

Chapter 2

The Grand Challenges of Social Welfare

2.1 Rise of Welfare States

“Welfare state” is conceptualized as a state committed to modifying the play of social or market forces in order to achieve greater equality (Ruggie 1988, p. 11). Lindbeck (1988) defined a welfare state as having different types of public programs subsidized by public finance. Government can create social assistance programs and insurance to help those in need, and a majority of these programs provide healthcare-related services, childcare, education, social security, and services for elderly. The expansion of welfare programs mainly took place during the 1960s and 1970s in almost all industrialized countries (Cox 1998), but welfare programs still tend to be small in number and scope in many developing countries.

The development of the social welfare state has been examined through three main scholarly lenses: modernization theory, polity or state-centered theory, and power resource theory. Modernization theory focuses on development since it increases welfare state provisions (Wilensky 1975, 2002). Polity or state-centered theory focuses on the importance and role of the state (Orloff 1993; Skocpol 1992). Lastly, power resource theory focuses on the class structure in a society, and competition over access to available resources (Esping-Anderson 1990; Huber and Stephens 2001). Regardless of the lens, a primary purpose of the welfare states was to create social safety nets or protection for the members of the society by focusing to meet the basic need of the members of society. However, critics of the welfare state argue that the welfare state undermines family and community responsibility and also interferes with the market.

Following the path of developed countries, many developing and emerging economies have adopted welfare policies, but the effectiveness of the state as a service provider has increasingly come under scrutiny. Rodger (2000) suggests that in recent history, many developed countries have been moving from welfare state

toward *welfare society*. The difference between these is the role of government: Government plays a major role in a welfare state, while the private sector is involved in a welfare society. Notwithstanding who is providing the services, the goal of a welfare system is to provide social protection and help to reduce inequality in the society. However, spending in the social protection programs varies across countries as reported by the ILO (2014). Western European countries spend 2.2% of GDP on the child and family benefits whereas African countries spend about 0.2% of GDP and Asian countries spend 1.5% of GDP. When government spends in the education sector, members of the society who have limited access to education tend to benefit from this service. For instance, Davoodi et al. (2003) found that in the sub-Saharan African countries 12.8% to the primary education spending went to the lowest quantile of the population. Yet, the result was reversed for the secondary and tertiary levels. According to the study, only 7.4% and 5.2% of the spending for the secondary and tertiary levels, respectively, went to the lowest quantile of the population, contrary to 38.7% and 54.4% that went to the richest quintile. Recently the World Bank (2012) has recognized that the positive spillover effect of the social protection can help to create human capital in the society. If an individual is not constantly concerned about the basic need of the family, then they can exert their effort in the productive activity of the society. A study conducted by Higgins and Pereira (2014) explored the impact of government distribution on income inequality. The study included the United States and Brazil and determined that government spending in the health and education reduced income inequality in both countries. However, the study suggests that the result should be taken with a caveat because members of the middle and upper income group moved away from the public education and health services toward private services.

2.2 The Relationship Between Economic Development and Income Inequality

Economic inequality issue has become a central argument among both critics and proponents of globalization, and has become a mainstream topic in local and national political arenas around the world. In countries like the United Kingdom and the United States and across Europe, income inequality has been blamed on globalization, and is linked to economic nationalism and even populist movements in several countries. In developing countries, the problem of inequality has a long history but has taken a new face with globalization.

The relationship between income inequality and economic development has been debated for decades. Kuznets (1959) showed that a U-shaped relationship exists between economic development and income inequality, suggesting that at initial stages of development, income inequality can be good. Recent theoretical and empirical studies suggest that inequality deters economic development. Despite continued debate on the relationship between income inequality and economic

development, researchers have also examined reasons underlying continued inequality, and have found that political environment, resource endowment, and institutions all play a role in generating income inequality in a society.

2.3 Some Additional Causes Underlying Inequality

The debate between the relationship between income inequality and development is still not settled. At the same time, researchers have been trying to determine how other social structures and political institutions can influence the income inequality level in society. For instance, democratic political institutions are more likely to reduce inequality than authoritarian conditions or an oligarchic society (Zacher and Matthew 1995). Along with economic development, other macroeconomic factors such as inflation, education policies, and infrastructure can help reduce inequality in a society (Lopez 2004).

In recent years, researchers have sharpened their focus on the role of the financial sector. Globalization has placed greater on financial sector development as well as financial liberalization, and change has been significant especially in the many developing countries coming from central planning or protectionist economic traditions. Financial development may enable the poor to borrow for productive projects, which may in turn help reduce income inequality (Galor and Moav 2004). Improved access to financial resources would also allow people to make an investment in formal education or technical training which are necessary for reducing income inequality (Law et al. 2014). However, poor institutions and information asymmetry in developing countries can put the poor at a disadvantage. For example, the poor and particularly the unbanked poor face barriers acquiring collateral and credit histories, which are both required to borrow from formal financial institutions. For this reason, although financial liberalization creates institutional structures which in principle are available to everybody, it is more likely to benefit well-off individuals because it is more difficult for the poor to participate.

In many developing countries, economic wealth and political influence are concentrated, often in the hands of a small proportion of the population or even a small number of families in a country. This type of entrenchment can further prevent the poor from accessing opportunities related to globalization because they lack not only the financial or other resources (e.g., lending history) to participate in financial institutions, but also access to political know-how, connections, and information. A study by Rajan and Zingales (2003) demonstrates that political influence is a major determinant of access to finance in a weak institutional environment, where the poor have greater barriers to access. Scholars have also examined how access to opportunity (or lack thereof) (Roemer 1993; Dworkin 1981; Arneson 1989, 1990) and “access to advantage” (Cohen 1989) contribute to the inequality. An important area of focus has been the healthcare sector. In many of the developing countries, individuals who are well off in the society tend to receive a higher quality of health care. Government spending also tends to be higher in this area. Anselmi et al.’s (2015) study examined

health sector expenditure in the low- and middle-income countries. The study concluded that healthsector spending tends to favor the rich. However, the study distinguished between the primary care expenditure, hospital care, outpatient care, and inpatient care. O'Donnell et al.'s (2007) study included developing countries in Asia and concluded that individuals with higher income received more healthcare spending than the individuals in the low-income level. In countries like Bangladesh, India, and Indonesia, 30% of the healthcare spending went to richest quintile.

2.3.1 Land Tenure and Asset Holding

In developing countries, the land is a major asset and represents a vehicle for investment, accumulation of wealth, intergenerational wealth transfer, and of course income. In fact, anywhere around 70–80% of the rural population in developing countries have agriculture as a major source of income, so growth in the agricultural sector can help reduce inequality in these countries (Johnston and Kilby 1975; Coxhead et al. 1991; Datt and Ravallion 1998a, b). However, the history of the land tenure system in many developing countries also reflects unequal distribution that originated or worsened with colonialism (Banerjee and Iyer 2005). This unequal distribution continues in some developing countries. Deininger and Squire (1998) show that high asset inequality, including land distribution as a proxy for the asset, has a significant negative impact on growth. On the other hand, Birdsall and Londono (1997) treated initial asset inequality as a control variable and did not find a significant impact on growth. While the impact of the asset inequality on economic growth is mixed, its role combined with the availability of a safety net can play an important role in entrepreneurship.

2.3.2 Wage Gap by Gender

Over the past decades, international organizations and governments in different countries have promoted and implemented policies to encourage women in the labor market and in political arenas (Krook 2009). However, labor market participation remains at the level of 40–50% in some countries (World Economic Forum 2016). In many developing countries, women have limited access to the formal labor market, particularly compared to women in developed countries. On average, around the world, 54% of women participate in the formal workforce while 81% of men participate. In agrarian focused countries, women work in family firms or nonfamily firms at a lower wage (Singh et al. 1986). In the Middle East and North African (MENA) countries, the female participation in the labor force is even lower than the global average, at around 25% (Herzberg and Sisombat 2016). According to the recent Global Gender Gap Report (World Economic Forum 2016), women generally make up a larger portion of the labor force that is discouraged to seek jobs in the

male-dominated industries. Women tend to have a higher rate of unemployment compared to men. The World Bank estimates that if women were able to participate in countries where there is discrimination in at least some sectors or occupations, labor productivity would increase by approximately 25% (World Bank 2012).

The existence of a wage gap between men and women in the labor force is almost universal but more pronounced in some countries than others. The most recent global figures show that men on average earn approximately more than 7000 dollars over women (World Economic Forum 2016). Another study by the International Labor Organization (ILO), which included 83 countries, found that women earn around 10–30% less than men (Herzberg and Sisombat 2016). Additionally, women are more likely to work part-time and more likely than men to contribute to the family enterprise (World Economic Forum 2016).

The sociocultural environment also contributes to the wage gap in the society. In many societies, some jobs are traditionally associated with women and do not promise any long-term growth opportunity (Newman 2001; Kusago 2000; Katz 1995; Standing 1999). This lack of opportunity leads to a lack of experience over time, which can mean that a woman is employable at a low- rather than high-paying job. It also means that she may not be able to access opportunities, e.g., for education or skill acquisition, which could qualify her for employment in other sectors with better long-term growth opportunities. This is especially salient as the pace of globalization picks up speed in many developing countries, and growth opportunities expand significantly in some industries (like those which export, or those which are embedded in global value chains) but not others. Artecona and Cunningham (2001) concluded that a significant wage gap exists between industries participating in the international trade and industries that do not.

2.4 The Relationship Between Entrepreneurship and Welfare States

Motivation is a major driving force behind engaging in entrepreneurial activity. The motivation can grow out of necessity or recognition of an opportunity. Regardless of the motivation, income inequality can be a deterministic factor since it dictates access to necessary resources for the entrepreneurial activity, and welfare sources can mitigate some of the constraints posed by the income inequality.

The existing literature shows mixed results related to welfare, entrepreneurship, and economic activity. The intended goal of welfare programs has been to serve as a social safety net, which can in theory free people to invest their capital (and even take risks like starting a business) with the security that they would not need to pay for basic needs like education and health care, as they would be publicly provided. This did not pan out as originally intended in many places. For example, Henrekson (2005) examined Sweden—a country with expansive welfare programs—and found no positive relationship between welfare programs and entrepreneurship. Agell (1996) argues that public programs can actually reduce motivation for savings. Personal

savings are necessary for overall economic growth, as well as for entrepreneurial activity because savings are a venue for financial capital of entrepreneurs. Less personal savings also translates to less wealth accumulation in the long term. Several studies suggest that personal wealth has an important effect on the decision to engage in entrepreneurial activity (Blanchflower and Oswald 1998; Taylor 2001), and a positive relationship between wealth and entrepreneurship has been found in both Sweden (Lindh and Ohlsson 1996) and the United States (Holtz-Eakin et al. 1994).

In many developing countries, women have less access to education than male (Verheul et al. 2006). Even in developed countries, women often face more economic hardships than men (McLanahan et al. 1989). For instance, Mitchell (1993) found that women and/or families headed by women have the highest poverty level in the United States, followed by Canada and Australia. Proponents of welfare states argue that income transfer programs help to ameliorate or lessen the poverty burden (Garfinkel and McLanahan 1986; Piven 1985). Governments who provide better welfare services, like childcare subsidies, may encourage more female entrepreneurial activity. These services can be beneficial especially for female entrepreneurs, because it not only enables labor force participation, but can also enable investment in future participation, e.g., education (Oyitso and Olomukoro 2012), and empower them by giving them access to different realms of society such as social, political, and economic activities (Duflo 2012). Female empowerment benefits not only them but also immediate family and local community. For example, studies such as Kabeer (2005) and LeVine et al. (2001) concluded that education helps with improved cognitive skills, raised aspirations, and increased access to information. Educated women also tend to reduce violence against women in the society (Mocan and Cannonier 2012; Kabeer 2005; Sen 1999).

Historic evidence suggests that when women became increasingly involved in paid economic activity, welfare societies saw growth in demand for some welfare services, like childcare (Huber and Stephens 2000; Orloff 1993). This can put pressure on welfare state development. While welfare programs could help meet basic needs, they could also reduce incentives to generate income through entrepreneurship (Parker 2004; Henrekson 2005; Koellinger and Minniti 2009). For example, individuals who might be forced to become entrepreneurs, because they lack other opportunities in the wage labor market, might be able to receive similar returns from welfare programs and the intended business venture. This is an important consideration, especially in low-paying sectors. This is discussed more in the next section.

2.5 Social Protections and Challenges for the Government

The government can provide private goods such as education and healthcare services, which are important resources for both male and female entrepreneurs. A combination of these services with increased entrepreneurship activity can help to reduce income inequality. Verbist et al. (2012) examined a large sample of countries and found that government transfers related to education, health, housing, early

childhood education, childcare services, and long-term elderly care services help to reduce income inequality by 5.7 percentage points. Yet, in order to provide these services, the government needs sources of revenue that can pose a challenge for the government. Tax is an indicator of “states capacity, power, and political settlements” (Di John 2006, p. 1). Compared to developed countries, developing countries tend to have less revenue and less capacity in the tax and revenue collection system to effectively regulate and enforce tax policy.

In addition, developing countries have limited tax bases compared to developed countries, which can result from several related problems, such as low formal sector participation, poor filing and reporting compliance and enforcement, complicated tax policy, arbitrary tax collection procedures, and/or low tax morale. The composition of sources of tax revenue varies across countries. For instance, property tax revenues are low in many regions across the world such as the Middle East and North Africa (MENA), sub-Saharan Africa, and Asia, and the Pacific, and income taxes are a major source of tax revenue in developed countries (Bastagli 2015). Property taxes in many developing countries may be low because of ineffective statutory land titling systems and their enforcement, which bestow formal property rights and ownership to individuals, coupled with many of the problems already mentioned. Table 2.1 shows the average-level tax revenue in countries with different stages of development between 2001 and 2014. The average level of tax revenue in low-income countries was 10.33% of GDP during the period 2001–2005. In contrast, developed countries saw 18.80% tax revenues during the same period. Lower middle-income and upper middle-income countries had revenues between 13.90 and 17.44% in the same period. Between 2011 and 2014, low-income countries exceeded the revenues of lower middle-income countries by about 2 percentage points of GDP.

Welfare states also have their virtues and vices. They can play the role of “invisible hand” by restricting involvement in allocative decisions and can be a “helping hand” by promoting private economic activities. More welfare and public services mean a larger government sector, which can have two implications. First, as the size of government increases, it may be able to overtake decision-making power. By internalizing this power to the public sector and creating regulations to provide ser-

Table 2.1 Levels of tax revenue 2001–2014 (average in percent of GDP)

	2001–2005	2006–2010	2011–2014
High income	18.80	19.01	18.73
Low income	10.33	11.40	14.44
Lower middle income	13.90	14.72	12.78
Upper middle income	17.44	19.52	18.64

Sources: International Monetary Fund, Government Finance Statistics Yearbook and data files, and World Bank and OECD GDP estimate. Income categories were based on World Bank 2015 classification—low-income countries have \$1045 or less GNI per capita, lower middle-income countries have GNI per capita between \$4036 and \$1026; upper middle-income countries have GNI per capita between \$4036 and \$12,475; and high-income countries have GNI per capita of \$12,476 or more

vices which were originally provided by the private sector, red tape can increase. Aidis et al. (2012) established that government size has a negative impact on entrepreneurship. Second, a larger government sector relies on a substantial tax base and has been associated with higher taxes overall. If taxes are very high, it could reduce entrepreneurial activity (Parker 2004) because individuals might have to give up more profits. Some conditions are especially relevant. This could discourage entrepreneurial activity especially in low-paying sectors or where industries are characterized by smaller profit margins if returns to the activity are close to returns from welfare programs. Also, high taxes could raise opportunity costs related to opportunity entrepreneurship by placing greater pressure on entrepreneurs to generate larger revenues quickly. In addition, both higher taxes and a larger government (if more bureaucratic) could reduce incentives for an entrepreneur to formally register a business (Estrin et al. 2013) because of higher taxes and higher compliance costs associated with bigger government (e.g., more product market regulation). Darin et al. (2011) examined tax rates and formal entry and entrepreneurial activity in 17 European countries between 1997 and 2004 and found a significant negative effect of taxation. Table 2.2 presents a summary of recent empirical studies related to the tax rate and entrepreneurship. Taxes tend to hurt small businesses more than larger businesses (Cullen and Gordon 2002) because most entrepreneurs start out small, and size itself could be a disadvantage. For example, Crane (2005) found that the

Table 2.2 Summary of recent empirical studies related to tax policies

Author	Effective tax policies on entrepreneurship
Belitski et al. (2016)	–
Balioune-Lutz and Garelo (2014)	–
Da Rin et al. (2011)	–
Djankov et al. (2010)	–
Wennekers et al. (2005)	–
Van Stel et al. (2004)	–
Parker and Robson (2004)	+
Gurley-Calvez and Bruce (2013)	+, – (MTR ^a for wage, MTR for entrepreneurs)
Bruce and Deskins (2012)	+
Stenkula (2012)	–
Hansson (2012)	–, – (MTR ^a , ATR ^a)
Bruce and Mohsin (2006)	–
Georgellis and Wall (2006)	–, + (U-shaped)
Stabile (2004)	–, +
Bruce (2000)	+, – (MTR, ATR)
Carroll et al. (2001)	–
Gentry and Hubbard (2000)	–, +(MTR, ATR)
Schuetze (2000)	+

^aMTR denotes marginal tax rate, ATR denotes average tax rate

cost of tax compliance for firms with less than 20 employees was estimated at \$1304 per employee but \$708 per employee for large firms.

Tax administration is a problem for many developing countries. In many, tax morale—defined as an individual’s motivation to pay taxes—tends to be low (OECD 2014). Extensive regulations related to tax administration can raise the burden of compliance costs for entrepreneurs (Alon and Hageman 2013). Bacher and Brühlhart (2010) found that more complicated tax systems reduce the rate of firm births. The effects of a burdensome tax policy and compliance could encourage entrepreneurs to decide not to start a business or to operate informally in order to avoid or evade taxes. Informal operations can be attractive especially for entrepreneurs “pushed” by necessity, more so than those who exploited an opportunity (van Stel et al. 2007).

The informal sector itself presents another challenge for tax authorities. Given the hidden nature of this manner of economic activity, it is difficult for tax authorities to effectively locate, assess, and tax actual revenues generated from the activity. Some countries have tried to expand coverage of the tax base by incorporating personal taxes in the taxation system, but this has been met with resistance from the employers (Fjeldstad and Heggstad 2011). In many instances, informal employers have been unwilling to register employees in order to remit personal income taxes.

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