehensive system of social insurance is very strong. There are many points of detail where those wishing to preserve the competitive system and those wishing to supercede it by something different will disagree on the details of such schemes; and it is possible under the name of social insurance to introduce measures which tend to make competition more or less ineffective. But there is no incompatibility in principle between the state's providing greater security in this way and the preservation of individual freedom.[13]

The contrast between contemporary Sweden and Venezuela provides an updated illustration of Hayek's point. While both are often described as "social democracies," their regimes could not be more different. Through the 19th and 20th centuries, Sweden designed social policies based on a notion of "the people's insurance." [14] Universal, flat-rate social insurance schemes, from child allowances to old age pensions, were created in the backdrop of a highly capitalistic economy, including privatized natural resources and liberalized trade. As a measure of this combination's success, in the century between 1870 and 1970 Sweden grew 70 percent faster than the United States and went from being one of the poorest countries in Europe to having the world's fourth-highest GDP per capita.[15]

Venezuela, in contrast, has been pushed to the brink of famine thanks to Chávez's (and now Maduro's) vision for "Socialism of the 21st century." This explicitly anti-capitalist ideology inspired the Chávista regime to go to war on economic liberty by nationalizing industry and natural resources, instituting wage and price controls, and enacting all manner of ad hoc, top-down, and choice-restricting legislation. Call Venezuela the "interventionist state" in contrast to Sweden's "social insurance state," or call it something else. Even the most ardent libertarian ought to recognize that, of the two approaches, Sweden's generous welfare state is far superior from the perspective of personal and economic liberty—high Value Added Taxes notwithstanding.

The economic malaise that visited Sweden in the 1970s and '80s is a within-country case-study of the same point. Following the 1973 oil crisis and the stagflation that ensued, a political tumult in Sweden pushed the country in a left-populist direction. Top-down labor market regulations proliferated, marginal tax rates spiked, struggling industries were subsidized, mercantile monetary policies were employed to prop up the export sector, and for a brief period corporate profits were socialized under the pretense of "economic democracy." As a result, private investment tanked, economic growth stalled, and deficits ballooned.[16] Sweden's economic dysfunction ultimately culminated in a major recession and banking crisis in the 1990s, a reckoning that only underscored the need for major reforms. Subsequently, Sweden significantly re-liberalized its economy while keeping its social insurance state largely intact, helping it to once again become an outlier in terms of economic freedom.[17]

Four Design Principles for a Free-Market Welfare State

It is one thing to admit that the social insurance state is better for economic freedom relative to some other, abjectly worse alternative. It's another thing entirely to reconcile the fact that social insurance states like Sweden and Denmark routinely score near the top in rankings of personal and economic freedom, even when such rankings are constructed by conservative and libertarian organizations that stack the deck against a high-tax-and-spend approach to fostering an open society.[18] For a Hayekian this makes perfect sense: Central planning is an enemy to freedom because it does damage to the

individual's capacity to plan for him or herself.[19] Social insurance, in contrast, exists to *enhance* an individual's capacity to plan by imposing a degree of certainty on future states of the world.[20] The societal value of social insurance is thus not unlike the societal value of rule-bound monetary policy, property rights, or the rule of law. In each case, the institution evolved to provide a level of social continuity—whether in terms of stable prices, secure ownership and contract, or "regulatory certainty"—needed for more specialized and complex economic coordination.

Specifically, social insurance can enhance market dynamism and economic freedom in four key ways: By enabling entrepreneurial risk-taking; by easing the adjustment and search costs associated with creative destruction; by detaching social benefits from market structure; and by making the economy more robust to immigration. Together, these point to a set of design principles for reforming existing U.S. social insurance programs in a pro-market way.[21]

1. Risk and Entrepreneurship

As the metaphor of a "safety net" suggests, social insurance can enhance risk-taking and entrepreneurship by ensuring failure (an inevitability in any dynamic market) is not catastrophic. This effect can be seen in the Supplemental Nutrition Assistance Program (SNAP), commonly known as food stamps. Research by the economist Gareth Olds suggests that the expansion of food stamps in the mid-2000s, which increased enrollment by 3–5 percentage points, added the equivalent of 1.1 million additional workers to the labor force by relaxing credit constraints in poor households. More interestingly, newly eligible households were also 20 percent more likely to start their own business, independent of whether they opted to receive the benefit—exactly what one would expect if food stamps acted as insurance for entrepreneurial risk-taking.[22]

SNAP is characterized as a nutritional program for convoluted, political reasons. In reality, the fungibility of grocery spending makes food stamps something much closer to a quasi-income support. Income floors, including proposals for a "basic income guarantee," differ from traditional unemployment insurance by insuring against income volatility rather than job destruction, *per se*, including the wage risk associated with entrepreneurship. The typical SNAP recipient, for instance, enters the program following a "trigger event" like a sudden drop in income, and stays in the program for a relatively short spell (8-12 months on average, depending on labor market conditions) before exiting once income volatility subsides.[23] As the economist Hamish Low and his colleagues note in their life-cycle model of wage and employment risk, "individual productivity shocks, other than major observable health shocks, are rarely insured in any formal way because of moral hazard and limited enforcement and commitment reasons."[24] Thinking of income supports like food stamps solely in terms of redistribution from haves to have-nots ignores this crucial risk-pooling dimension and thus amounts to a basic conceptual error. This line of thinking suggests that entrepreneurship can be enhanced, not by cutting food stamps, but by simplifying enrollment and converting the benefit into cash.

Direct cash transfers are particularly important from a "free-market welfare state" perspective because they preserve neutrality with respect for individual choice. This extends from value-based lifestyle choices to day-to-day decision making. The most immediate credit constraint in a poor household, for instance, may be rent or phone bills rather than grocery spending, rendering cash more effective than food stamps. And yet our current paradigm considers exchanging more than $100 in food stamp benefits for cash a felony with a maximum penalty of five years in prison—a risk no one should be forced to take.

2. Search and Adjustment Costs

In agrarian societies, workers never dealt with issues of transitional unemployment or labor-market mismatch. Instead, the firm and the family tended to coincide, with a degree of social insurance provided by kin- and community-networks. This all changed with the industrial revolution and the enormous increase in the division of labor, which in turn created idiosyncratic unemployment risks and a variety of novel labor market "search" and information frictions. Public unemployment insurance schemes proliferated throughout the early 20th century as a result, as private insurance failed in the face of large adverse selection problems.[25]

The countries that are most specialized and open to trade are not coincidentally countries with some of the most well-developed social insurance systems.[26] Denmark has relatively few statutory labor laws, for example, but only because workers who are laid off in periods of market restructuring are ensured a smooth transition through generous wage replacements and active labor-market policies. While your job may not be secure in Denmark, your employment is. Thus, 1 in 5 Danes change jobs every year—one of the highest job mobility rates in the world—with the greatest job-switching in the export sector. Denmark's key innovation was to detach economic security from a particular market structure, allowing the marketplace to be organized in accordance with productivity and free choice.[27]

As Edward Alden notes in his book *Failure to Adjust*, "At the heart of the trade dilemma is the question of 'adjustment costs.'"[28] While the size of the internal U.S. market—representing nearly one quarter of global GDP—made policy makers complacent about adjustment costs, the unique historical circumstances of the U.S. economy are destined to change as the rest of the world develops. A starting point should be to reverse the secular decline in active labor-market policy expenditures witnessed over the past three decades. This could be done by reinvigorating unemployment insurance with a system of subsidized employment for the long-term unemployed, combined with job search and relocation supports for geographically locked workers. Additionally, SSDI could be reformed along the lines of the United Kingdom's core disability program, the Personal Independence Payment (PIP). Unlike SSDI, which restricts the ability of claimants to work, PIP is universal and unconditional, meaning that those who are assessed for recurring disability benefits are not penalized for re-entering the labor force if and when their condition improves.[29]

3. Benefit Portability

Firms exist as optimal units for production, not optimal units for social insurance. Markets therefore work best when social benefits follow the individual and are detached from any particular firm or market structure. This can be achieved through portable-benefit legislation and complex public-private schemes, but in many cases it's simpler for the state or federal government to provide social insurance directly.

Consider health insurance. Over half of all American workers receive health insurance through their employer, a historical accident that persists to this day thanks to over $250 billion in annual tax subsidies for employer-sponsored plans. Receiving health insurance through an employer is well known to create job-lock. Less obviously, it also creates a bias in favor of large firms with the economies of scale required to absorb compliance costs and to efficiently pool risk.[30] The Affordable Care Act took modest steps towards addressing this issue by creating an individual marketplace, but in turn introduced an array of new regulations, mandates and complex subsidy schemes that have added greatly to the existing kludge. Ironically, the relative success of the Medicaid expansion suggests a universal public option, modeled on a system of

universal catastrophic coverage, would have been a better approach from the perspective of free-markets. Universal catastrophic coverage has a long pedigree among free-market economists, including Milton Friedman.[31] Niskanen Center Senior Fellow Ed Dolan has explored the exact details of how such a system could be built on, or even replace, Medicaid and Medicare.[32]

A similar story can be told about employer-linked retirement benefits. While the U.S. government felt immense pressure to bail out General Motors in 2008 due to its $100 billion in unfunded pension obligations, countries like Denmark, which center their retirement security system on universal, defined-benefit pensions, don't face nearly the same political pressure.[33] Indeed, it's hard to see how Denmark's open and laissez-faire model would have survived if it were otherwise. With exports equal to roughly half of GDP, a shift in trade winds has the potential to send shockwaves throughout the Danish economy. Thus in 2012, the world's largest wind turbine manufacturer, Vestas, was forced to lay off roughly one sixth of its workforce in the face of falling global demand. Vestas lobbied the Danish government for a bailout, but Denmark's Energy Minister refused, stating, "We cannot and will not support a single company. It is against the government's general state aid policy."[34]

4. Migration Robustness

While this essay is focused on resiliency to trade and technology shocks, no high-level discussion of welfare policy is complete without addressing its interaction with immigration. According to conventional wisdom, the welfare state and open immigration are fundamentally incompatible, particularly when immigration is low-skill. It's an interaction that is complicated by the fact that low-skill immigration is often used as a scapegoat under more general conditions of economic austerity.[35] While fully disentangling the socio-cultural and economic components of contemporary populist movements is beyond the scope of this essay, it's nonetheless worth noting that social insurance programs can be more or less robust to high rates of immigration depending on the details of their design.

In the words of the Niskanen Center's namesake, William Niskanen, "Build a wall around the welfare state, not around the country." That's essentially the approach the United States has taken ever since the 1996 welfare reform restricted recent immigrant access to most forms of public assistance for their first five years. Designing social insurance systems to require prior contributions through related fees or taxes can have a similarly salutary effect on the fiscal impact of new immigrants, real or perceived. As the economist Martin Ruhs notes, "If welfare benefits are seen as payments resulting from insurance funds to which people have contributed while working in the host country, migrants who claim such benefits may not be perceived to be a great problem."[36] Free movement within Europe is leading many countries to reform their non-contributory systems along these very lines.

Additionally, recent research suggests anti-immigrant backlash in Europe is driven largely by immigrant use of in-kind benefits like public housing, rather than social spending, *per se*.[37] The inelastic supply and geographical boundedness of in-kind benefits mean increases in immigration cause short-run congestion issues, and thus create a salient distributional conflict with local populations. A free-market welfare state, by prioritizing direct cash transfers and contributory social insurance schemes, mitigates the tension between welfare spending and immigration by leaving the supply of actual goods and services to the market.

PART 2:

WHEN THE MOOD DOESN'T MATCH THE TERRITORY

The common conflation of high taxes and public expenditure with 'big government' in the sense of regulatory overreach and central planning is mistaken but not surprising. As social animals, we depend on simplifying heuristics to sort friend from foe. Ideological alignment thus has far more to do with "mood affiliation" than coherent policy groupings.[38] When we see someone railing against lazy bureaucrats, draconian regulations, and the "takers" who exploit the "makers," for example, we assign to him or her an "anti-government mood," rather than decomposing the issue into its constitutive parts.

The "economic freedom indexes" produced by conservative think tanks like the Heritage Foundation and Fraser Institute provide a case in point. Both pool indicators of institutional quality (like rule of law, protection of private property, and ease of doing business) with indicators of government size (like total spending and tax revenues as a percentage of GDP) to produce a composite ranking of economic freedom by country. The Niskanen Center has been critical of these indexes in the past, but it's not just us.[39]

A January 2018 article in the journal *Social Indicators Research*, "Measuring Economic Freedom: Better Without Size of Government," unpacks the subcomponents of each index and tests them for their relevance, finding

> ...levels of government spending, consumption, and transfers and subsidies appear to correlate positively with the other indicators related to institutional quality, while this correlation is close to zero for the level of taxation as a percentage of GDP. Using government spending, consumption transfers and subsidies as positive indicators is no alternative, because these levels stand for very different government activities, liberal or less liberal. This means that levels of government activities can better be left out as negative or positive indicators.[40]

In other words, the Heritage Foundation and Fraser Institute worsen the external validity of their indexes by including subcomponents based on "government size" that are at best neutral (taxation) and at worse positively correlated with institutional quality (transfers). That this is a sacrifice both organizations are willing to make shows the extent to which their indexes are driven by anti-government ideological priors rather than social-scientific utility. *Caveat emptor*.

The bias in the Heritage index is known to political scientists as "dispositional sorting" and occurs in many other domains as well.[41] If you support action on climate change, for example, you're also more likely to support recycling laws. Although the two issues couldn't be more different in their specifics, they share a common "pro-environment" mood that predicts affiliation far better than any sober analysis of costs and benefits.[42] A strong belief in human-caused climate change, though justified, may not even be well correlated with knowledge about the very basics of climate science.

This becomes a major problem at the level of political affiliation since, as a rule, there is no abstract reason for the kinds of policies that clump together according to disposition to reflect stable political-economic equilibria. Instead, stable regimes are forged by historical circumstance and reinforced by actors with an interest in maintaining the status quo.

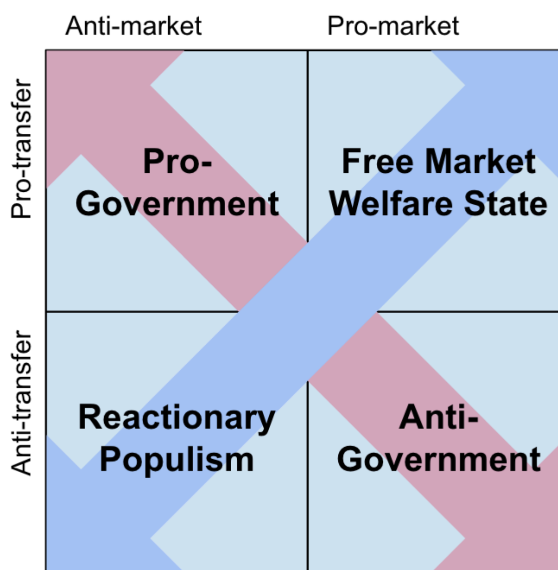
Denmark's combination of flexible labor markets and employment security, for example, stems from a century-old compromise between labor and capital, carried forward to the present day through voluntary collective bargaining agreements. It's also a model that runs orthogonal to traditional mood affiliation, since the ideological cohort that typically rails against the burden of statutory labor law (the "anti-labor" mood, say) also tends to oppose unionization, public pensions, and larger social transfers. Indeed, the consensus driven, high-trust backdrop to Danish politics strongly suggests there is no "getting to Denmark" by giving either end of the ideological spectrum free rein over public policy. Like other varieties of liberalism, Denmark's success is liminal, existing on the boundary of conflicting worldviews.

Toward a Multi-Axis Model of Political Ideologies

The dilemma created by the mismatch between mood affiliation and actual political-economic outcomes can be illustrated in a multi-axis model of political ideology that makes an explicit distinction between light-touch social insurance and heavy-handed market interventions (**Figure 2**). "Anti-market" in this context refers to things like intrusive, statutory labor market and business regulations, trade protectionism, nationalization and ad hoc industrial policies—all of which are recognizable populist reactions to real and perceived economic insecurity, and conceivably substitutable with a more general tax and transfer scheme.

The traditional ideological spectrum runs diagonally from the bottom right, "libertarian" or anti-government quadrant (pro-market, anti-transfer), to the top left, "social democratic" or pro-government quadrant (anti-market, pro-transfer). Orthogonal to the traditional spectrum are what could be thought of as the "reactionary populism" and "free-market welfare state" quadrants. Reactionary populists leverage resentments against foreigners and other perceived "takers" to justify restricting transfer programs, closing the border, and intervening in the economy to the benefit of particular firms or interest groups. Of the four, the free-market welfare state is closest to the economics textbook: lightly regulated markets with insurance schemes that compensate the losers from creative destruction.

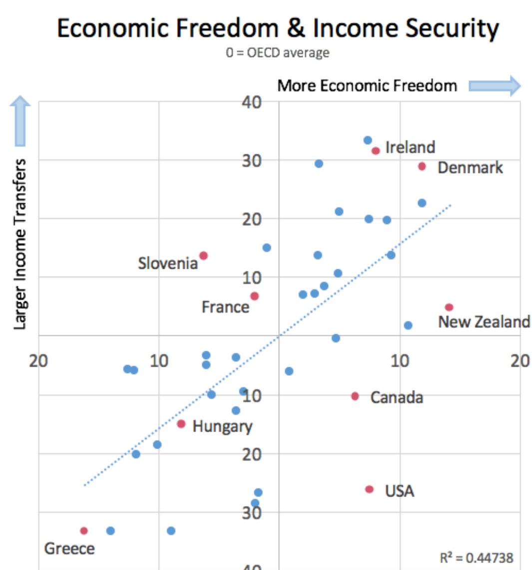
Figure 2. Ideological sorting v. Real world outcomes



Countries can be sorted into the four regime types using the Economic Freedom Index data prepared by the Heritage Foundation.[43] The index is made up of subcomponents that score countries from 0 to 100, where 0 is least free and 100 is most free. Included are three measures of "regulatory efficiency," three measures of "openness," and three measures of "rule of law" which, when combined with a geometric mean, generate a single index for "interventionism" that excludes the last three measures based on "government size." Given the coarseness of total government spending, the transfer axis is best constructed with the metric from the OECD social-expenditure database shown[44] in **Figure 1** that measures the net income-support provided by social programs, given as a percent of me-

dian income—in essence, a county's de facto "guaranteed minimum income." The world's developed economies can then be plotted according to the multi-axis model described above by each country's deviation from the OECD average for both indexes. As shown in **Figure 3**, a positive economic freedom score indicates above-average openness, rule of law and regulatory efficiency, while a positive social welfare score indicates above-average income transfers.

Figure 3: Plotting the Multi-Axis Model



A strong positive relationship between social insurance and free-markets is immediately apparent, with regime types that closely match intuition. In a clear case of American exceptionalism, the United States is the country most deeply in the "libertarian" quadrant, thanks to its relatively free-markets and patchwork income support system. A gradient of liberal regimes then runs from Commonwealth countries like Canada and New Zealand with average income supports to more generous systems like those in Ireland and Denmark. In the progressive corner is Slovenia, with its history of state socialism. Finally, in the farthest corner of the populist quadrant are places like Hungary and Greece with conservative-reactionary histories. Most countries involve some mix of influences, however. France, for instance, has typical income supports, but is above average in terms of *dirigisme*, placing it on the line between social democracy and a more reactionary model.

While history is not predetermined, the multi-axis model suggests that the current U.S. equilibrium is unstable.[45] In fact, measured economic freedom in the U.S. has been slowly declining in recent years, and under the leadership of Donald Trump, there's a risk that the trend will accelerate towards the reactionary-populist quadrant. Despite campaigning as a moderate on social programs, Trump has governed as an anti-market, anti-transfer president exactly as the multi-axis model predicts: relatively "libertarian" members of Congress are permitted to pursue tax and social spending cuts, and in exchange the president picks fights with private corporations and launches trade wars. Despite a freeze on new *formal* regulations, from a Hayekian point of view, the Trump presidency has thus far been a disaster for an individual's ability to plan for the future.

The Political Economy of "Big Government"

At the level of our moral tribe, politics feels like a tug of war between the top-left and bottom-right quadrants: Right-wing austerians versus nanny-state progressives. But at the level of likely political-economic outcomes, developed economies tend to fall in a spectrum between the top-right or bottom-left quadrants.

It's easy to see why. When social insurance states like Sweden ventured down the path of market interventionism, they nearly killed the goose that laid the golden egg, making their generous spending

programs seem unaffordable relative to (off-budget) command-and-control regulations. It's a vicious cycle that, absent liberalizing reforms, leads down the road to serfdom, as has tragically happened in Venezuela. On the other hand, unregulated, open economies that lack robust forms of social insurance are vulnerable to reactionary populist backlashes when the forces of creative destruction leave large swaths of society behind. This is particularly the case for liberal democratic regimes with multiple formal channels for transferring populist energy from grassroots to public policy.

Public choice economists argue that the internal incentives of democratic governments cast doubt on our ability to optimally address various types of market failure. But rarely is the same political-economic filter applied to the politics of austerity. As my colleague Will Wilkinson puts it, "Folks on the right need to consider the possibility that we've been wrong to see demand for government as the sort of dependent variable that can be manipulated through education or propaganda or political organizing or too-clever-by-half fiscal policy gymnastics or far-fetched constitutional amendments."[46] After all, as the economist Peter H. Lindert once noted, Wagner's Law—the observation that as national income grows, so does per-capita public spending—is "the most durable black box in the whole rise-of-the-state literature."[47]

The leading theory behind Wagner's Law is simply that bottom-up demand for public goods like social insurance increases with a nation's income. Liberal democracies do a better job at meeting that public demand, which is why the exceptions to Wagner's Law tend to be authoritarian city-states, or countries with unusually binding institutional constraints. Under the authoritarian Pinochet regime, for example, Chile had aggressive pro-market reforms and austere social policy, but not without vigorous public demonstrations. Immediately after Chile's re-democratization in 1989, the new government "alleviated the tension by expanding the size of welfare expenditures" while maintaining an open, liberal market regime.[48] Chile also expanded collective bargaining and labor rights, but still found a way to balance conflicting interests in a way that steered clear of the interventionist, state-led model that typified Allende's socialist government.

The economist Tyler Cowen calls this the "paradox of libertarianism." Economic liberty and capitalism make nations rich. And yet, "The more wealth we have, the more government we can afford." Cowen blames the failure of libertarians to embrace the empirical connection between liberty and "big government" on a type of mood affiliation. "That's why libertarianism is in an intellectual crisis today," he continues, "The major libertarian response to modernity is simply to wish that the package deal we face isn't a package deal."[49]

Why Universalism Matters

The preceding sections have put forward a number of strong theoretical and empirical arguments for how free-markets can be enhanced by a universal welfare state. These have been underscored by cross-national comparisons that suggest the policy bundling we take as more-or-less given in the United States—free-markets with limited income security—is potentially unstable. Either we will be pulled toward a reactionary equilibrium that trades in reduced social transfers for central planning and protectionism, or we will make the market resilient to economic shocks by expanding complementary social insurance systems.

This raises the question of how the United States, or any country for that matter, transitions from one equilibrium to another. On this point, the study of economic development suggests universalism is key. Take the issue of the "middle income trap," in which countries experience fast catch-up growth only to hit a developmental ceiling far below that of rich countries. There are many explanations for the

trap, but the common theme is a failure to smoothly transition into new modes of production due to institutional constraints. The countries that avoid the middle-income trap appear to do so by making a transition away from micro-level corruption and favoritism to some semblance of rule of law. This legal transition is mirrored fiscally by a transition to relatively universal social insurance programs, replacing firm-specific bribes and kin- or guild-based support networks with general, rules-based systems of social protection.

As Mancur Olson warned, the tendency for regulations to have "concentrated benefits and diffuse costs" risks making democracies sclerotic over time, as a mosaic of rules accumulates into a substantial—and locked-in—drag on economic dynamism.[50] The same can be said of niche transfer programs, ranging from agricultural subsidies to flood insurance, or the dozens of distinct federal anti-poverty programs. As the cliché that "programs for the poor are poor programs" suggests, means-testing is one way to create narrow programs that are easy for parochial interests to defend. In the United States, means-tested programs like SNAP are thus linked with powerful retail and agricultural lobbies, despite an expert consensus that SNAP would work better as a direct cash transfer. The same goes for virtually every federal program that supplies in-kind benefits to low-income parents and children, and the particular lobbies that they simultaneously benefit. In one case, the International Dairy Foods Association lobbied intensely—and quite publicly—against adding fruits and vegetables to the Women, Infants, and Children (WIC) special nutrition program, fearing that it would dilute public spending on milk products.[51]

Lying between means-tested and universal programs in the taxonomy of welfare states is "corporatism," or systems in which social protections are organized at an industry or sectoral level. The rise in occupational licensing follows a corporatist pattern, for instance. As employment shifted out of unionized sectors like manufacturing and into services, licensing has risen as a kind of third- or fourth-best solution for providing workers with wage and job security. The problem is that licensing also raises prices for the rest of us, reduce service quality and competition, harm labor mobility, and limits our capacity to transition workers into productive areas of employment following an economic shock. Absent a more general system of income security, the decline of unions seems to have simply expanded the adoption of the next-most expedient alternative, like shifting the air in an interventionist balloon.[52]

Breaking out of these sub-optimal arrangements requires substituting the political-economy of concentrated benefits with what Olson called the "encompassing coalition." Canada's Conservative Party, for instance, used the creation of a universal, cash-based child allowance to consolidate a number of smaller niche programs, while also heading off demand for nationalized daycare. The universality of the program and neutrality of cash in a sense "encompassed" the interests of traditional and career-oriented families, ensuring the program's durability.[53] In contrast, analogous "cash assistance" programs in the United States have the stigma that accompanies highly means-tested programs—a pattern seen throughout the OECD.[54]

Given time, the slow decay in the generality of our laws and the accumulation of regulatory kludges will push us away from the productive frontier. History suggests that avoiding the reactionary political equilibrium, and the interventionism that comes with it, will require the United States to redouble its commitment to the rule of law, including as applied to social spending. In the U.S. context, that means discarding the prevailing understanding of welfare as merely a form of poor relief (in the case of means-testing) or industry responsibility (in the case of corporatism), and embracing the universal

forms of social insurance that maximize economic freedom in a democratic context.

CONCLUSION

In this policy essay, I have sought to defend the basic complementarity of economic freedom and universal social insurance. Well-designed welfare programs go beyond relieving poverty and inequality to represent a type of cooperative institution, not unlike the market, which exists to enable individual self-authorship and planning in the face of uncertainty. This includes insurance against the sort of idiosyncratic productivity and employment shocks that are part and parcel of a specialized, risk-tolerant economy.

The process of creative destruction naturally creates winners and losers, and often in highly asymmetric ways. Democracies can respond to the economic insecurity generated by dynamic markets in one of two ways. Either the cooperative surplus of a productive, growing economy can be used to buoy workers in transition, or those affected by displacement will demand direct interventions in the market process itself, generating growth- and freedom-killing regulatory kludges, from occupational licensing to trade protectionism. By encompassing a wide number of competing interests, universal programs are particularly adept at reducing the demand for parochial interventions, and, when linked to prior contributions, can even mitigate the backlash to immigration.

Indeed, when developed countries are grouped according to their commitment to free and open markets and the strength of their social insurance system, "free-market welfare states" stand out as among the freest countries on earth. Contrary to our ideological axis, which runs from "small government" libertarian (pro-market, anti-transfer) to "big government" progressive (anti-market, pro-transfer), countries tend to converge around an off-diagonal axis running from reactionary (anti-market, anti-transfer) to liberal (pro-market, pro-transfer). Universal social insurance programs are thus not only freedom- and dynamism-enhancing in and of themselves, but appear to go together as part of a stable political equilibrium. This provides a framework for a research and reform agenda that goes beyond insulating markets from a reactionary backlash, to one based on social welfare policy as a tool for actively accelerating the American economy into the future.

---

[1] Special thanks to Jerry Taylor, Steven Teles, Ed Dolan, Brink Lindsey, Will Wilkinson, Karl Smith and David Dagan for providing valuable feedback on early drafts of this essay.

[2] Schumpeter, Joseph A. 2010. *Capitalism, Socialism and Democracy*. Routledge.

[3] Swank, D. 2003. "Globalization, the Welfare State and Right-Wing Populism in Western Europe." *Socio-Economic Review* 1 (2): 215–45.

[4] For an in-depth examination of the economics of populism and its connection to social insurance, see: Rodrik, D. 2017, "Populism and the Economics of Globalization", *CEPR Discussion Paper* #12119.

[5] Feenstra, Robert, and Akira Sasahara. 2017. "The 'China Shock', Exports and U.S. Employment: A Global Input-Output Analysis." https://doi.org/10.3386/w24022.

[6] Autor, David H., David Dorn, and Gordon H. Hanson. 2016. "The China Shock: Learning from Labor-Market Adjustment to Large Changes in Trade." *Annual Review of Economics* 8 (1): 205–40.

[7] Zhang, Jiakun (jack), Deborah Seligsohn, and John Seungmin Kuk. 2018. "From Tiananmen to Outsourcing: The Effect of Rising Import Competition on Congressional Voting Towards China." *SSRN Electronic Journal*. https://doi.org/10.2139/ssrn.3123307.

[8] Autor, David H., David Dorn, Gordon H. Hanson, and Kaveh Majlesi. 2016. "Importing Political Polarization? The Electoral Consequences of Rising Trade Exposure." *NBER Working Paper* No. 22637.

[10] Decker, Ryan A., John Haltiwanger, Ron S. Jarmin, and Javier Miranda. 2016. "Declining Business Dynamism: What We Know and the Way Forward." *The American Economic Review* 106 (5): 203–7.

[11] For a more in-depth treatment of this point see: Heath, Joseph. 2006. "The Benefits of Cooperation." *Philosophy & Public Affairs* 34 (4): 313–51.

[12] Hayek, F. A. 2014. *The Road to Serfdom: Text and Documents: The Definitive Edition*. Routledge.

[13] To paraphrase F.A. Hayek in The Constitution of Liberty, the modern libertarian or anarchist notion of freedom as absence of taxation and other kinds of legal interference is essentially rooted in French Enlightenment rationalism and romanticism, rather than English or Scottish classical liberalism. For more, see: F.A Hayek, *The Constitution of Liberty* (University of Chicago, 1960), 54.

[14] Rothstein, Bo. *Social Traps and the Problem of Trust*. Cambridge (UK: Cambridge University Press, 2005), 90.

[15] Jörberg, Lennart. 1965. "Structural Change and Economic Growth: Sweden in the 19th Century." *Economy and History* 8 (1): 3–46.

[16] Pontusson, Jonas, and Sarosh Kuruvilla. 1992. "Swedish Wage-Earner Funds: An Experiment in Economic Democracy." *ILR Review* 45 (4): 779–91.

[17] Bergh, Andreas. 2011. "The Rise, Fall and Revival of the Swedish Welfare State: What Are the Policy Lessons from Sweden?" *SSRN Electronic Journal*. https://doi.org/10.2139/ssrn.1884528.

[18] Wilkinson, Will. (2016, January 08). "Double-Edged Denmark." NiskanenCenter.org.

[19] This insight is the corollary to the "economic calculation problem" that was perhaps most succinctly put by James Buchanan in the title of his essay, "Order Defined in the Process of its Emergence," available in: Buchanan, J, Gordon, D, Kirzner, I. et al. "Readers' Forum, Comments on 'The Tradition of Spontaneous Order' by Norman Barry." 1982. *Library of Economics and Liberty*.

[20] The philosopher Joseph Heath argues that the most popular normative justifications for the welfare state, e.g. that it exists to solve inequality (i.e. is purely redistributive) or to meet certain communitarian ends, are wrong. Instead, he argues a historical reconstruction of the welfare state's development points to a "public economics" justification. Social insurance programs exist to solve market failures (or to fill incomplete market) and thus share the positive-sum normative logic of the market, and other Pareto-efficient institutions. See: Heath, Joseph. 2011. Three Normative Models of the Welfare State. *Public Reason* 3 (2): 13-44.

[21] Discerning readers may recognize an Austrian School influence in the first of these three defenses of social insurance. Austrian School economics places an emphasis on (1) entrepreneurial discovery in the face of fundamental uncertainty; (2) equilibrium as a dynamic, evolutionary process; and (3) the decomposability of capital, implying particular market structures will often need to liquidate given shifting patterns of specialization and trade. While the Austrian School has become mood-affiliated with small government libertarianism, its basic analytical toolkit turns out to be highly congenial to the "free-market welfare state" perspective. For an introduction to these themes see: Kling, Arnold. 2016. *Specialization and Trade: A Re-Introduction to Economics*. Cato Institute.

[22] Olds, Gareth. 2016. "Food Stamp Entrepreneurs." *Harvard Business School Working Paper,* No. 16-143.

[23] Leftin, Joshua, Nancy Wemmerus, James Mabli, Thomas Godfrey, and Stephen Tordella. 2014. "Dynamics of SNAP Participation from 2008 to 2012," Prepared by Decision Demographics for the U.S. Department of Agriculture, Food and Nutrition Service: Alexandria, VA.

[24] Hamish Low & Costas Meghir & Luigi Pistaferri. 2010. "Wage Risk and Employment Risk over the Life Cycle," *American Economic Review*, vol. 100(4), pages 1432-67, September.

[25] The few quasi-private examples of unemployment insurance we have, like those provided by unions, only reinforces the point. As the economist Nicholas Barr notes, "trade-union schemes should not be characterized as actuarial insurance with risk-rated premiums; rather they should be regarded as a form of decentralized social insurance for members of the union concerned." Barr, N. A. 2003. *The welfare state as piggy bank: Information, risk, uncertainty, and the role of the state.* Oxford: Oxford University Press, 42.

[26] Walter, Stefanie. 2010. "Globalization and the Welfare State: Testing the Microfoundations of the Compensation Hypothesis." *International Studies Quarterly*, (2): 403–26.

[27] Hendeliowitz, J. 2008. *Danish Employment Policy National Target Setting, Regional Performance Management and Local Delivery.* Employment Region Copenhagen & Zealand The Danish National Labour Market Authority.

[28] Alden, Edward. 2017. *Failure to Adjust: How Americans Got Left Behind in the Global Economy.* Rowman & Littlefield.

[29] For an excellent discussion of why U.S. and U.K. labor force participation rates have diverged, with reference to their different disability programs, see: Tedeschi, E. (2018, February 23). "Why has the US fallen behind the UK in labor force participation?" Medium.com

[30] Bailey, James, and Douglas Webber. 2016. "Health Insurance Benefit Mandates and Firm Size Distribution." *The Journal of Risk and Insurance*. https://doi.org/10.1111/jori.12164.

[31]Milton Friedman. 2001. "How to Cure Health Care." *Hoover Digest.*

[32] Dolan, E. (2017, August 4). "Building Bipartisan Health Care With Conservative Bricks." MilkenReview.org

[33] Universal old age pensions are sometimes criticized for "over-paying" relative to means-tested programs that reduce or eliminate retirement benefits for wealthy retirees. This once again commits the conceptual error of confusing risk-pooling arrangements with purely redistributive ones. As a collectively purchased annuity, old age Social Security eliminates the risk of outliving one's savings, producing an efficiency benefit over and above what is possible under a system based on individual savings.

[34] "Denmark rejects bailout of Vestas." (2012, October 31). Chieftain.com.

[35] Colantone, I., & Stanig, P. 2017. "The trade origins of economic nationalism: Import competition and voting behavior in Western Europe." *BAFFI CAREFIN Centre Research Paper Series* No. 2017-49

[36] Ruhs, Martin. 2015. "Is Unrestricted Immigration Compatible with Inclusive Welfare States? The (Un)Sustainability of EU Exceptionalism." *SSRN Electronic Journal*. https://doi.org/10.2139/ssrn.2625486.

[37] Cavaille, C., & Ferwerda, J. 2017. "How distributional conflict over public spending drives support for anti-immigrant parties." Unpublished paper, *Georgetown University*.

[38] Cowen, T. (2011, March 31). "The fallacy of mood affiliation." MarginalRevolution.com

[39] Dolan, E. (2017, December 08). "The Way Economic Freedom Indexes Measure Regulation is Deeply Flawed." NiskanenCenter.org.

[40] Ott, Jan. 2018. "Measuring Economic Freedom: Better Without Size of Government." *Social Indicators Research* 135 (2). Springer Netherlands: 479–98.

[41] For a full survey of the phenomenon of dispositional sorting applied to income redistribution, see: Johnston, Christopher D., Howard Lavine, and Christopher M. Federico. 2017. *Open versus Closed: Personality, Identity, and the Politics of Redistribution*. Cambridge University Press.

[42] Stern, Paul C., Linda Kalof, Thomas Dietz, and Gregory A. Guagnano. 1995. "Values, Beliefs, and Proenvironmental Action: Attitude Formation Toward Emergent Attitude Objects1." *Journal of Applied Social Psychology* 25 (18): 1611–36.

[43] Heritage Foundation. 2018. *Index of Economic Freedom*.

[44] An easily accessible version of this OECD SOCX data is available at: Tax and Benefit Systems: OECD Indicators, http://www.oecd.org/els/benefits-and-wages.htm

[45] In economics jargon, I am proposing the political-economic axis represents a kind of "saddle path." Deviations from axis cause movements back toward the path until reaching a steady-state.

[46] Wilkinson, W. (2016, October 19). "What If We Can't Make Government Smaller?" NiskanenCenter.org.

[47] Lindert, P. H. (2007). *Growing public. the story: Social spending and economic growth since the eighteenth century*. Cambridge: Cambridge University Press.

[48] "Political Dynamic and the Welfare State in Chile under Economic Globalization." 2013. *The Korean Journal of International Studies*. https://doi.org/10.14731/kjis.2013.06.11.1.201.

[49] T. Cowen (2013, April 23). "The Paradox of Libertarianism." Cato-Unbound.org.

[50] Olson, Mancur. 2008. *The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities*. Yale University Press.

[51] "Simply adding fruits and vegetables to the WIC program probably would not have touched off the current lobbying battle. But Congress is unlikely to increase funds for the program, so adding new foods would mean cutting money for dairy." Ruskin, G. (2015, January 22). "International Dairy Foods Association – key facts." usrtk.org.

[52] E. Soltas. (2014, April 18). "Occupational licensing is replacing labor unions and exacerbating inequality." Vox.com.

[53] Hammond, S. (2017, May 31). "What Libertarians and Conservatives See in a Child Allowance." SpotlightOnPoverty.org.

[54] Jacques, Olivier, and Alain Noël. 2018. "The Case for Welfare State Universalism, or the Lasting Relevance of the Paradox of Redistribution." *Journal of European Social Policy* 28 (1): 70–85.