

# Revisiting the Tension Between Classical Liberalism and the Welfare State

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## Abstract

A classical liberal market order relies on competition which, in a neoliberal perspective, should be supported by a government regulating the admissible degree of market power. Market competition itself is seen as an engine of innovation and growth. The downside of such a classical liberal market order is a lack of economic security for market participants. It is the very core of such an order that it enforces consumer sovereignty, but the demand articulated by consumers vis-à-vis single suppliers can be volatile. In this article, we revisit the classical liberal debate on means of providing economic security. We then discuss the problem in a contractarian framework that allows for conflicts between individual absolute values. We argue that political institutions that facilitate an open debate on these conflicting values are essential, and that attempts to derive optimal sizes of welfare states in a technocratic fashion are futile.

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## 1. Introduction

Market economies have generated, and continue to generate, steady increases of wealth and prosperity. From a historical perspective, this positive verdict cannot be disputed. Competition is the only reliable mechanism known to incentivize entrepreneurship, and entrepreneurship in turn is the source of a persistent stream of technological progress and product innovation that has been improving our standard of living since the Industrial Revolution. But if we look at this positive long-term trend in greater detail, we see that long-term progress often comes at short-term costs, and these in turn are a heavy burden on some individuals. Innovation brings structural change which in turn leads to a devaluation of specific physical and human capital, and this deprives the incomes of affected households.

Real market economies operate under the condition of positive transaction costs, and some of these costs come as high adjustment costs in processes of creative de-

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struction. Long-term progress comes at the cost of short-term risks posed to individual incomes and living standards. And arguably, market economies also come with degrees of income inequality that are considered as politically problematic by some pundits and researchers. This tension has always haunted market economies, and it is empirically unclear whether economic insecurity has increased or decreased over the very long term. In any case, debates about these problems are ubiquitous both in political and academic realms today, probably more than they were twenty or thirty years ago.

Contrary to popular prejudice, modern economics is also deeply concerned with questions of income distribution, but also about trade-offs between efficiency on the one hand and distributional concerns on the other hand. Consider, for example, standard welfare economics (for an introduction, see Johansson 1991). Suppose we apply a common Bergson-Samuelson welfare function which simply adds individual utilities with equal individual weights and identical individual utility functions for all households. Any effort of welfare maximization that is constrained only by a given amount of income to be distributed, but not by behavioral responses, would always result in an entirely egalitarian solution.

Matters become more complicated, of course, if the cake to be divided is not of a fixed size. If redistribution involves negative incentive effects, the resulting trade-off between efficiency and equality limits the feasible degree of redistribution, and some optimal degree of inequality results.<sup>1</sup> This seems trivial, yet entire influential strands of economic literature, such as the theory of optimal income taxation beginning with Mirrlees (1971), have developed around this very basic problem (for overviews, see Boadway 2012 and Salanié 2011).<sup>2</sup> Interestingly, the general normative thrust of this literature also favors equality of disposable incomes. Equality is the general ideal, but the arising incentive problems are obstacles that make it impossible to perfectly implement the ideal.

Within the welfare economics approach, different conclusions could only be supported by discriminatory individual weights, or by individual-level heterogeneity in preferences for monetary incomes. The former necessitates a normative judgment that the welfare of one individual or group of individuals counts more than that of another. But historically, the claim that equal weights should be attached to each individual's welfare has been responsible for the appeal of early utilitarian thinking as a progressive, reformist frame for normative analysis.<sup>3</sup> Re-introducing individual or group-level discrimination into the welfarist approach appears to be difficult to justify normatively. On the other hand, the latter approach suffers from the practical problem that individual preferences are difficult to identify empirically, and it is difficult to

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<sup>1</sup> If nothing else is mentioned, “equality” always refers to equality of incomes.

<sup>2</sup> For a recent exposition of the problem, see e. g. Heathcote *et al.* (2017).

<sup>3</sup> There are, however, approaches that take heterogeneous welfare weights into account, such as Saez and Stantcheva (2016).

gauge to what extent low incomes are the result of choice, rather than bad luck or difficult circumstances.

One possible way towards taking a different perspective on the problem is to change the playing field, and to entirely abandon the welfare-maximizing perspective in favor of other justifications for income redistribution. There are good reasons to do so. Buchanan (1959) had already raised some important concerns. He criticized the assumption of the existence of an omniscient welfare maximiser, and more importantly, he also proposed that in the absence of an omniscient maximiser, actual consent of the individuals affected by a policy is a much more plausible normative criterion than some more or less arbitrary social welfare function.

The contractarian approach that Buchanan subsequently developed as a comprehensive alternative to welfare-economic analysis does not deny the importance of income redistribution, as one might *prima facie* expect from an approach that requires unanimous support and therefore assigns a veto right to individuals who expect to be net payers. The contractarian approach does, however, require that redistribution is in some way prudent and also beneficial for those who expect to be net contributors.

Along the lines of the contractarian approach, it is not material equality as such which serves as a decisive ideal, but consent. The habit of proposing a specific, seemingly welfare-maximizing income or wealth distribution as a policy objective is replaced by a search for institutions that affect primary and secondary distributions of income and wealth in a way that is, ideally, acceptable to everyone. The difference is crucial, because the legitimacy of institutions is carried over to a possibly wide range of distributions that can result within these institutions. Hypotheses about which institutions and policies can be supported by unanimous consent obviously differ, depending on the assumptions made. Nozick (1974) comes to vastly different conclusions than Rawls (1971), to name only two well-known examples.<sup>4</sup> They are, after all, only hypotheses that would need to find the actual support of a large number of actual voters if they were to be transformed into policies (Vanberg 2014, 24).

Even though the Colloque Walter Lippmann (CWL) of 1938 took place decades before constitutional economics was developed, and also years before *Ordnungs-politik* in the German tradition became influential, its discussions on the social question can be read through a contractarian lens. The questions raised are much closer to modern contractarian approaches than they are to standard welfare economics. The participants were not concerned with finding an optimal degree of income inequality, or an optimal distribution of incomes. Rather, they discussed the question to which degree the material insecurity that endogenously arises in dynamic market economies needs to be reduced by governments in order to maintain a functioning liberal order. Implicitly, they hypothesized a constitutional consensus in support of a liberal order, including a reasonably free market economy. And they

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<sup>4</sup> See also Hochman and Rodgers (1969) for an early economic approach to Pareto optimal redistribution.

anticipated that prudent policies including income redistribution may be necessary in order to support this basic constitutional consensus.

For the remainder of this article, we will discuss the problem of providing some economic security, as it was discussed at the CWL, from a perspective that combines classical liberalism and contractarianism. In section 2, a brief overview over the relevant discussions at the CWL will be given. In section 3, we discuss the interaction of economic security, inequality, and individual liberty. Value pluralism along the lines of Berlin (1969) will also be introduced here. In section 4, we argue that in a world with value pluralism, we cannot find a definitive contractarian answer to questions regarding the size and design of the welfare state. We can, however, come to some conclusions regarding the process of policy-making. Finally, section 5 concludes the paper.

## **2. The Colloque Walter Lippmann on Economic Security**

In the afternoon session of 28 August 1938, the participants of the CWL discussed the following questions:<sup>5</sup>

Is liberalism capable of fulfilling its social tasks? Can it ensure: (a) A minimum of security. Does liberalism lead to structural crises or, at least, to crises of an intolerable scope, expecting a liquidation [of such crises] through the simple play of economic forces (as a result of the growth of assets, of increasingly widespread speculation, etc.?) (b) A vital minimum for all, given the difficulties of labor migration. It is the problem of chronic unemployment, of technological unemployment. In short, is the liberal system cruel? Is it likely to meet the social needs of the masses' consciousness today? (Reinhoudt and Audier 2018, 149).

Jacques Rueff had the task to give an introduction, as well as a more precise interpretation of these questions. His first focus was on insecurity, which he argued is endogenously produced by markets. When they are not in equilibrium, they force individuals to revise their plans, sometimes with significant negative effects, for example when assets need to be revalued, or when labor demand decreases and long-term unemployment results. Speaking with the recent Great Depression in mind, Rueff asked whether such prolonged structural crises are a result of market forces alone, or whether they can also be attributed to policies that impair quick adjustment to new equilibria. By and large, Rueff attempted to defend the efficiency of the market mechanism. He identified pre-Depression monetary policy as a decisive mechanism to delay the start of the crisis, with the unintended side effect of deepening it. He also argued that labor market regulations have been the main cause of involuntary un-

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<sup>5</sup> For the transcripts of the entire CWL, see Reinhoudt and Audier (2018), the debate on social justice referred to here is in Chapter 6. This subsection is a brief summary of the main statements collected in that chapter.

employment, culminating in the claim that “(a)ll the interventions of the State in the economic realm have had for effect to make workers poorer” (*ibid.*, 150).

While Rueff argued that a market that is left alone will lead to seamless, quick adjustments to efficient new equilibria in most cases, other CWL participants such as Walter Lippmann himself and Louis Baudin focused on the adjustment costs that had to be borne by market participants. In an argument resembling Schumpeter’s notion of creative destruction, Baudin in particular emphasized that equilibrium is merely a theoretical concept, while real markets are constantly in disequilibrium and always characterized by exit and entry of market participants. While he saw this as a structural characteristic of a market economy, Baudin also argued that government intervention should, where possible, be used to reduce the amplitude of the business cycle, in order to reduce also the individual-level insecurity associated with large cyclical movements.

Louis Marlio, on the other hand, saw a problem with entrepreneurs creating a negative externality to society when laying off employees. Knowing that unemployment benefits will be paid by the general public, firms, according to Marlio, will not account for the full social costs of layoffs. Consequently, he proposed that layoffs should be taxed in order to internalize the perceived externality. Rueff retorted with the argument that in an undistorted labor market, involuntary unemployment will not exist. Similarly, John Bell Condliffe argued that the recent crisis had been exacerbated by bad macroeconomic policies, and not by market imperfections. Concurring with Rueff, he pledged for better government policies in education, but less intervention into the market process itself.

Friedrich August von Hayek and Ludwig von Mises both supported the view that long-run involuntary unemployment can be explained only by adjustment costs introduced by the state, such as badly designed unemployment insurance which creates inefficient incentives for employees, or policies that increase wages above their market-clearing levels. With respect to inefficient wage policies, Marlio also concurred. Finally, Rueff summed up the deliberations of this session with the following statement: “The nature of liberalism is to give workers greater satisfaction than directed regimes can, [as directed regimes] in fact always lead to a decrease in the standard of living of individuals” (*ibid.*, 156). With regard to questions of economic security, the CWL participants thus took a surprisingly unambiguous overall stance. Even though the tendency of market economies to create individual-level income risks was acknowledged, serious problems were presumed to be the result of inefficient government intervention.

This is surprising, given the proximity of the CWL to the Great Depression, and the fact that the CWL is widely perceived as the birthplace of neoliberalism, i.e. of a variant of liberalism that attributes greater importance to the role of the state as a provider of a stable institutional framework than earlier *laissez-faire* liberalism (Kolev

2018, 67; Plickert 2008, 93–103).<sup>6</sup> However, discussions on a positive role of the state have included matters of economic security and social policy to a relatively small extent. The discussants certainly did not have developed modern welfare states in mind when they thought about the desirable scope of social policy. It seems that government intervention in this respect beyond very basic subsistence-level transfers was not deemed necessary to support the functioning of a liberal market order.<sup>7</sup> This begs the question if, from a modern constitutional economic perspective, this conclusion still holds.

### 3. Classical Liberal Positions on Liberty, Economic Security, and the Problem of Inequality

#### 3.1 Defining Economic Security

Before proceeding with the discussion whether, and to what extent, the conclusions reached at the CWL with regard to economic security are still plausible, it is useful to clarify what exactly we are debating. Finding a definition for *economic security* is already not as straightforward as it may seem. One could understand it as the expected perpetuation of future individual income streams roughly on today's level – i. e., nearly complete insurance against income risks. For well-known reasons of moral hazard, such almost complete insurance is either associated with severe incentive problems for the insured (if organized as a coercive system by the government), or associated with extremely high insurance premiums which will trigger problems of adverse selection if organized as a voluntary private insurance (Sinn 1997).<sup>8</sup>

Already quite in line with these later insights, the CWL called for “a *minimum of security*” (Reinhoudt and Audier 2018, 149). The participants have, however, not elaborated on the income replacement rate that suffices to guarantee such a minimum. But some hints can be found in other contexts. Hayek (1960, chapter 14) for example argues that mandatory social security systems can be justified from a classical liberal point of view, insofar as, in the absence of these systems, societies would unequivocally be obliged to support individuals in need. This leads to moral hazard: Without a mandatory system, individuals could *de facto* free-ride on a society's moral obligation to provide a basic level of support independent of individual efforts to insure themselves. In order to avoid free-riding of this kind, Hayek argues, it is reasonable to set up mandatory social insurance systems. Whether this should happen in a mandatory private insurance, or in a uniform public insurance scheme is a dif-

<sup>6</sup> See also Kolev *et al.* (2020) for an overview over discussions between different branches of post-war liberalism among members of the Mont Pèlerin Society.

<sup>7</sup> See Reinhoudt and Audier (2018, 155) for Hayek's reference to the British Poor Laws.

<sup>8</sup> See e. g. Eliason *et al.* (2019), Farber and Valletta (2015), and Chetty (2008) for recent evidence on moral hazard associated with public income insurance schemes.

ferent question. The argument this far only states that social insurance can be supported from a classical liberal point of view (at least) to the degree that free-riding is avoided, and that due to free-riding, voluntary contracts alone cannot be expected to provide this basic level of social security.

But this is merely a formal criterion, and therefore we still do not have a precise idea of what *minimum of security* should be guaranteed by the state in material terms. Given cultural and institutional differences, a general definition of a *minimum of security* cannot exist; it needs to be negotiated in democratic societies. Hayek does, however, argue that the motivation for a policy is important. When a society defines a level of necessary security that it chooses to implement through a mandatory social security system, this is fundamentally different from redistributing income with the aim of achieving more equality. It is not inequality as such that is considered a problem, but only income levels that are below a basic level deemed necessary in a given society. And he warns that in political practice, systems originally intended to provide the former are often eventually misused to provide the latter (Hayek 1960, chapter 14). Translating this distinction into policy-making remains one of the core problems for classical liberalism to this day.

Hayek is not the only CWL participant who took such a position. Others, such as Wilhelm Röpke, held similar views. Röpke (1944, 184) warns that a state that attempts to achieve too much will fall prey to special interest groups and henceforth do more harm than good. Furthermore, he warns that an excessive dependence of individuals on social transfers may induce a decay of autonomy and self-reliance, in particular if it crowds out the individual ability to accumulate private property and wealth as an alternative source of economic security (*ibid.*, 251–253). In general, the idea that a limited welfare state is necessary, but needs to be contained rigorously in order to avoid a slippery slope of interventionism, later also resonated with other classical liberals, such as Milton Friedman (1962), and also Buchanan (1988), who contrasted the legitimate welfare state with what he calls, referring to Anthony de Jasay, the churning state. The latter redistributes income to a much larger extent, and without adhering to well-defined norms, but rather according to political clout of net contributors and net recipients.

### 3.2 Economic Security and Inequality

A welfare state that is designed to insure basic income risks will automatically reduce inequality to some degree. However, inequality as such is not necessarily a problem for classical liberals. If fundamental income risks are insured, further redistribution would require a separate rationale from those that we have already discussed. Hayek (1960, chapter 6) is quite clear in this respect, when he argues against the imposition of some arbitrary secondary income distribution as a goal for society. In Hayek's view, attempts to impose material equality, either by politically controlling factor incomes or by imposing progressive income taxes, are primarily a source of

inefficiency and also of coercion. Hayek (1976) argues particularly forcefully against the concept of social justice, arguing that this is an empty concept that has no discernible meaning at all. He claims that because market distributions of incomes are not the result of some overarching will, but come about spontaneously, it makes no sense to call a particular degree of inequality just or unjust.

In this respect, Hayek is very much in concurrence with Friedman, who similarly argues that inequality in outcomes is in itself neither good nor bad, but necessary if we want to use markets as efficient mechanisms for the allocation of resources (Cole 2008). Interestingly, Buchanan makes a slightly different argument. He compares Adam Smith's notion of natural liberties with John Rawls' concept of equal liberties and argues that both may not be in strong contradiction to each other. He sums up his conclusions stating that a "strong defense of the liberties of individuals, which can only be secured in an operating market economy, may be joined with an equally strong advocacy for the reform of basic social institutions designed to produce greater equality among individuals in their initial endowments and capacities" (Buchanan 1976, 16). Buchanan (1983) even goes so far to propose an inheritance tax rate of one hundred percent. However, his core argument there is not egalitarian, but efficiency-related. He argues that bequests induce rent-seeking of children towards their parents, in order to be included in their parents' will, and this type of rent-seeking is as inefficient as rent-seeking among firms. In general, however, Buchanan's focus on distributive justice is, as one might expect, not on specific outcomes in terms of an income distribution, but on fair general rules (Buchanan 1986).

The focus on the choice of just rules, rather than the search for just distributions, is shared to a large extent by German ordoliberalism. As Vanberg (2010) shows, the core assumption of the Freiburg School is that rules which secure market competition are the most important element of a just order. On the other hand, privileges that safeguard special interest groups from competition are perceived as inherently unjust. Franz Böhm famously argued that competition is chiefly a mechanism that erodes power.<sup>9</sup> Thus, income inequality that derives from market power is always endogenously challenged in a functioning competitive order. But the order itself needs, according to the German ordoliberals, to be upheld by a strong state setting and enforcing the necessary rules. Maier (1950) argued that three components are needed to guarantee economic security: a competitive order, stable money, and an attenuation of business cycle fluctuations. This may be seen as an extreme position, because other ordoliberals agreed with the necessity of a basic welfare state. But it illustrates how, in general, inequality that emerged within a functioning competitive order was not seen as a problem in itself.

There are, however, some exceptions in the ordoliberal tradition. In particular, Röpke (1950, 160–175) laments what he calls a tendency of "proletarianizing" society. Simply put, with this he meant a loss of individual autonomy and civic virtues in

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<sup>9</sup> See Böhm (2007), as well as Kolev (2019) for an English summary of the original argument.



large fractions of society, due to economic dependence either on wage income, or on social transfers. For Röpke, autonomy and civic virtues depend to a significant degree on the security that is associated with a household's property and wealth. Accordingly, he supports policies that help private households to accumulate wealth. Another variant of ordoliberal policy-proposals is what Alexander Rüstow (1961) calls *Vitalpolitik*, a set of policies that attempt to improve individual capacities to participate successfully in the competitive order of markets. Rüstow argues that individual autonomy and responsibility for one's own life, which he strongly endorses, rely on preconditions such as education, which in turn can be improved through prudent policies. But again, it is important to note that both Röpke and Rüstow are not so much concerned about inequality as such, but about specific preconditions that need to be provided in order for individual autonomy to flourish.

### 3.3 Individual Liberty

Individual liberty clearly is a priority for all the variants of classical liberal thinking discussed so far. As Buchanan (1976) shows, using the examples of Smith and Rawls, it takes this priority due to a fundamental normative decision that it should be the most important value. There can be arguments for and against every normative decision of this kind, but they can neither be definitely refuted or proven correct. If another person claims that material equality should take absolute priority, one can try to convince her that the costs of such a normative choice are too high, but if she still insists on her choice and claims that the cost are worth it, there is little further one can do. Even Buchanan himself, with his contractarian approach, needs such a basic normative decision. In his case, it is the claim that individuals are the only carriers of normative judgments on social orders (Buchanan 1960, 118). But this implies that the constitutional preferences of individuals ultimately need to be accepted.

Following this line of thought, individual liberty on the post-constitutional level is not an absolute value in itself. But in many cases, Buchanan is confident that he can show that a social order that preserves individual liberty to a great extent is prudent, and therefore acceptable for individuals who deliberate on their constitutional rules. The basic structure of this justification for individual liberty can, of course, be traced back at least to Adam Smith's argument that a competitive market order can direct self-interested individuals towards socially beneficial behavior – beneficial in this case in terms of promoting long-term growth and standards of living.

Clearly, there are many other plausible arguments in favor of individual liberty. For example, there is the well-known argument of epistemic privilege, claiming that every individual knows best for herself what is truly the best choice for her, because other individuals can never get a precise idea of what her preference ordering looks like. Buchanan (1999) criticises that the argument of epistemic privilege is too shallow. In a strictly subjectivist fashion, he makes the ontological claim that stable preference orderings do not exist at all. But if there is no preference ordering, there is also no

possibility to gauge the effects of choices on individual welfare from an external point of view. A formal argument along similar lines has been made by Sugden (2004).

There may be plausible arguments for giving individual liberty if not lexicographic priority over, then at least a significantly greater weight than other values. Empirically, however, we hardly ever observe a broad political consensus of this kind. Instead, different values that often cannot be reconciled with each other compete in the arena of politics and in the formation of public opinion. The fact that these are often competing absolute values, with no smooth trade-offs between them, is also another reason for the futility of using a social welfare function. Isaiah Berlin famously stated that often in public debate, there is a naive belief that

all the positive values in which men have believed must, in the end, be compatible, and perhaps even entail one another. ... But is this true? It is a commonplace that neither political equality nor efficient organization nor social justice is compatible with more than a modicum of individual liberty, and certainly not with unrestricted laissez-faire; ... And it is in no great way from that to the generalization that not all good things are compatible, still less all ideals of mankind (1969, 167).

The pluralism of absolute values leads to difficult choices. But more importantly, it leaves societies constantly vulnerable to recurring promises that competing values can, after all, be reconciled and a state of harmony can be reached. And in particular, Berlin warns, there is the danger that such promises abuse the notion of individual liberty, for example by suggesting that succumbing to some authority which claims to be fulfilling a general will of the people actually is a kind of liberty (*ibid.*, 170–172). In sharp opposition to such misuses of liberty, Berlin insists that, properly understood, liberty must be understood precisely as an individual right of being allowed to do as one pleases. Liberty, thus understood, can and often will contradict utilitarian pretensions (Berlin 2002, 19–20). But more importantly, it will also be in conflict with other political objectives, regardless how worthwhile and noble they may be. Complete and unrestricted individual liberty, understood as unrestricted negative liberty, will never be present in modern societies, because it is always in conflict with other worthwhile political objectives. Therefore, to Berlin it is important to frankly acknowledge the conflicts between different absolute values when evaluating the merits of policies. From a classical liberal perspective in particular, it will always be important to account for the costs in terms of forgone liberty that may occur when other worthwhile objectives are pursued. But a world in which individual (negative) liberty is the only worthwhile goal is inconceivable to Berlin.

Even though Berlin exhibits a strong preference for individual liberty throughout his work, it is also possible to interpret Berlin's emphasis on value pluralism (Crowder 2018) as a constitutional-level classical liberalism. If a harmonic state of affairs with congruent values is not possible in modern societies, then the result is perpetual political conflict between proponents of different absolute values. It becomes important to find and preserve a political framework that allows for the competition between objective, universal human values such as liberty, security, or equality, to take

place in a civil, and, if possible, productive, and also open-ended fashion. From the pluralist perspective, classical liberalism implies both a priority for individual liberty, and the insight that this priority does not follow from irrefutable logical considerations, or natural rights, but from a decision in favor of one of many competing values. And the success of classical liberalism therefore depends on the ability to convince others of giving liberty priority.

#### **4. The Welfare State, Liberalism, and the Stability of the Market Economy**

The discussion so far has shown that it is virtually impossible to prescribe to which extent infringements on individual liberty and into the market process can be generally justified. We have seen that, from a classical-liberal perspective, some redistribution can be justified. But we have also seen that classical liberals have very different points of view with regard to the extent of a legitimate welfare state. This is true both among authors that self-identify as classical liberal, and even more so among the broader group of authors who take a contractarian stance, but need not take an explicitly classical liberal perspective. In both cases, the degree to which tax-financed redistributive spending can be justified in order to reduce inequality for example, or to provide a basic level of economic security, depends on value judgments that are not general, but may differ from country to country, and from individual to individual. If we accept the starting point that individuals – actual, not theoretical individuals – are the only sources and carriers of values, then attempts to find objective limits for justifiable redistribution are pointless and futile.<sup>10</sup>

##### **4.1 Why Classical Liberals Can Accept a Limited Welfare State**

Several important arguments which have convinced classical liberals in the past to accept the existence of a (limited) welfare state have already been referred to above. The welfare state serving as a coercive insurance mechanism that avoids free-riding is one important argument, and the welfare state lending legitimacy to the dynamic, but risk-laden system of a market economy is another. Schumpeter (1942, chapter 7) famously claimed that the essential fact about capitalism is that market economies are driven by an endless process of creative destruction. But while the creative side of the process is at the centre of attention, the costs of adjustment associated with the destructive side are sometimes overlooked, hoping that a general compensation along the lines of the Kaldor-Hicks criterion will improve the lot of everybody in the (very)

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<sup>10</sup> See e.g. Gordon (1994) for a critique of Buchanan's arguments on redistribution from a radical Austrian perspective for an attempt to logically define limits of redistribution.

long run. But if a sufficiently large or politically influential group of citizens believes to be on the losing end of structural change, it is possible that they will use their political clout to slow down the dynamics of the market, or to demand large and inefficient redistributive schemes, and henceforth reduce economic growth (Persson and Tabellini 1994). Similarly, very unequal societies may find it difficult to organize political majorities which focus on the supply of efficient, growth-enhancing public goods (Alesina *et al.* 1999). In this sense, a moderate, risk-reducing welfare state can be growth-enhancing.

Recent evidence also indicates that higher inequality is associated with lower future income growth of the poor, while future income growth of the rich is not negatively affected, and may even increase with inequality (van der Weide and Milanovic 2018). If perpetually widening income gaps threaten the perceived legitimacy of both democracy and the market economy, it is possible that redistributive policies are supported by a broad coalition of groups including the rich who find it in their own best interest not to risk the stability of the market order. Goldschmidt and Fuchs-Goldschmidt (2013) argue that on a constitutional level, every individual should have an interest in being guaranteed the ability to participate in society. Starting from there, an argument for a modern version of what Alexander Rüstow has called *Vitalpolitik* could be made in a contractarian framework (Dörr and Goldschmidt 2016).

These are only a few examples. It is important that on this level of political debate, any discussion on the extent and design of a welfare state on the one hand circles around matters of prudence: What are the good reasons that can also convince a classical liberal that having some measure of redistribution, or some kind of social policy, is also in his own best interest? On the other hand, however, the conflicts around different values will never cease completely. Consider again, for instance, Buchanan's (1983) already mentioned proposal that a very high inheritance tax will help to reduce inefficient intra-family rent-seeking. The argument will appeal to individuals who strongly prefer their children to lead an independent life, and to pursue their own, individual pursuit of happiness. It may, on the other hand, appear much less plausible to individuals who have strong dynastic preferences and interpret intergenerational altruism such that it implies a transfer of material wealth. Both values, or preferences, are to some degree incommensurable, and the conflict between them cannot be solved solely by arguments referring to prudence and efficiency.

## 4.2 Why Non-Liberals Should Accept Limits to the Welfare State

Analogous to the preceding subsection, a number of arguments can be made in favor of limiting the size and scope of the welfare state. Pestieau and Lefebvre (2018, 78–88) discuss empirical evidence indicating that welfare states in many European countries have now reached levels where they have adverse direct effects on economic growth, placing undue stress on public budgets. Lindbeck (2004) argues that, if

unconstrained, political and economic dynamics may set the stage for an ever-expanding role of the welfare state. A part of this dynamic may be that a social norm to live off one's own income is slowly eroded by an extensive welfare state (Lindbeck *et al.* 1999). However, a negative effect of redistribution of growth seems to be appearing only above relatively high threshold values for redistribution, which indicates that substantial redistribution can be achieved without negative effects on long-run growth (Berg *et al.* 2018).

But even where an extensive welfare state does not erode economic growth immediately, it can still be the source of other important problems. As it grows in size, it is often constructed in a way that achieves little actual redistribution towards lower income percentiles, and actually channels substantial income towards the middle classes (Feld and Schnellenbach 2014). But in this case, it is not only well-established welfare losses associated with distortionary taxation which are imposed without much effect in terms of achieved equalization. Individual liberties of net payers are also encroached while the expected beneficial effects are small. Furthermore, more productive public spending for public investments or other public goods may be crowded out by welfare spending if special interest groups backing the latter are strong enough. Part of these groups will be members of the extensive bureaucracy that is found in most modern welfare states.

The broad trends suggest that in most developed economies, the size of the welfare state has been growing for decades, and that few of these economies have managed to restrain their redistributive efforts to smaller scales (Balcerowicz and Radzikowski 2018). If there is political market failure that leads to a steady crowding out of other spending by redistributive efforts, then a discussion about means of limiting welfare state growth, or channeling spending into more effective welfare policies, may be called for. And if non-liberals have an interest in an effective and efficient welfare state which is also sustainable in the long-term, they should also have an interest in conducting this discussion. However, similarly to the previous subsection, there may again be values held by individuals that keep them disinterested in discussions about efficiency. If, for example, a very egalitarian individual favors every policy that taxes the upper income percentiles, regardless of what happens with the money, discussions even about an efficient limitation of the redistributive state might not convince her.

### 4.3 Learning How to Redistribute

Vanberg (2016) points towards a possible interpretation of the state as a club, which serves the common interests of those individuals who are members, either by birth or by conscious decision to be a member of such a club. In particular, Vanberg makes a distinction between club goods, which are provided to all citizens of a jurisdiction, and territorial goods, which are provided to all who are present on its territory. It is well-known that redistribution as a territorial good can be faced with difficulties, in particular on the sub-national level of government, because individuals can escape

taxation at relative low cost by moving to a different territory. The problematic process of adverse selection may, however, be atoned if citizenship, and not presence in a specific territory, is used as the lever for redistributive taxation.

Within such a framework, Vanberg argues, competition of different clubs providing welfare state services can be sustained, also within an entity such as the European Union, where there has been some political pressure towards a centralization of redistributive tasks (Sinn 1997). The result would be a sustained variety of different approaches to economic security and redistribution, which would have a number of positive effects. First, even if ruinous competition were not to take place, there would be some degree of political competition. This is neither Tiebout-like competition with perfect sorting of individuals, neither competition that leads to a single one-size-fits-all solution resulting as the winner, but rather a limited type of yardstick competition where information about the experiences made in other jurisdictions can move across borders and be utilized.

Secondly, there is an endogenous restriction to the scope of redistribution. Individual citizens incur a higher exit cost compared to territorial goods, but in principle, they can change their club membership by changing their citizenship. In order to do so, they are free to exit their current membership, but no other club is obliged to accept them for membership. It is, however, likely that (expected) net payers will be able to find alternatives, which is a *de facto* individual-level insurance against fiscal exploitation. But it also allows to move to a jurisdiction where the values underlying policies are closer to the values held by oneself.<sup>11</sup> Somewhat paradoxically, some sorting along the lines of values may be beneficial also to those in favor of extensive redistribution. Empirical evidence indicates that populations that are more heterogeneous along different dimensions are less willing to organize large-scale redistribution (Acemoglu *et al.* 2013).

And thirdly, it appears to be important to tailor the size and the institutions of the welfare state to some specific characteristics of the group that is covered by these institutions. For example, Algan *et al.* (2011) demonstrate empirically that the size of welfare states depends on the level of trust in society. The higher the level of trust, the less an expectation prevails that the welfare state will be exploited by individuals who do not play by the rules. Consequently, countries with higher trust tend to channel more money into income redistribution. If trust in equilibrium is itself congruent with actual behavior, it is probably efficient to have less redistribution where social norms of rule-abiding behavior are weaker.

Taking these arguments into consideration, it is probably useful to view the policies that constitute the welfare state from an evolutionary perspective – especially in a classical liberal framework (Schnellenbach 2016). Under the conditions discussed here, a variety of welfare states is endogenously created and reproduced through

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<sup>11</sup> See e.g. Luttmer and Singhal (2011) for evidence regarding the heterogeneity of values held by individuals towards redistribution.

processes of policy-making that adapt to the specific conditions of single countries. However, they do not do so to implement some kind of hypothetically welfare-maximizing set of policies. Rather, policy-making is a process of trial and error. Finding a set of broader political institutions that facilitate rational debate both on the conflicting absolute values underlying policy-making, and on the effects of alternative policies with regard to these values seems to be key. And in particular, an openness for a critical revision of the status quo appears to be important under these conditions, as is the insight that in redistributive policy-making also, all policies are tentative and provisional (*ibid.*, 65–67).

## 5. Conclusions

We have seen that in a modern classical-liberal framework that takes a contractarian approach, it is impossible to give a clear-cut recommendation as to the desirable size and design of a welfare state. The implicit approach taken at the CWL, to search of the level of economic security that is required to preserve the functioning and stability of a market order, is interesting as one input (among many) into a contractarian exercise, but it cannot serve as a definitive guideline. Rather, it is necessary to account for value pluralism that exists in any complex, modern society. In a world with conflicting, sometimes incommensurable values concerning all kinds of issues, including the welfare state, any actual design of a welfare state will be a compromise. Dogmatic approaches which seek to restrict redistribution by arguing, for example, that progressive taxation is incompatible with some libertarian first principles, are futile and meaningless in such a world.

We argue, however, that on a constitutional level, institutions should be implemented and preserved that facilitate learning from political experiments. In particular, we argue against centralization and harmonization of redistributive policies in political entities like the European Union. Variety and openness to change can be virtues in themselves in a policy field like the welfare state, where both fallible hypotheses about the complex effects of welfare policies, and conflicting values about the desired scope of these policies need to be taken into consideration.

This is not to deny that classical liberals when they leave the constitutional level and begin debating actual policies in the political arena will most often be guided by their own values to defend liberty. They will most often look for arguments of prudence that could convince even non-liberals of limiting coercive redistribution. But in a pluralist society, they cannot claim that theirs is the only legitimate stance towards these issues and that only persuasion can and should be instrumental in implementing a classical liberal version of the welfare state.

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