

The Third Welfare Policy Seminar

Economics and Ethics of
the Welfare State

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Welfare Economics and the Welfare State*

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The complicated analyses which economists endeavour to carry through are not mere gymnastic. They are instruments for the bettering of human life. The misery and squalor that surround us, the injurious luxury of some wealthy families, the terrible uncertainty overshadowing many families of the poor—these are evils too plain to be ignored. By the knowledge that our science seeks it is possible that they may be restrained. Out of the darkness light! To search for it is the task, to find it perhaps the prize, which the “dismal science of Political Economy” offers to those who face its discipline.

— Arthur Cecil Pigou***

1. Introduction

The time is now ripe for re-examining the concept of the welfare state with a view to searching for a common understanding on the agenda and ethical foundations of the welfare state in a contemporary society. The time is also ripe for re-orienting welfare economics with a view to renovating this discipline so that it can contribute actively to the enhancement of human well-being in general, and to the design and implementation of fully-fledged welfare state policies in particular. The necessity and urgency of such a re-examination and re-orientation seem all too clear for at least two reasons.

First, ever since the publication of Amartya Sen’s epoch-making synthesis of social choice theory in 1970 and John Rawls’s monumental edifice in moral and political philosophy in 1971, the concept of well-being has been enriched substantially, liberating us from the narrow cage of utilitarian sum of individual utilities, and enabling us to accommodate such basic considerations as liberty,

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*** Pigou (1950, p. vi).

opportunity and procedural justice within the extended concept of well-being. If the welfare state is one that is ready to commit herself to the enhancement of well-being of her people, this widening of the concept of well-being should reflect itself properly in the concept and agenda of the welfare state.

Second, any reasonable conception of the welfare state hinges squarely on the boundary between the *private sphere*, within which the relevant private agent should be empowered to choose his/her private actions on his/her own initiative and at his/her own risk, and the *public sphere*, within which the welfare state should be held responsible for taking public actions to the enhancement of well-being of her people. John Stuart Mill, John Maynard Keynes, Friedrich Hayek, John Rawls and Robert Nozick are all in full agreement that there should exist a certain "assured private sphere [Hayek (1960, p. 13)]," which should not be interfered by anybody, the state in particular, even in the name of enhancing general well-being, or any other portmanteau catchword. However, severe disagreement inevitably develops when we proceed to discuss where to draw the line between the private sphere and the public sphere. The more inclusively we define the public sphere vis-à-vis the private sphere, the more costly will the resulting welfare state policies become. It is clear that the practical discussion on the limit of welfare state policies has been strongly influenced by such cost considerations. This being the case, it is all the more important that we should be crystal-clear about the ethical foundations of the welfare state.

With these agenda in mind, the rest of this paper is structured as follows. Section 2 is devoted to the brief account of the post Rawls-Sen concepts of well-being and procedural justice, which form the theoretical basis of our subsequent analysis. Section 3 presents a brief overview of the welfare state policies as we see them with the purpose of orienting our subsequent discussion on each component thereof. Section 4 begins with a brief discussion on Mill's principle concerning the private sphere versus the public sphere. Even if private agents are assured of freedom to choose their private actions within their private sphere on their own initiative and at their own risk, however, they must compete with each other in order to attain what they aspire, which is because no activity of any private agent is so completely private as never to obstruct the activity of any other private agent. Hence the design and enforcement of fair rule of competition is an integral role to be played by the welfare state. Section 4 makes some observations on this important component of the welfare state policies. The more we emphasize the role of competition in the private sphere, however, the more will the welfare state become vulnerable to various coordination failures. Section 5 discusses the sources of coordination failures and the nature of the public mechanism for rectifying these dysfunctions. Even if the rule of fair competition is designed and implemented, and the public mechanism to cope with the

coordination failures is properly functioning to complement the competitive mechanism, however, there may be natural and social hazards that may severely disfavour some private agents, for which they should not be held responsible. Section 6 describes the role to be played by the welfare state in the provision of a social safety net against such natural and social hazards. The final Section 7 takes stock, and concludes with a list of future agenda for materializing the welfare state policies as we envisage them in this paper.

2. Consequences, Opportunities and Procedures

Arthur Pigou was a utilitarian, so his “old” welfare economics was based on the concept of well-being which is utilitarian in nature. The social choice theory initiated by Kenneth Arrow, which is the culmination of the “new” welfare economics of Nicholas Kaldor, John Hicks, Tibor Scitovsky, Abraham Bergson and Paul Samuelson, was a lineal descendant of the Benthamite-Pigovian utilitarian tradition with ordinalist renovation and without interpersonal comparability of utilities. Although it was dissociated from the utilitarian sum of individual utilities, the attention was focussed exclusively on the *consequences* of economic policy.¹ Furthermore, the descriptions of consequences were solely in terms of the *utilities* people receive from these consequences. To understand what underlies well-being of people with a view to designing and implementing the welfare state policies, this *welfarist-consequentialism*, so-called, which clearly permeates through the traditional welfare economics, old as well as new, and the Arrowian social choice theory, is hard to sustain as the informational basis. Indeed, as Amartya Sen aptly emphasized, when people suffer from injustice and destitution for a long time, they cannot but adjust to their harsh reality, and their misery, pain and resentment do not reflect themselves properly in the measuring rod of utilities. Besides, utility is simply the subjective vindication of individual advantages rather than the objective and interpersonally commensurable measure thereof, so that to focus exclusively on utilities is to commit a subjectivist mistake, which may prevent us from identifying and implementing the welfare state policies towards the enhancement of well-being.

Dissatisfaction with the welfarist-consequentialism was forcefully voiced by John Rawls, Ronald Dworkin and Amartya Sen. In their idiosyncratic ways,

¹ It was Arrow (1987, p. 124) who observed in his characteristically lucid manner that “[e]conomic or any other social policy has consequences for the many and diverse individuals who make up the society or economy. It has been taken for granted in virtually all economic policy discussions since the time of Adam Smith, if not before, that alternative policies should be judged on the basis of their consequences for individuals.”

Rawls, Dworkin and Sen proposed that we should purge utilities from their traditional status of the informational basis of well-being and replace them by some objective measures of individual advantages. Among these proposed alternative measures, Rawls's *primary social goods* and Dworkin's *resources* met harsh criticism from Sen to the effect that they are *means*, rather than *ends*, to the enhancement of well-being.

To avoid the subjectivist mistake of welfarist-consequentialism as well as the fetishist mistake of Rawls and Dworkin, and to gear more directly with individual advantages, Sen's proposal was that we should focus on what he christened *functionings*: "[a] functioning is an achievement of a person: what he or she manages to do or to be. ... [It] is ... different both from (1) having goods (and the corresponding characteristics), to which it is posterior, and (2) having utility (in the form of happiness resulting from that functioning), to which it is ... prior [Sen (1985, pp. 10–11)]." The *capability* of a person is the set of functioning vectors from which he/she is empowered to choose when the *resource allocation mechanism* and the *rights system* are specified. Human misery and destitution should be viewed as the failure of capability development caused by the malfunctioning of economic systems.

Sen's concepts of functionings and capabilities are vehicles in terms of which we can examine the performance of economic systems from the viewpoint of an individual's opportunity to realize the life which he/she values on reflection. However, Sen's space of analysis, viz. the space of functionings, is no more than an alternative space of consequences. Indeed, the capability of a person is a measure of the consequential performance of economic systems in the form of opportunity they enable him/her to pursue in the space of functionings. The fact that this measure is free from the subjectivist mistake of welfarist-consequentialism as well as from the fetishist mistake of Rawls and Dworkin does not change the fact at all that Sen is still working within the boundary of consequentialism.

To understand that the commitment to consequentialism, irrespective of how and in which space the consequences are described, is still seriously lacking as the informational basis of well-being, we have only to consider the following simple example:²

Example (Dividing a Cake Fairly): A father is to divide a homogeneous cake fairly among three children. Method I is that he divides this cake into three equal pieces, and tells them to take a piece each or leave it. Method II is that the

² This example is taken from Suzumura (1999), where some other examples are also presented. See Pattanaik and Suzumura (1994) for related observations.

children are given the opportunity to discuss how this cake should be divided fairly among them, and cut it into three pieces in accordance with the conclusion they agree on. If they happen to conclude that the equal division is the fair outcome after all, and if we are informed only of the consequences of the cake division, we cannot but conclude that these two methods of division are the same. It is clear, however, that this identification is inappropriate. In Method I, the children are not provided with any right to participate in the process through which their distributive shares are determined, whereas in Method II, they are endowed with such an important right of participation.

This example should suffice to suggest the crucial importance of procedural considerations along with consequential considerations in developing the fully-fledged analysis of individual advantages. It may be worthwhile to recognize that the importance of procedures lies not only in their *instrumental value* in promoting some other ends, but also in the *intrinsic value* of their own. For example, Sen's (1981) analysis of famine convinced us that democratic decision-making procedure is of instrumental value in preventing devastating famines: it is fear of electoral defeat and of political opposition that compels democratic governments to be responsive to threats of famines. To supplement this side of the coin, however, we should note that democratic decision-making procedure is of intrinsic value in that all relevant parties in the democratic system are warranted of the basic rights to participate in the process through which their life chances are circumscribed.

Furthermore, the procedural viewpoint is of crucial importance in giving substance to the concept of justice itself. Recollect that there are two basic approaches to the concept of justice, which are sharply contrasting with each other. The first approach presupposes an explicit *outcome morality*, which enables us to define just outcomes in the space of consequences. The concept of just decision-making procedures is then derived from that of just outcomes: a decision-making procedure is just if it brings about just outcomes in terms of the prescribed outcome morality. In the terminology coined by Rawls, this approach represents the viewpoint of *perfect procedural justice*, which bestows on procedures the instrumental value and nothing else. It is this first approach that permeates through the traditional welfare economics and social choice theory. In contrast, the second approach reverses the sequence of inference altogether, and construes a consequential outcome to be just if it is brought about by a just decision-making procedure. In the terminology of Rawls, this approach embodies the viewpoint of *pure procedural justice*, which bestows on procedures the intrinsic value of its own. In other words, the justice of decision-making procedures is given logical priority over the justice of its outcomes. For this

approach to make sense, however, it is clear that we should define the justice of decision-making procedures independently of their consequential outcomes. The advocates of this approach follow Rawls and other contractarians and construe a decision-making procedure to be just if it is socially chosen in the primordial stage of rule selection, where any morally irrelevant information should be hidden behind the veil of ignorance. Since no one is in the position to tailor decision-making procedures to his/her advantage, everyone is situated to participate in the primordial stage of rule selection on an equal footing, and expresses his/her impartial judgements “which must express what [he/she] prefers (or, rather, would prefer) on the basis of impersonal social considerations alone [Harsanyi (1955, p. 315)].”

Although the viewpoint of pure procedural justice as well as its background concept of primordial stage of rule selection behind the veil of ignorance is highly abstract, it is premature to rush to the conclusion that this procedural viewpoint is irrelevant in the down-to-earth context of welfare state policies. It is true that the primordial stage of rule selection is a state “which, if ever it did, does not now, and in all probability never will exist. ... [However, it is a state] of which ... it is absolutely necessary to have just notions to judge properly of our present state [Rousseau (1964, p. 169)].” Indeed, “[t]he idea [of the primordial stage of rule selection] is simply to make vivid to ourselves the restrictions that it seems reasonable to impose on arguments for principles of justice, and therefore on these principles themselves [Rawls (1971, p. 18)].”

Due recognition of the crucial importance of procedural considerations along with consequential considerations, particularly when one is concerned with the issues of rights, freedom and justice, has been often expressed in the literature. For example, Assar Lindbeck (1988, p. 295) aptly observed in his *Joseph Schumpeter Lecture* that “the issue of ‘individual freedom’, which is closely related not only to actual achievements but also to the process by which these are realized, is seldom squarely confronted in economic analysis.” However, Lindbeck’s interest in the process through which outcomes are realized quickly recedes to the background and his attention becomes focussed on the *opportunity set* from which outcomes are chosen. Sen (1997, p. 202) also suggested the use of opportunity set in capturing the role to be played by procedural considerations in analysing freedom of choice: “[T]he value of [opportunity] set need not invariably be identified with the value of the best—or chosen—element of it. Importance can also be attached to having opportunities that are *not* taken up. This is a natural direction to go if the process through which outcomes are generated is of a significance of its own.”

Instead of the Lindbeck-Sen approach which tries to capture procedural considerations indirectly through opportunity sets, we follow Arrow (1963, pp.

90–91) and adopt the following more direct approach: “[A]mong the variables which taken together define the social state, one is the very process by which the society makes its choice. This is especially important if the mechanism of choice itself has a value to the individuals in the society. For example, an individual may have a positive preference for achieving a given distribution through the free market mechanism over achieving the same distribution through rationing by the government.”^{3, 4}

To summarize our analysis so far, we should capture the consequences of economic policy in terms of the functioning vectors and capabilities à la Sen, but we should supplement consequential considerations with procedural considerations in order to obtain a fully-fledged informational basis for the analysis of individual advantages in the welfare state.

3. Welfare State Policies: A Brief Overview

It may facilitate understanding if an overview of our broad picture of the welfare state policies is given before we discuss any component of these policies in full detail. In our perception, the welfare state consists of one main system and three sub-systems whose task is to support smooth and effective working of the main system. The main system and the sub-systems are complementary in the sense that each system will not work properly and effectively unless the other systems are working properly and effectively.

The main system of the welfare state is the *competitive mechanism* which permeates through many aspects of life in a contemporary society. The importance of competitive mechanism lies in the fact that it enables private agents to try out their life chance on their own initiative and at their own risk in order to make the best use of the opportunity open to them as they think fit. Another merit of the competitive mechanism, which is no less important than the former, is that it minimizes the need for gathering initially dispersed private information in the hands of the state, thereby allowing private agents to retain

³ The analytical development of Arrow’s insightful remark was initiated by Pattanaik and Suzumura (1994; 1996), which was further explored by Suzumura (1996; 1999) in the context of libertarian rights assignment, and by Gotoh, Suzumura and Yoshihara (1999) in the context of choosing fair resource allocation rules in economic environments.

⁴ In the similar spirit, Agnar Sandmo (1990, p. 58) observed that “[j]udging allocation mechanisms either by results or by the allocation processes themselves may not be a very fruitful contrast. ... One problem with this approach is that it is not always clear how one should draw the distinction between outcomes and processes, because the individuals in the economy may have preferences that are partly defined over the processes themselves.”

their privacy as much as possible. It should be clear that the competitive mechanism presupposes that private agents are assured of the *right of autonomy* in the choice of their competitive measures. Thus, it is of crucial importance to circumscribe the domain of competition properly, viz. to draw a proper line between the *private sphere*, within which private agents are endowed with such a right of autonomy, and the *public sphere*, where the welfare state must be held responsible for the enhancement of well-being of her citizens.

Even after the boundary that separates the private sphere and the public sphere is properly drawn, however, it remains as the major task of the welfare state to design a set of *fair rules of competition* and to enforce it so that the competitive game is played by private agents in full accordance with the duty of fair play. This is the task to be entrusted to the *competition policy sub-system* of the welfare state.

For all niceties of the main system of competitive mechanism, supplemented by the competition policy sub-system, there are several factors under which it is destined to fail. To complement the main system of competitive mechanism effectively whenever such a so-called coordination failure occurs is the task to be entrusted to the *coordination policy sub-system* of the welfare state. In designing and implementing such complementary policies, the crucial requirement is that such policies will not nullify the major merits of the main system, viz. it should be in basic conformity with the incentives of private agents, and it should not violate privacy of private agents by forcing them to submit their private information to the state against their wishes.

The main system of competitive mechanism and the complementary mechanisms of competition policy sub-system and coordination policy sub-system are deeply rooted in the belief that private agents should be provided with freedom of choice in their private spheres on their own initiative and at their own risk as much as possible so that they can make the best use of their own opportunity by themselves. However, it may well be the case that private agents are subject to many natural and social hazards, for which they cannot be held responsible, that may place them in an unfavourable position in the competitive arena. For example, some private agents may be born with natural handicaps which may hinder them in the competitive arena, or may even prevent them from entering the competitive arena in the first place; there may be exogenous macroeconomic shocks which may disfavour some employees so much so that they may be discharged without fault of their own. It is the task of the *social security sub-system* to design and implement the *social safety net* against these natural and social hazards. It is of crucial importance that this sub-system would not vitiate the incentives of private agents to try out their life chance in the main system of competitive mechanism; it is also of vital importance that this sub-system will not make those private agents feel ashamed, or disgraced, when they must take

recourse to the social safety net provided by the social security sub-system. In other words, the social security sub-system should be so designed and implemented as to be free from two vices: *welfare fraud* and *welfare stigma*.

The task of the *welfare economics of the welfare state* as we envisage it is to deliberately design the main system—the competitive mechanism—and three sub-systems—the competition policy sub-system, the coordination policy sub-system, and the social security sub-system—of the welfare state so that the whole system will be incentive-compatible and work effectively. The task of the *ethics of the welfare state* is to clarify the philosophical foundations of the welfare state policies on the informational basis of individual advantages that we have developed in Section 2.

So much for the brief preliminary overview of our subject. Let us now proceed to the analysis of each component of the welfare state policies.

4. Competitive Mechanism: Designing a Fair Game and Enforcing the Duty of Fair Play

The problem of how to draw a line between the private sphere and the public sphere is deep and at least as old as the ideas of John Stuart Mill, who posed the following basic question: “What ... is the rightful limit to the sovereignty of the individual over himself? Where does the authority of society begin? How much of human life should be assigned to individuality, and how much to society [Mill (1977, p. 276)]?” Mill’s own answer was a deceptively simple principle: “Each will receive its proper share, if each has that which more particularly concerns it. To individuality should belong the part of life in which it is chiefly the individual that is interested; to society, the part which chiefly interests society.”

It does not take long before one realizes that Mill’s principle is destined to failure because of the ambiguity of the crucial term: *chief interest*. Despite many subsequent attempts to go beyond Mill’s unsustainable principle, no one has ever succeeded in finding a universally applicable principle. As a matter of fact, the search for a universal principle is dangerously close to “the *a priori* barbarities of Procrustes—the vivisection of actual human societies into some fixed pattern dictated by our fallible understanding of a largely imaginary past or a wholly imaginary future [Berlin (1969, p. 171)].”

Instead of wasting any more time in search for the non-existent universal principle, let us just keep two simple remarks on record.

First, by drawing a line between the private sphere and the public sphere, we are in effect deciding the extent of the *right of autonomy* within the private sphere. The conferment of this right has important implications from the point of view of social efficiency. It was Sen (1970, Chapters 6 & 6*) who showed in

terms of his justly famous *impossibility of a Paretian liberal* that there exists a basic conflict between the welfaristic value of Pareto efficiency, on the one hand, and the non-welfaristic value of individual right of autonomy within his/her private sphere, on the other. This conflict may be construed to mean that the efficiency loss incurred by the conferment of individual right of autonomy is an unambiguous signal that tells us to re-examine the *raison d'être* of this right. Alternatively, Sen's dilemma may be construed to mean that the efficiency loss incurred by the conferment of individual right of autonomy is nothing other than the social cost which the society should be ready to persevere in order to protect individual right of autonomy as an integral component of the functioning vector. Thus, the crucial question to be asked whenever the conflict between the two values surfaces is the following: are we prepared to persevere this much of sacrifice in terms of the loss in social efficiency for the sake of protecting individual right of autonomy? If the answer to this question is in the affirmative, then the society is committed to protecting this right at the sacrifice of efficiency loss, whereas if it is in the negative, it follows that the society does not regard this right as of basic importance as an integral component of the relevant functioning vector. In the final analysis, the issue of drawing a line between the private sphere and the public sphere may hinge on the answer to this question, which may serve as a litmus paper for checking the extent of the society's commitment to individual autonomy.

Second, even if a line between the private sphere and the public sphere can be somehow drawn, it does not follow that the welfare state could be, and should be, completely indifferent to what private agents do within their respective private sphere. Indeed, even if private agents are assured of autonomy within their respective private sphere, "[m]en are largely interdependent, and no man's activity is so completely private as never to obstruct the lives of others in any way. 'Freedom for the pike is death for the minnows'; the liberty of some must depend on the restraint of others [Berlin (1969, p. 124)]." Thus, it is a major task of the welfare state to design the rule of *fair game* to be played within private sphere, and to see to it that private agents compete by observing their duty of *fair play*. This is the task which should be assigned to the competition policy sub-system of the welfare state.

At this juncture of our analysis, it is worth observing that there exists a multi-layered structure of competition, which may be called the *fractal structure of competition*, which permeates through the whole life of private agents in a contemporary society.⁵ More often than not, each and every private agent

⁵ This observation was first made in Suzumura (1996a) in the specific context of Japanese society, but it seems to be of much wider applicability.

belongs to an organization, typically a corporation, within which he/she competes with colleagues for pecuniary and/or non-pecuniary rewards such as status, better work assignment, bonus, and promotion, but all private agents in the same corporation will collaborate in the arena of *competition for the market*, and *competition in the market*, with other corporations.⁶ Corporations in a specified industry compete fiercely with each other under normal circumstances, but they may form an industry association and collaborate to protect and/or promote their common interest against other industries. Besides, they may form a collaborative R&D association and cooperate in the precompetitive R&D stage for the sake of pursuing the common cause of coping effectively with outside competitors. In this case, not all competing domestic corporations may be inducted into the insider group, so that the outsider group consists of competing foreign corporations and domestic outsider corporations.

Why do private agents compete within this fractal structure of competition? As we have already mentioned, a part of the answer lies in the pecuniary and non-pecuniary remunerations which will be awarded to winners, but an additional answer will be a human desire to prove one's distinction and eminence in the competitive arena. For whatever reason, to participate in the fractal structure of competition under fair terms and to try out one's life chance on one's own initiative and at one's own risk is a valuable privilege in itself, which should be an important component of the relevant functioning vectors. To disseminate this privilege openly and fairly to all willing agents and to prepare the fair and transparent arena in which competition takes place must be an important task of the welfare state.

Depending on which stratum within the fractal structure of competition we choose for scrutiny, the content and extent of the expected role of the competition policy sub-system of the welfare state must differ substantially. For example, competition within a corporation for promotion and recognition may be the stratum where the welfare state can play only a limited role, but the Rawlsian *liberal principle of fair equality of opportunity* may still be relevant in this arena as well, which "expresses the conviction that if some places were not open on a basis fair to all, those kept out would be right in feeling unjustly treated even though they benefited from the greater efforts of those who were allowed to hold them. They would be justified in their complaint not only because they were excluded from certain external rewards of office such as wealth and privilege, but because they were debarred from experiencing the realization of self which comes from a skillful and devoted exercise of social

⁶ Even when a private agent is an independent professional, what we argue in what follows applies to his/her life *mutatis mutandis*.

duties. They would be deprived of one of the main forms of human good [Rawls (1971, p. 84)].” The legislation and enforcement of equal opportunity law may be a step towards full implementation of this Rawlsian principle in this stratum of the fractal structure of competition.

Far more unambiguous is the role to be played by the competition policy sub-system in the arena of competition in the market, and competition for the market. Indeed, the legislation of fair and rigorous competition law and its faithful enforcement should be one of the major tasks of the competition policy sub-system. This claim being rather uncontroversial, we have only to add just one simple remark. It was Friedrich Hayek (1976, p. 2) who aptly observed that “[e]ven in the modern welfare societies the great majority and the most important of the daily needs of the great masses are met as a result of processes whose particulars government does not and cannot know. The most important of the public goods for which government is required is thus not the direct satisfaction of any particular needs, but the securing of conditions in which the individuals and smaller groups will have favourable opportunities of mutually providing for their respective needs.” The role of anti-monopoly law and competition policy is precisely to provide “the most important of the public goods” in the sense of Hayek, by designing and implementing the *fair game* of competition in the market, by monitoring the competitive process so that all the participants would compete in full compliance with the obligation of *fair play*, and by discovering and rectifying the infringements of the rule of fair competition.^{7, 8}

5. Coordination Failures and Complementary Mechanism⁹

Competition is a useful mechanism that is of instrumental value in decentralizing decision-making in a contemporary society. It is also of intrinsic value in that it

⁷ This view on the nature and role of anti-monopoly law and competition policy is systematically explored in the specific context of Japanese law and policy in Goto and Suzumura (1999).

⁸ In contrast with our stance, according to which anti-monopoly law and competition policy are no more than the infrastructure to be provided by the welfare state with the purpose of enabling willing private agents to try out their own life chance at their own risk and on equal footing, there are some scholars who regard the role of anti-monopoly law and competition policy as that of protecting socially vulnerable transactors, such as consumers and small firms, by constraining the exercise of monopoly power. It should be clear that we are taking the procedural viewpoint, whereas the alternative viewpoint focusses on the outcomes or consequences of market transactions. We will not pursue this alternative viewpoint in this paper.

⁹ This section capitalizes on our studies of industrial policy in general, and Japanese industrial policy in particular, which we pursued over many years in Itoh, Kiyono, Okuno-Fujiwara and Suzumura (1991), Komiya, Okuno and Suzumura (1988), and Suzumura (1995; 1997; 1997a).

enables each and every agent to try out his/her life chance on his/her own initiative and at his/her own risk. For all these noteworthy merits, however, blind reliance on the competitive mechanism is a luxury that the welfare state cannot afford. As often as not, the competitive mechanism fails to function well due to such factors as (i) imperfect information, (ii) the cost of information acquisition, transmission and coordination, (iii) factors generating Marshallian externalities, and (iv) imperfections in risk and capital markets. In these cases of *coordination failures*, so-called, the welfare state must act to complement the competitive mechanism, which is the task to be entrusted to the coordination policy sub-system. This is easier said than done for several reasons.

First, the state must have accurate information regarding the segment of the economy in which coordination failures have occurred, as well as the causes and consequences of distortions thereby created, for the successful diagnosis of coordination failures. This condition requires, among others, that the state is able to gather and make use of information, such as technology, consumer preferences, and initial distribution of resources, which is dispersed among numerous private agents. Since the initial holders of these information may be unable to transmit what they know in a clear and consistent manner to the state, even when they have no strategic reason to hide or distort their private information and knowledge, it is practically difficult, if not theoretically impossible, for the coordination policy sub-system to gather this initially dispersed information for public use at one stroke.

Second, the state must be equipped with enough administrative authority to take effective public actions to deal with coordination failures diagnosed. This condition, which is required to treat coordination failures appropriately, may infringe upon basic economic freedoms of private agents such as the freedom to engage in business and the freedom to choose ones own occupation, and may also be in conflict with competition policy which is another important role the welfare state should play.

Third, the state must be able to look far beyond the direct and immediate effects of remedial measures adopted, taking its indirect side effects into account. This condition is necessary for the sake of appropriate aftercare of the remedial measures, which requires that the state is capable of anticipating complex causal linkages and foresee the distant future through the thick veil of uncertainty.

It goes without saying that these conditions for the *first-best* coordination policy towards coordination failures are hard to satisfy in practice, if not theoretically impossible, and the coordination policy sub-system may have to settle with something in the nature of the *second-best* policy. Partly for lack of accurate information, and partly for lack of ability to understand the causes and consequences of coordination failures, the problem faced by the coordination

policy sub-system is not that of constrained optimization of a given social objective, but that of designing and implementing an appropriate cooperative mechanism for information exchange, coordination and dissemination, in which private agents as well as public agents participate, interact, persuade and negotiate. It is through this cooperative and interactive mechanism that disparate and potentially conflicting objectives of private agents are made essentially compatible, and voluntary compliance by all parties involved with the second-best remedial policies may be secured. Likewise, it is through this cooperative and interactive mechanism that reliable information are disseminated and shared among private agents and public agents, thereby motivating and helping private agents to adjust and coordinate their plans and expectations accordingly.

The more we emphasize the role of a cooperative mechanism for information exchange, coordination and sharing, however, the more we become vulnerable to further questions: (Q₁) Cooperative behaviour among competitors may prepare the stage for collusion to the detriment of social welfare. How can this subtle and dangerous shift from cooperation to collusion be detected and contained?; (Q₂) Cooperation among competitors may dull the edge of their competitive swords, and may even inhibit effective competition itself, leading to a loss of economic efficiency. How can this danger be alleviated?; (Q₃) Frequent and informal negotiations and persuasions among government bureaucrats and private agents may facilitate private agents to seek favouritism from government bureaucrats in exchange for pecuniary and/or non-pecuniary compensations. How can this danger deeply rooted in *human fallibility* be contained?

The keyword in our answer to these questions is, again, competition. An institutional structure must be deliberately developed so that private agents within the cooperative mechanism must participate in the *contest-based competition* for prizes in the form of preferential access to favourable measures. It is this contest-based competition, which should be internalized in the cooperative mechanism, that effectively prevents inefficiency, favouritism and corruption. Thus, even within the context of a cooperative mechanism for coping with coordination failures, the crucial word, competition, strenuously comes back. In the absence of coordination failures, it is the market-based competition that matters, whereas in the presence of coordination failures, it is the contest-based competition within the cooperative mechanism that rules the roost.

6. Provision of a Social Safety Net: Social Security Sub-System

Although the competitive mechanism enables private agents to try out their life chance on their own initiative and at their own risk, it treats them equally only to

the extent that they enter the competitive arena on equal terms. However, an undeniable reality of life is that private agents are *not* equally favoured by nature. Some may be handicapped by birth, whereas some others may be born with favourable natural assets and/or large inherited wealth. The competitive mechanism *per se* does not do anything to rectify such favouritism by nature. Quite to the contrary, it may magnify the unequal treatment by richly rewarding those who are born with favourable conditions. It may go even as far as to refuse those who were born with severe handicaps to take part in the competitive game in the first place. It goes without saying that those who are born with handicaps cannot be held responsible for their hard luck. Likewise, there are social hazards that fall on some unlucky private agents, for which they cannot be held responsible. Suffice it to imagine an exogenous macroeconomic shock which so severely affects some corporations that they are left with no other measure than to discharge elderly employees who cannot be held responsible for such a cause that triggered their misfortune. It is the task of the social security sub-system of the welfare state to design and implement a social safety net which can effectively protect private agents from these natural and social hazards.

The provision of a social safety net by the social security sub-system means that resources are used to help those private agents who suffer from natural and social hazards, which means in turn that a *de facto* redistribution of resources from those who are favoured to those who are dis-favoured is introduced and enforced. How can such a redistribution of resources be justified in the first place?

Although there exists a devoted libertarian such as Robert Nozick (1974, p. ix) who goes as far as to claim that “the state may not use its coercive apparatus for the purpose of getting some citizens to aid others,” the *raison d'être* of the provision of a social safety net seems to be deeply rooted in the procedural justice considerations, according to which no one should be advantaged or disadvantaged by natural fortune or social circumstances in the choice of principles of the welfare state. In the primordial stage of rule selection where no one knows who are going to be favoured and who are going to be disfavoured by natural fortune and social circumstances, it is reasonable to surmise that the provision of a social safety net will be unanimously agreed on, particularly in view of the seriousness of damages caused by natural and social hazards.

After the veil of ignorance is lifted, it is true that those who are favoured by nature and/or society would have to pay substantial portion of the cost of a social safety net without actually getting any specific benefit therefrom, but this feature is not unique to this type of public goods. The best life of a person is one in which he/she has no opportunity whatsoever to ask for police protection and/or legal salvation, yet he/she would feel better off if it is known that law and order are firmly established and well maintained in the society, and would be

willing to contribute to the provision of these public services. After all, the benefit of the public goods lies not in their use value, but in the fact of their existence.

Two major problems to be faced by those who are in charge of the social security sub-system are: *welfare fraud* and *welfare stigma*. On the one hand, if private agents act in full awareness of the existence of a social safety net which will compensate for natural fortune and social circumstances, their actions may change through the change of their incentive system so much so that some agents may choose to give up their effort to try out their own life chance in the main competitive system and settle with living on undue social security benefit. On the other hand, the procedure for receiving social security benefit may be found so disgraceful and humiliating that some private agents may choose not to ask for their due social security benefit for fear of losing self-respect, which is an important component of their functioning vectors. These are serious and real problems to be faced by those who are in charge of the design and implementation of a social safety net.

We do not pretend that we have a magical answer to these perennial problems. The best we can do is to narrow down the range of possible options by using two conceptual dichotomies: *guarantee of opportunities* versus *guarantee of consequences*, on the one hand, and *guarantee of minimum basic capability* versus *guarantee of previous living standard*, on the other. If the social security sub-system is such that those who are disfavoured by natural fortune and/or social circumstances are entitled to the *consequence* in which their previous living standard, or the expected living standard without natural handicap, is guaranteed, the system comes dangerously close to motivating people to ride on the social security benefit, thereby depriving them of an opportunity to try out their second life chance under the auspices of the welfare state. If, in contrast, the social security sub-system is such that those who are disfavoured by nature and/or society are warranted of a nominal opportunity to seek for the minimum subsistence level subject to meticulous and unfriendly tests, the system does not seem to contribute much to the enhancement of human well-being in the welfare state where people should be entitled to aspire for a life which is worthwhile to live with self-respect. What we need is the social security sub-system in which all willing private agents are assured of as many life chances as they wish to try out without sacrificing their self-respect in exchange. In other words, the social security sub-system should provide the social safety net which is capable of guaranteeing the minimum basic capability to all private agents, where the basic capability should be a set of relevant functioning vectors whose components include the achievement of life which is worthwhile to live with self-respect.

It should be clear that the social safety net to be provided by the social security sub-system, as we envisage it, is intended to be consistent with the main

system of competitive mechanism. Indeed, the intended role of the social safety net is to provide private agents a fair opportunity to try out their life chance by participating in the main system of competitive mechanism even if they are disfavoured by natural fortune at birth, and/or social circumstances at some stage of their subsequent life. In so doing, it is meant to support private agents to achieve a life which they themselves think worthwhile to live with self-respect.

7. Concluding Remarks

Let us take stock and summarize the main points of this paper.

- 1) From the methodological viewpoint, we have suggested that the fully-fledged analysis of welfare state policies should be such that the descriptions of consequences are expanded from those in terms of “income, wealth, and welfare” as in the traditional framework of welfare economics to those in terms of “functionings, capabilities, and well-beings” à la Amartya Sen. We have also suggested that the informational basis of well-being analysis should go beyond the descriptions of consequences so as to include the descriptions of procedures through which these consequences are brought about. These conceptual expansions are motivated by recent developments in welfare economics and social choice theory.
- 2) Concerning the concept of welfare state, we have proposed that it should be visualized as a compound system consisting of the *main system of competitive mechanism*, the *competition policy sub-system*, the *coordination policy sub-system*, and the *social security sub-system*. The respective role of these systems, which are strictly complementary with each other, are: (i) private agents should be empowered to pursue their life chance autonomously within the main competitive system as much as possible; (ii) the competition policy sub-system should design the fair game of competition and ensure that players will compete in full accordance with the duty of fair play; (iii) the coordination policy sub-system should design and manage the collaborative mechanism of information exchange and coordination, which can cope with coordination failures that impose the limit on the working of main competitive system; and (iv) the social security sub-system should provide a social safety net which will enable private agents to participate in the main competitive system and try out their life chance even when they are disfavoured by nature and/or by society.
- 3) The basic principles underlying our perception of the welfare state can be summarized as follows: (i) the welfare state should confer her citizens the right of autonomous pursuit of their life chance on their own initiative and

at their own risk as much as possible; (ii) the welfare state should guarantee her citizens their freedom of participation in the process through which their life chance is circumscribed; and (iii) the welfare state should guarantee her citizens the minimum basic capability which enables them to pursue their life chance with self-respect even under adversarial circumstances.

Needless to say, this paper is only the first rough description of the ethics and welfare economics of the welfare state. Let us conclude with a short list of future agenda which we are keenly aware of. To begin with, we did not specify the complete list of relevant functionings to be used in the further study of welfare state policies along the line we have suggested. This can be a seriously controversial issue, and it is not at all clear whether we may define the space of functioning vectors on the basis of wide consensus in a contemporary society. Secondly, even after we somehow succeed in defining the relevant space of functioning vectors at the conceptual level, we must face the further problem of quantitative measurements of these functioning vectors. The fact that these measures must have interpersonal commensurability may make this problem even harder to deal with. Thirdly, we must somehow cope with the possibility that many relevant functionings may be strongly interdependent. Finally, we should make the crucial expression, *responsibility*, much clearer. When we say that a private agent should be or should not be held responsible for X, what precisely do we mean? This is a deep and controversial issue indeed, which has been the focus not only of Aristotle's *Nicomachean Ethics*, but also of some recent studies led by Arneson (1989), Dworkin (Summer 1981; Fall 1981; 1987) and Fleurbaey (1994; 1995). It certainly deserves further careful scrutiny in our concrete context of the welfare state policies.

Although these remaining problems are formidable, the modest purpose of this paper would be served if it could call the reader's attention to the necessity and urgency of reconsidering the concept of welfare state as well as the content of welfare state policies.

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