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## Social Protection Without Protectionism\*

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The various papers in this volume highlight different dimensions of the rise in insecurity. The increased threat of terrorism may have decreased our sense of physical security. With growing numbers of Americans not covered by health insurance, there is an increase in “health insecurity.” In addition, global warming confronts everyone around the world with an important new set of environmental risks. This chapter focuses on one key dimension of insecurity—economic insecurity.

In spite of the social and economic progress of society in recent decades, in many countries—both developed and developing—individuals have less economic security today than they did earlier. This is especially true in the United States. As the International Commission on the Measurement of Economic Performance and Social Progress observed, our measures of GDP do not adequately reflect this important aspect of well-being (Fitoussi,

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Sen, and Stiglitz 2010). If they did, improvements in the standard of living would be less than current measures suggest.<sup>1</sup>

Today the world is immersed in a global financial crisis.<sup>2</sup> The risks and uncertainties are unprecedented. No one is sure how this crisis will evolve. In the years after the Great Depression, we erected in the United States and many other advanced industrial countries a set of social protections. But in the United States and some other countries, the last three decades have seen these social protections weakened—in the name of increased economic efficiency.

The arguments for doing so, at least in some cases, were of dubious merit.<sup>3</sup> For instance, the shift from defined benefits retirement programs to defined contributions has imposed more risk on individuals and, by weakening the economy's automatic stabilizers,<sup>4</sup> increased economic volatility. As markets crashed in 2008 and 2009, many saw their life savings disappear before their eyes. Those who had looked forward to a comfortable retirement now face unprecedented anxieties as they confront their old age.

Other changes have simultaneously decreased equity in our society and increased economic volatility. Social protection programs (relative to the size of the economy) have been scaled down, and the degree of progressivity of the income tax system has been reduced.

The weakening of social protections has, from a macroeconomic perspective, both adverse demand and supply-side effects. Individuals who see their income and (retirement and housing) wealth erode will cut back on consumption—especially in the United States, where the average household savings rate has been near zero. The increased risk (associated not only with retirement but also with unemployment) is also likely to contribute to increased savings—especially in a country where the need for precautionary savings for medical and other emergencies is so great, especially if the safety valve of being able to borrow has been dampened down.

With strong anti-age discrimination laws in the United States, there is a further supply-side effect in labor markets: Many who otherwise would have retired may be forced to work longer. With the supply of labor increasing and the demand for labor decreasing, unemployment (open and disguised) will increase.

This will, of course, put more downward pressure on wages, exacerbating the already increasing inequalities in American society.

As the effects of the financial crisis begin to be felt in the real economy, unemployment will increase.<sup>5</sup> The official unemployment rate will underestimate the stress in the labor market—large numbers will drop out of

the labor force, others will take part-time jobs simply because no full-time jobs are available, and still others will claim disability benefits. The official unemployment rate is likely to hit 8% to 10%, the effective (“real”) rate will be at least 50% higher, and the unemployment rate in certain marginalized groups (youth, minorities) will be greater still.<sup>6</sup>

Unfortunately, in recent years, unemployment insurance has been cut back, to the point that less than forty percent of the unemployed receive benefits, and the replacement rate (the ratio of benefits to normal income) has fallen, to around a half (compared with three-quarters in some European countries).

Even before the crisis, those in manufacturing were facing problems. The pre-crisis excesses—a bloated financial sector garnering for itself 40 percent of all corporate profits and a real estate sector absorbing forty percent of all investment—will compound the challenges of restructuring the economy. Unless the hoped-for government stimulus package is well constructed,<sup>7</sup> it will do little directly for those in manufacturing, real estate or even in finance: Those in the financial sector are not likely to retrain themselves to work on road construction crews.

Social changes, including the weakening of unions, have heightened these problems. Job protections are weaker and, in Europe, there is ongoing pressure to weaken them further in the name of labor market flexibility. Enhancing the ability of individuals to move from one job to another has obvious efficiency benefits. However, imposing high costs on individuals by stripping away hard-won protections also has obvious costs—a loss in security, which has received too little attention. The rhetoric of increased labor market flexibility is often just a code for lower wages and fewer job protections. The question (to which we turn later in this chapter) is, can we have more labor market mobility with greater security? Although some countries may have struck the balance too much in favor of security, the United States may have gone too far in the opposite direction.

In many developing countries, matters are even more dire. The consequences of weakening job protections are worse because economic volatility in these countries has been increased as a result of capital, financial, and trade liberalization (see the section “Globalization and Social Protection” later in this chapter).

In the face of these uncertainties, demands for protection are inevitable. So concerned were the G-20 leaders about such demands that one of the few commitments undertaken at their first meeting in Washington

in November of 2008, was a commitment to not resort to protectionism in response to the crisis.

This chapter argues that a need for enhanced social protection exists and that this social protection will not only decrease the demand for protectionism but also enhance the efficiency of the economy. This chapter then describes some innovative forms that this social protection might take. First, however, the theory of market failures on which the principle of social protection lies is explained, and how globalization may have made the problem of providing social protection more difficult is described.

### The Theory of Market Failures

At least since Keynes, we have understood that markets are not self-regulating, at least in the relevant time frame. The Great Depression led to new insights as to how periods of unemployment could persist. Today everyone (or almost everyone) is a Keynesian<sup>8</sup>—both the Left and Right agree that there is a role for government in maintaining the economy at full employment.

After the Great Depression, a peculiar doctrine prevailed called the neoclassical synthesis, which held that once the market failure of unemployment was corrected, markets could be relied upon to allocate resources efficiently. It was not a theorem, but a simple belief—perhaps held so that all the investments in neoclassical economics would not be thrown by the wayside.<sup>9</sup> The idea was always suspect, though. Why should market failures *only* occur in big doses? Recessions were more like the tip of the iceberg. There were many smaller market failures, harder to detect, lurking beneath the surface; many were related to imperfect information, incomplete markets, and irrational behavior. Indeed, a closer examination of behavior revealed huge inefficiencies, for instance in the so-called tax paradoxes.<sup>10</sup>

The current crisis is a microeconomic failure leading to a macroeconomic problem. As we have noted, financial markets are supposed to allocate capital and to manage risk. But they misallocated capital and mismanaged risk. Markets did not create financial products that would have enabled individuals to manage the risks which they face. Individuals cannot buy insurance against risks associated with their future wages or even against broader macroeconomic risks (such as GDP risks). Instead markets focused their attention on innovations that were, for the most part, perfecting regulatory, accounting, and tax arbitrage. The “innovative” mortgage

products, while they succeeded in increasing the transactions costs received by the financial sector, made it even more difficult for individuals to manage the risk of home ownership.<sup>11</sup>

Behind this market failure is a general theorem: Whenever information is imperfect or markets are incomplete (in other words, always), markets are not constrained Pareto efficient. That is, taking into account costs of collecting and processing information or of creating markets, there are government interventions that can make everyone better-off (Greenwald and Stiglitz 1986).

Many of the important risks that individuals face are not insured (or insurable) by private markets. The burden of insecurity is placed on individuals. Without government, individuals would have no unemployment insurance. Private retirement programs do not insulate individuals against the risks of inflation; only the government social security program—and some defined benefit programs—do so. The mortgage products that were sold by financial markets forced many individuals to bear huge risks associated with interest rate volatility. Not only were products not provided that helped these individuals mitigate the risks they faced, but markets totally misjudged their ability to bear the risks associated with the financial products (such as mortgages) that they sold them.

Not only did the financial markets fail to provide the products which would have enabled ordinary citizens to better manage the risks they faced, the markets have even resisted innovations to improve risk-bearing. When I was a member of the Council of Economic Advisers, I pushed for the introduction of inflation-indexed bonds. We finally succeeded, despite the opposition of many from the financial markets. When Argentina proposed introducing GDP bonds as part of its debt restructuring, enabling better risk sharing (related to the uncertainties about how much debt the country could reasonably bear), financial markets resisted.

Insurance markets often fail, either as a result of moral hazard or of adverse selection. Nonmarket insurance (e.g., provided by social [non-governmental] institutions) often make matters worse; they might exacerbate, for instance, the problems of moral hazard and crowd out market insurance with less effective “informal” insurance (Annott and Stiglitz 1991). In this chapter, however, we are concerned primarily with publicly provided (*social*) insurance for risks such as unemployment, which private markets almost never provide.

One of the reasons that markets often do not provide such insurance is that these are systemic risks—with huge potential losses beyond the ability of any individual or firm to bear.<sup>12</sup>

The failure of individuals to purchase insurance against some of these risks—when insurance is available—is a reflection of moral hazard; they know that in a modern society the government cannot allow individuals or society to suffer excessively from their failure to purchase insurance or to take appropriate actions to mitigate risk. The banks have been particularly guilty; there have been repeated bailouts, and the bailouts have been poorly designed, with the banks (and more particularly, the bankers, the shareholders, and the bondholders) bearing few of the consequences of their bad lending decisions. In most of these cases, society could have been just as well or better protected without the financial sector investors having been bailed out, at least to the extent that they were.

Any provider of insurance needs to be sure that the insured-against event does not occur—or that it occurs with less frequency and severity. That is part of the rationale for regulation. (Not surprisingly, those like the banks, who are beneficiaries of this subsidized social insurance, not only call for more insurance, they also call for less regulation.)

At the same time, the fact that the government will step in if private parties fail to adequately self-insure provides a rationale for compulsory provision of social insurance (social security).

There are additional reasons for (publicly provided) social insurance: Transaction costs may be lower than for privately provided insurance (as in the case of the U.S. Social Security program). One reason transaction costs are lower is the lack of spending on unproductive advertising. Another is that private firms have an incentive to engage in cream skimming—in ascertaining who the low-risk individuals are.

For a societal perspective, under a utilitarian or a Rawlsian social welfare function (that is, a society which maximizes either the sum of the utilities of individuals or the well-being of the worse off individual), optimal social insurance entails pooling—not discriminating among individuals with different risk categories. But pooling cannot be sustained within private markets.<sup>13</sup>

Finally social insurance also may be an effective way (with limited costs) to engage in redistributive policies. Some redistribution occurs, for instance, through the U.S. Social Security program.

Effective social protection may have societal benefits not fully appropriated in private markets. Individuals who feel more secure are willing to engage in more risk-taking. In economies with progressive taxation, the government shares disproportionately in the upside of such risk-taking. By itself, this would discourage risk-taking; but with some downside protection

provided, the adverse effects are partially or possibly fully offset. In the New Economy, innovation and risk-taking have taken on special importance. Innovating individuals typically appropriate only a fraction of the social returns from their activities.

There is a final rationale for government intervention in markets, perhaps particularly evident in the recent crisis. Markets behaved in a way that is hard to reconcile with rationality. In a sense, a failure of rationality by itself may not be a persuasive basis for government intervention, if the result was that individuals only harmed themselves. But others have been harmed—and governments have had to take action. The logic against government intervention, however, has been largely predicated on rationality, and the current episode provides convincing evidence of massive departures from rationality, with massive consequences.

For instance, markets used models that were flawed, and flawed in predictable ways. They underestimated systemic risk and obvious correlations. They ignored the fact that an increase in interest rates or that a decrease in aggregate demand would have adverse effects on housing prices across the nation; therefore, the risk of foreclosure would be correlated. And they repeatedly underestimated the significance of fat tail distributions. Events that their models claimed could happen only once in a century were happening once a decade—partly because of the aforementioned results, partly because markets underestimated other systemic effects. They systematically overestimated the value of the insurance they had purchased (coverage from undercapitalized insurance companies was of less value than they thought), and they underestimated potential consequences of conflicts of interest and moral hazard problems, the perverse incentives to which the contracts they had gave rise, and the scope for fraud.<sup>14</sup> Each of these and other problems had been discussed extensively before becoming evident in this crisis; most had manifested themselves in one way or another in earlier crises.<sup>15</sup> It had been noted, for instance, that stock options give rise to incentives for bad accounting. Especially when combined with the bonus incentive system, stock options gave rise to shortsighted behavior and to excessive risk-taking.<sup>16</sup> Yet most market participants ignored the warnings.

Further, there was a kind of intellectual incoherence in many bankers' analyses. They argued that they had created new products that transformed financial markets; their creativity helped justify their high compensation. Yet these bankers based risk assessments on data from before the creation of the new products—data that assumed the new risk products had not changed anything. This is particularly disturbing given that securitization

not surprisingly reduced the quality of lending (due to the newly introduced asymmetries of information). So too, many in the financial sector argued that financial markets were efficient and based pricing on spanning theorems, which infer prices of, say, a new financial product from the prices of existing products. Yet they also argued that they were creating new products that transformed financial markets. If spanning theorems and efficient market hypotheses were approximately correct, then the maximum value of the new products was the savings in transaction costs. Yet expenditures on transaction services were actually increasing—with the financial sector eventually garnering for itself 40 percent of all corporate profits.

Other paradoxes are hard to reconcile with “rational markets.”<sup>17</sup> For instance, even if those originating mortgages had flawed incentives, why didn’t investors buying mortgages exercise better oversight? If they were rational, they would have understood the obvious risks posed by securitization. Why weren’t they more attentive to the perverse incentives provided by the peculiar incentive schemes?

What makes these behaviors so hard to explain is that these problems have been repeated. Evidently markets are slow to learn.

If only those individuals who engaged in these “irrational” behaviors suffered, then the rationale for government action might be debatable. Interventionists would be accused of paternalism. Shouldn’t individuals be allowed to make their own mistakes and to suffer the consequences?

There are two answers: The first is that these particular irrationalities have had systemic effects—and that these have occurred systematically. Others have had to bear the consequences. Governments cannot sit idly by when the well-being of the entire economy is at risk. In passing the \$700 billion Wall Street bailout, many congresspeople felt that they had a gun pointed at their head. Those who had mismanaged the economy were demanding ransom to save it! Legislators knew that this seemed wrong: They knew that taxpayers would not be happy—but they felt that the downside risk of not doing it was even greater.

The second answer is that individuals—and society more generally—may realize that they (collectively) act irrationally, but know that such behavior cannot *individually* be stopped, at least without regulation. (Some of the instances of collective irrationality are not inconsistent with individual rationality. Some firm managers knew that paying out dividends unnecessarily increased tax payments, but they also knew that—given the beliefs of others—not to pay out dividends would result in a decrease in stock market values.) There may be an understanding that economies are plagued by

panics, booms, and busts; individuals suffer from herding, both rational and irrational. This knowledge by itself, however, is not enough. The behaviors that give rise to it have to be circumscribed. Individuals (in their moments of rationality) know this and, in effect, ask government to regulate these behaviors believing that they (individually and collectively) will be better off if the government takes appropriate actions.

Other aspects of financial markets are hard to explain. Markets still have not made available mortgages that would have helped individuals manage the risks that they face; there are obvious welfare-enhancing innovations. Such alternatives have been introduced elsewhere. The Danish mortgage bonds have a proven record of success. Given capital market imperfections, there are advantages of variable rate, fixed payment, and variable maturity mortgages. In the past, government has often had to play an entrepreneurial role in improving risk and capital markets. Prior to government provision of social security, annuity markets were virtually absent. Prior to government provision of mortgages, mortgage markets for most citizens were thin. It was government that pioneered the securitization of mortgages and the providing of student loans.

Today there is a host of lacunae in the private sector's provision of risk mitigation products—some easy to understand (the classical problems of insurance market failure), some harder to explain. One of the reasons for social protection is to fill in these gaps.

### Globalization and Social Protection

Globalization has enhanced the need for social protection; unfortunately, it has also often been associated with a decrease in the provision of social protection.

Globalization, at least as it has typically been managed, has exposed countries to new risks. Economic and financial crises have become more frequent. Openness exposes countries to new sources of outside shocks.

Although in principle, one of the arguments for capital market liberalization was that it would enable stabilizing capital flows, for the most part, capital flows have been procyclical. As the old adage has it, bankers do not like to lend to people who need their money. When a country faces a downturn, those who have lent that country money demand it back. The evidence is that, at least for many countries, capital and financial market liberalization has been associated with increased volatility.

Increased volatility imposes particularly heavy burdens on unskilled workers and small businesses. Even when countries respond quickly and effectively to the new shocks, the average unemployment rate increases. When job destruction resulting from trade liberalization is matched by job creation, the job losses are associated with significant wage decreases. But in many countries, job destruction has outpaced job creation, at least for significant periods.

Although globalization has imposed additional burdens for social protection, it has weakened government's ability and willingness to provide such protections.

Many countries have argued, for instance, that the increased competition associated with globalization requires that they strip away social protections to make the economy more nimble and to help it adapt to changing circumstances. They have argued for more labor market flexibility. Globalization has implied changing comparative advantages, requiring redeployment of workers. Lack of labor market flexibility impedes that process. But globalization has meant that, in effect, unskilled workers in the advanced industrial countries have had to compete with comparable workers in developing countries—workers who are often paid a fraction of the wages received by those in advanced industrial countries. Not surprisingly, employers would like their workers to accept large wage cuts; this is what they often mean by increased labor market flexibility.

Because globalization has proceeded in a very asymmetric way, with financial and capital market liberalization outpacing labor market liberalization, and markets for skilled labor being liberalized more rapidly than markets for unskilled labor, countries have faced increased competition for capital and, in some cases, for skilled labor.

This has had both direct and indirect consequences. It has reduced the bargaining power of labor versus capital and especially that of unskilled labor. Thus globalization has contributed to growing inequality within most countries of the world and to the weakening of social protections. Competition from abroad has lowered the ability of unions to deliver higher wages and better working conditions, and this has weakened unions. There has been a vicious circle, in which workers have been the losers.

Asymmetric globalization has also forced countries to lower taxes on capital and to reduce environmental and health protections on unskilled labor. Developing countries have been forced to cut back on tariffs, and they have not been able to make up for the shortfall in tax revenues in other ways. Although government revenues and the scope for progressive

taxation have been diminished, globalization has also put pressure on governments to cut back deficits and to redirect spending toward increasing the attractiveness of private investment. All of this leads inextricably to the reduction of government expenditures on social protection.

The argument for globalization has typically been that it would so increase growth that everyone would benefit—an updated version of trickle-down economics. But trickle-down economics has not worked, at least in many countries, perhaps because the increases in inequality have been so large and the benefits in growth have been so small that the adverse effects of the former have outweighed the positive effects of the latter.

There is, indeed, an argument to the contrary: Unbridled globalization has led to increasing inequality and insecurity. Increasing insecurity undermines, as we have noted, the willingness of individuals to undertake high-return risky activity, thereby lowering growth. But there is a further political economy effect: Growing inequality enhances the scope for distributive politics. Rather than a consensus around high-return public investments and social protections that enhance individuals' ability to cope with the risks posed by globalization and, in turn, to increase their willingness to accept the challenges that it presents, politics becomes more divisive. Social justice may demand that more of government revenue go toward redistribution, which the rich resist—except when they benefit from the redistributions themselves (as in the massive bailouts). The rich, worried that a strong state might use its powers to redistribute, work to weaken the power of the state and its ability to perform even its productivity enhancing role. Especially in democracies like the United States where campaign contributions and lobbying can have a large influence on shaping political outcomes, the perspectives of the rich may come to predominate—or at least to have an influence far outweighing their share in the population. The new equilibrium that emerges may be a relatively smaller state, with less social protections and less productive public investments, in which most citizens are actually worse off.

### Designing Social Protection in an Era of Globalization

Countries have approached the problem of social protection differently. Among the advanced industrial countries, the United States is perhaps at one extreme, the Nordic countries at another. Some of the differences may reflect differences in behavior and social cohesion—the likelihood that individuals will take advantage of government-provided benefits.

But even in a country as diverse as the United States, I believe that the current arrangements are Pareto inefficient; and that there is a risk that things may be getting still worse. I believe that we could provide more security and increase national output. Doing so requires changing macroeconomic, regulatory, and social protection policies.

Social protection is designed to safeguard individuals from a variety of adverse circumstances—illness, disability, loss of work, and so on. Some of these adverse events are predictable, at least to some extent. As individuals get older, there is a higher risk that they will lose income from work, either from voluntary retirement, incapacity to work, or the loss of a job; employers are reluctant to hire someone over 70. Market investments in which individuals put their money are highly volatile. If they put their money in the stock market, it may lose value. If they put it into short-term Treasury bills, the yield may fall to zero. They may live longer than they expected, so the amount they set aside for retirement may not suffice. Inflation may erode the value of their retirement income. As we have noted, markets provide inadequate insurance against the risks that individuals face. When markets do provide insurance, transaction costs may be unjustifiably high or restrictions may be imposed that make the insurance highly imperfect. Government has had to provide social protection simply because the market has failed.

Here I focus on one aspect of social protection—against unemployment and macroeconomic volatility—but much of what I have to say is equally applicable to other forms of social protection.

### *Macroeconomic Stability*

The first and most important aspect of economic security is to maintain the economy at as close to full employment as possible and to protect individuals from what happens when governments fail to achieve that objective. (Full employment is also an important aspect of physical security: It has a strong effect on crime.) That, in turn, requires (a) moderating exposure to external and internal shocks; (b) ensuring that there are strong, built-in stabilizers; (c) avoiding built-in destabilizers; (d) using effective discretionary policies to compensate for deficiencies in the effectiveness of the automatic and structural policies; (e) having in place active labor market policies to facilitate individuals moving from one job to another, in response to the necessary adjustments to the economy; and (f) protecting individuals who do lose their jobs and can't provide full-time alternatives.

As noted earlier, many of the so-called reforms in recent years have moved in exactly the wrong direction.

Of particular concern are **monetary policies** that focused on inflation, assuming that controlling inflation was necessary and almost sufficient for stability and growth. We now see how wrong that perspective is. As monetary authorities pursued price stability, they supported deregulation and liberalization policies that increased the fragility of the financial system, the consequences of which we are now seeing. There was no excuse: We have seen these problems repeatedly.

An **excessive focus on deficits and debt** (reflected in Europe in the Growth and Stability Pact) constrains the use of discretionary fiscal policy when needed. Not only is this shortsighted from the short-term perspective of stability, it is also misguided from a growth perspective and from that of the country's long-term national debt. What countries should focus on is their balance sheet; borrowing for high productivity assets improves the economy's long-term prospects.

I described earlier how we have weakened some of the **automatic stabilizers**—those in the private and public sector and in tax and expenditure policies. Automatic stabilizers providing social protection simultaneously reduce the need for social protection by ensuring that the economy is maintained closer to full employment and by helping individuals cope with the consequences of imperfect macroeconomic policies—the failure to maintain the economy at full employment. Not only, have some countries' automatic stabilizers been weakened, we have put in place automatic destabilizers.

### *Regulatory Policies*

Some of the reforms designed to enhance the strength of the financial system approached the problem from a microeconomic perspective—that of a single firm facing a problem—and ignored systemic effects. The result was procyclical automatic destabilizers. Rigid capital adequacy standards were imposed or rigid rules about loan-to-value ratios. The result was that when, say, a property bubble developed so that the nominal value of the assets soared, banks were allowed to lend more (in total and to each property), fueling the bubble.<sup>18</sup> There is an alternative—**macro-prudential regulation**—where the capital adequacy and loan-to-value ratios are adjusted to reflect the state of the economy.

*Coping with Instability*

Even the best-designed automatic stabilizers, regulatory policies, and discretionary interventions will be imperfect: There will still be some economic volatility. This means that someone should fill the gap. Private markets have failed to provide insurance. Government has had to step in to fill the breach.

At least two reasons for private sector failure illustrate the broader issues raised earlier. The first is that the size of the macroeconomic risk is too large: Unlike death (other than from war and plagues), unemployment is a highly correlated risk. When the economy goes into a deep and prolonged recession, such as the Great Recession of 2008, the requisite payments are simply too great for a private insurance company to bear.

The second reason is the problem of asymmetric information: Individuals most likely to purchase insurance are also those most likely to see themselves unemployed. Those in secure positions would not buy the insurance.

Employers do provide severance pay, but it is typically limited and of minimal effectiveness. If the company provides severance pay if an individual is fired, there will be an incentive to induce individuals to quit, by making the job unpleasant. If the employer provides too large a severance payment, the individual has little incentive to work; indeed, any severance pay increases the compensation that a firm has to pay to ensure that a worker does not shirk his duties (Shapiro and Stiglitz 1984).

Almost all advanced industrial countries recognize that, for these and other reasons, one cannot rely on privately funded unemployment insurance. But different countries have enacted legislation making it harder (or easier) to fire a worker and providing larger (or smaller) benefits, obtainable under more (or less) stringent terms. Many in Europe have proposed redesigning unemployment and job protection systems, and have called for more labor market flexibility, which their proponents emphasize will lead to more employment. These proponents might acknowledge that—incidentally—this could lead to lower wages and to less security.

Such reforms have to be evaluated in terms of the impact that they have on societal welfare. Even if it were true that GDP as measured went up, that does not mean that such reforms are desirable; GDP takes no account of the value of security, and such reforms can markedly lower security. Nor does GDP take into account the impact on distribution: Pressing down already low wages may enhance GDP, but at what cost?

Even in the more narrow terms of GDP and unemployment, however, these reforms may be counterproductive. The fallacy in the standard argument is easy to see. It is argued that individuals have to be motivated to search for a job. Unemployment benefits attenuate incentives to search. There may be some validity to that argument in normal times, when the unemployment rate is 4%. More intensive searching might enable us to lower the “frictional” unemployment rate. But today, with dozens of applicants for every job, adding one more individual to every queue will have a miniscule effect on employment levels. Lowering unemployment benefits to motivate searching will, on the other hand, have a significant detrimental effect on societal well-being.

More generally, policies aimed at reducing job projections may actually lead to higher levels of unemployment. In the Shapiro-Stiglitz “no-shirking” incentive model of unemployment, what motivates individuals to work hard is the length of time that an individual is unemployed. That is a function of two variables: the size of the unemployment pool and the rate of flow into (and out of) that pool. Regulations that allow or that encourage easy firing of workers (when, for example, they are not perfectly matched with the needs of the firm) engender faster inflows (and in equilibrium, outflows) from the unemployment pool; therefore, in equilibrium, there will be higher wages and larger unemployment—exactly the opposite of what was intended by enacting more labor market flexibility.<sup>19</sup>

Even with the best of macroeconomic policies, some individuals will lose their jobs and need to find new jobs. Active labor market policies directed at helping individuals move from one job to another have shown that these policies can work—but obviously, only if there are jobs to which the jobless can move.<sup>20</sup> Training workers for a labor market in which there are no jobs is not going to succeed.

### Explaining the Changes

Recent years have seen marked changes in perspectives on social protection. Some of these changes were the result of misguided government interventions to increase individual responsibility in the belief that markets work well on their own. Some of these changes were the result of misguided views on the extent of the problems of moral hazard (the adverse effects of providing any insurance). Conceptually it is possible that as individuals

get wealthier, they are in a better position to bear risk, or that as markets improve, there is less need to rely on social protections.

A closer look at what has happened provides an alternative, and less benign, interpretation of what has happened. Markets still do not provide retirees with adequate insurance against inflation. Markets still do a poor job of protecting against market volatility. No private insurance company can provide the kind of security that the U.S. Social Security program provides—and none can do it with anywhere near as low transaction costs.

Fine-tuning of government programs can fully take into account the balancing of risk mitigation and incentives—there is no need to abandon social protection.

Much of the drive for change is coming from a quarter that has no interest in making the economic system work better—especially not for those who need social protection. Rather it is coming from those in the financial sector who see risk management as their domain of competency; and they see a takeover of activities in these sectors as a rich, new opportunity for enhanced fees (i.e., high transaction costs).

The demonstrated incompetency in financial sector risk management and the divergence between their private interests and broader social concerns should give us cause for reflection: Some of the reforms in social protection undertaken in the last ten years may make sense, but some may reflect the success of the self-interested ideology that the financial sector so successfully foisted on much of the world.

### *Globalization and Changes in Social Protection*

Globalization makes the challenge of maintaining economic stability greater—greater potential volatility, greater restraints in responding—but it also requires redesigning social protection and, in particular, shifting the locus of social protection away from corporations to society. The system of social protection that prevailed in the Soviet Union and in the United States—where corporations were responsible not only for production but also for providing welfare services—is no longer viable. It never made a great deal of sense. Institutions should have focus, and this focus should be on their comparative advantage. This increases productivity and allows more efficient sorting (that is, ensuring that good firms survive and bad firms fail). Today we may not be sure whether U.S. automobile companies are failing because they are inefficient or because they have a legacy of social burdens.

The implication is that the *social* protection role of government is even more important today than it was in the past. An example of this changed role is provided by Denmark's system of "flexicurity."

Such reforms are particularly important in the context of U.S. provision of health care. The United States has been pursuing more modest reforms within the current structure, such as facilitating mobility by forbidding provisions that deny coverage for preexisting conditions or reducing vesting requirements in retirement programs and moving toward individual accounts.

Some of these are moves in the right direction; some (like the individual accounts) have weakened social protections, and are likely never to work very well. In particular, individual accounts are likely to be marked by high transaction costs and, simultaneously, to provide ineffective social protections (no pooling equilibrium) and to weaken built-in stabilizers.

### *Improving the Efficiency of Social Protections*

The greater competition provided by globalization means, of course, that we have to enhance efficiency in the provision of economic security. One important reform entails integrating social insurance programs (as Singapore did with its Central Provident Fund). This can lead to better security with higher-powered incentives (Stiglitz and Yun 2005). For instance, most episodes of unemployment are short-lived. If capital markets worked better, individuals could self-insure. Allowing individuals to borrow against their pension funds allows for intertemporal smoothing—but then one needs to provide lifetime insurance against the risk of a series of bad outcomes, such as extended unemployment (Stiglitz and Yun 2010b). It should be clear that we have not paid enough attention to the design of social protection systems that reduce the scope for moral hazard and simultaneously allow for greater smoothing of consumption over time and across states of nature.

### *A Catalytic Role for Government*

Social protection is designed to help mitigate the consequences of the risks that individuals face in a market economy. We noted earlier that it is striking how poorly markets have fared in providing risk mitigation products. Earlier I described pervasive market failures in the provision of market

insurance. The crisis has brought out the fact that some—perhaps many—of the U.S. financial market’s innovations in recent years actually exacerbated the real risks that borrowers faced and exploited borrower ignorance. This should not come as a surprise: The misalignment between private incentives and social returns that led markets to perform so poorly in allocating capital and in managing risk also implied that they had distorted incentives with respect to innovation.

In a sense, though, incentives in innovation are more distorted because of the difficulty of appropriating returns from financial products that actually might succeed in mitigating risks faced by individuals. A good product would simply be imitated, and the innovator would not be able to capture much of the returns.

As a result, the government needs to take a role not only in regulating financial markets (e.g., restricting the kinds of mortgages that they can offer) but also in developing new risk mitigation products. For instance, I have repeatedly made reference to the need for better mortgages. Even with more extensive social security, there is a need for better retirement insurance. The private sector continues to fail to provide protection against inflation and protection against changes in *relative* position. If wages and productivity increase rapidly, a worker who retires at 65 and relies on savings from his own wages is likely to find his level of consumption much lower than that of the rest of society by the time he is, say, 85. Some protection against both of these risks is, of course, included in the current social security program.

More broadly, defined benefit retirement programs have provided protection against risks that cannot be insured in the market. Individuals with defined contribution programs are thus left exposed. If the market cannot or does not provide insurance against these risks, then the government should.

Today many defined benefit programs are in serious economic straits. They put aside money based on beliefs concerning “normal” returns and were allowed to take out some “excess returns.” Now, with the deep drop in the markets, they are underfunded. There is a need for government reinsurance for defined benefit programs and for better regulation to ensure that they are adequately funded.<sup>21</sup>

(Of course, with publicly provided insurance, the government must do what it can to reduce the risk of the insured against events occurring; in the case of the financial sector, this entails better, and stronger, regulation and better macroeconomic management.)

We should be broadening social protections *and* enhancing the ability of individuals and families to manage the risks that they face by themselves.

Better educated people are better able to adjust to the shocks they face. They are more mobile and more adaptable. Families with two wage-earners have a built-in shock absorber. Thus family and education policies can be viewed, in part, as part of social protection policies.

Such policies can help address a variety of market failures (such as capital market imperfections) and may, at the same time, have positive supply-side and welfare effects. These policies increase individual expected utility and societal well-being (however that term is defined, whether in the utilitarian or in the Rawlsian sense).

### Concluding Comments

I want to draw attention to one further aspect of strengthened social protection: Increased social protection may enhance political support for globalization.

Many forces contribute to the growing inequality and decreased social mobility. Globalization is only one of them. But it is one about which individuals think that they can do something. (They can't do anything about changes in technology that alter the relative returns to, say, skilled versus unskilled labor.) Social protections—including adjustment assistance—may make globalization more acceptable.

The old criticism of the welfare state was that it resulted in attenuated incentives. It was based on the presumption that markets by themselves were efficient. The Great Depression undermined that belief, but it was almost resurrected through Keynesian economics and the neoclassical synthesis. Limited government intervention—limited to maintaining the economy at full employment—was all that was required to ensure economic efficiency. The theoretical foundations for this belief in the efficiency of markets—in this more limited sense—were undermined a quarter-century ago. Nonetheless, advocates of market fundamentalism continued with their crusade. Today no one can believe that unfettered markets lead to efficiency or stability.

Of course, ordinary citizens have long understood market failures. They knew that markets did not provide them with insurance against the important risks that they faced. But market fundamentalists argued that interventions in the market to provide insurance were distortionary—or even worse, interventions to require insurance were paternalistic. We have

argued that with the irrationalities in the market that have been so evident recently (and so evident repeatedly), citizens may well (and in some sense *rationally*) desire some degree of paternalism. Moreover, the large external effects generated by the failure to provide and obtain appropriate risk protections necessitate collective action.

Globalization and the current economic crisis require that we revisit our system of social protections. There is room for improvement in most countries, but especially in the United States. Appropriately designed social protections cannot only enhance individual and societal well-being as broadly defined, but may even lead to an increase in output and growth.

As the United States and the world confront an economic downturn, we must be mindful of the anxieties of those who will not quickly find jobs. For the United States, this means providing health insurance (perhaps through the Medicare system) for the unemployed and assistance to avoid foreclosures (such as the UK does)<sup>22</sup>. It should be clear that the market has failed to provide insurance against many of the risks that loom most importantly in individuals' lives and that the government so far has not stepped into the breach.

In the run-up to the crisis, the private sector—and some government regulators—demonstrated enormous hubris in their assertions about their (and the markets') ability to manage risk. But advances in economics do mean that we understand the issues far better than we did, say, forty years ago. We have a deeper grasp of moral hazard and adverse selection and of the consequences of incomplete and asymmetric information and imperfect and incomplete risk markets. I believe we can use this knowledge in a way that can generate more security—with less adverse incentive effects—than has been the case in the past.

The Great Recession has reminded millions around the world of the frailty of their prosperity. Life prospects can change dramatically with the loss of a job. The confidence of the young that they can then quickly get a new job after being let go has been shattered. Security is important—very important—for most ordinary citizens. The response of these millions to this new insecurity will be either to reduce the threats to their security—through protectionism—or to improve the system of social protections. In short, the response to globalization should be to strengthen and to improve systems of social protection, not to strip them away.

The future dynamism and openness of the advanced industrial countries will depend on which of these choices they make. I hope it is along the path toward more social protection without protectionism.

## Notes

1. While this chapter was written shortly after the collapse of Lehman Brothers and the beginning of the global financial crisis, as this book goes to press, four years later, the global economy is still weak and future prospects uncertain.

2. Actually, in the United States, even in the conventional measure, most individuals have not been doing well. Median household income in the United States in 2011 was nearly 9% lower than it was in 1999 (U.S. Census Bureau).

3. The argument for weakening social protections paralleled the argument for stripping away regulations. In both cases, it was contended that there would be overwhelming efficiency gains—gains so large that all would benefit. Deregulation of financial markets may have led to increased short-term profits for that sector, but there is little evidence that there was any relationship between those short-term profits and long-term increases in societal productivity and the well-being of most citizens. Although a small fraction of the financial sector was devoted to financing new innovations (in particular, venture capital firms), most of the so-called innovation was directed at regulatory, accounting, and tax arbitrage. The theory was that deregulation would lead to greater efficiency in the financial sector—to an enhanced ability to manage risk and to allocate capital. But the new innovations increased risk. Capital was misallocated on a massive scale. The sectors' net private returns over a half-decade now appear to be negative—its social returns massively so.

4. Automatic stabilizers inject money into the economy when it is weak.

5. This chapter was written shortly after the collapse of Lehman Brothers, when the unemployment rate was only 6.9% (U.S. Bureau of Labor Statistics). The predictions of what would follow from that collapse turned out to be correct: Subsequently, unemployment increased to 10%, with one out of six Americans who wanted full-time jobs not being able to get them. As this revision goes to press, the unemployment rate is still stuck at 7.8%.

6. Even though the overall unemployment rate reached its peak at 10.6% in January 2010, the youth (ages 16–19) unemployment rate soared to 26.9%, and the African American unemployment rate was 17.3%.

7. A stimulus package of almost \$800 billion was enacted in February 2009. It was less effective than it should have been; almost 40% of the package was tax cuts. Little of it was directed at restructuring the economy.

8. This moment of universal Keynesian was short-lived. As this book goes to press, countries around the world are engaged in cutbacks in expenditures and are worried about the large deficits that accompanied the global slowdown.

9. The idea is usually attributed to Paul Samuelson. For an early critique of this idea, see Greenwald and Stiglitz (1987).

10. See, in particular, the dividend tax paradox: Firms can reduce the total corporate plus individual income taxes paid by repurchasing shares rather than paying dividends (Stiglitz 1973).

11. For a fuller analysis of the causes of the crisis, see Stiglitz (2010).

12. This does not provide a full explanation because all that it takes to make a market is differences in views and/or differences in aversion/ability to bear these risks. I have discussed these issues more broadly in Stiglitz (1993).

13. For an analysis of optimal insurance in the presence of adverse selection and moral hazard and an explanation for the role of government, see Stiglitz and Yun (2010a).

14. Among the conflicts of interest were appraisers owned by originating companies and rating agencies paid by those producing products.

15. For instance, in the East Asia crisis, some of the cover for foreign exchange risk that Korean firms thought they had disappeared with the bankruptcy of the firm providing that cover. Many banks thought they have obtained insurance against some of the risks they faced by buying insurance through AIG (e.g. in the form of CDS's), though AIG was clearly over-exposed. (In the end, the banks got "insurance" through the government; there is some suspicion that at least some of the banks may have counted on this.) Securitization gave rise to new asymmetries of information. Almost twenty years ago, at the beginning of the securitization movement, I suggested that it would end badly: "...the banks have demonstrated an ignorance of two very basic aspects of risk: (a) The importance of correlation...(b) The possibility of price declines" (Stiglitz 1992:25).

16. In fact, in Stiglitz (2003), I attributed some of the problems of the previous economic downturn to excesses and to distortions created by such incentive schemes.

17. Even earlier, I had called attention to a large number of other such paradoxes—behavior that was hard to reconcile with profit maximization or with value maximization. In particular, firms paid more taxes than they needed to (the so-called tax paradoxes and, in particular, the dividend paradox). There are also compensation paradoxes—ways of providing higher power incentives, with lower taxes and less risk (Stiglitz 1982).

18. The U.S. regulatory authorities behaved in an even worse way: As the bubble developed, they increased the allowable loan-to-value ratios and lowered the capital adequacy standards.

19. These results are robust( SeeRey and Stiglitz (1996) ). The more general point is that free market solutions, by themselves, are not constrained Pareto efficient (Stiglitz 1974; Shapiro and Stiglitz 1984; Arnott and Stiglitz 1985; Greenwald and Stiglitz, 1986, 1988).

20. Again we can ask: Why is government necessary to provide such programs? There are two reasons. First, once individuals are out of a job, they typically face severe financial constraints, which make it difficult for them to finance these training programs. But perhaps more relevant, in many countries (including the United States), for-profit skills-training programs have a disproportionately large number of firms that are scams providing little in benefits. They excel not in education, but in deception.

21. As part of the defined benefits (deferred compensation) provided by firms, there is insurance against certain risks. As in other areas of insurance, the government has to make sure that there is adequate funding so that the promises made will be fulfilled.

22. One of the signal achievements of the Obama Administration was the passage of legislation ensuring access to health care for all Americans. It did not, however, build in the Medicare system, but rather was designed as a “patchwork” on the existing health care system, marked by high costs associated with private health care providers.

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