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# Health Insurance before the Welfare State

## *The Destruction of Self-Help by State Intervention*

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PAVEL CHALUPNÍČEK AND LUKÁŠ DVORÁK

Social scientists, especially sociologists and economists, are paying increasing attention to the concept of social capital. The expansion of its use has been so rapid that it has led some to warn against its misuse and against overstatement of its importance (see, for example, Portes 1998, 21). Bearing these caveats in mind, we show in this article how the concept of social capital can help us to understand some adverse effects of government social policy.

Since the publication of Charles Murray's *Losing Ground* (1984), if not earlier, it has been clear that Western-style welfare states are encountering deepening problems and that despite social scientists and politicians' efforts and an increasing amount of resources, these states' traditional measures are failing to achieve their main goals. Harvard sociologist Nathan Glazer, one of those who helped to formulate these welfare policies, summarizes the difficulties in his 1988 book *The Limits of Social Policy*. Sentences such as "It didn't work" and "[W]e seemed to be creating as many problems as we were solving" (2) are a leitmotiv of his account.

Today, analysts generally agree that the structure of incentives is crucial for the

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success of any such effort. To illustrate this point, we provide here a social-capital-based explanation of the origins and development of voluntary “social insurance,” focusing on health (or “sick”) insurance. We build on ideas presented in studies by Peter Leeson (2005, 2007) and by Anthony Carilli, Christopher Coyne, and Peter Leeson (forthcoming). We first describe the theory of government interventionism that provides a conceptual framework for the rest of the article. We then analyze historical cases of voluntary provision of social insurance by friendly and fraternal societies around the turn of the twentieth century.

## Social Capital

Early uses of the term *social capital* can be ascribed to sociologists. Among them, Pierre Bourdieu is usually credited with the idea’s elaboration that led to its widespread use. In 1986, he described social capital as “an attribute of an individual in a social context. One can acquire social capital through purposeful actions and can transform social capital into conventional economic gains. The ability to do so, however, depends on the nature of the social obligations, connections, and networks available to you” (qtd. in Sobel 2002, 139). Although Bourdieu’s description explicitly ties social capital to an individual (and thus makes it an individual asset), the parallel emphasis on the social context has created much confusion.<sup>1</sup> In this article, we treat social capital as an individual asset, building on James Coleman’s (1988, 1990) contribution.<sup>2</sup>

Employing an interesting analogy, Coleman writes about people who are investing in their social capital as exchanging “credit slips”—that is, confirmations of their mutual obligations (1990, 306). The investor (person A, who did something for person B) holds the credit slip “to be redeemed by some performance” (306) by person B later, and all such slips together constitute A’s accumulated stock of social capital. Coleman also employs an analogy between these “credit slips” and “fiduciary money” (186), both of them having in common the need for trust between the trading parties inasmuch as they are not backed by any “real” values.

Leeson (2005, 2007) and Carilli, Coyne, and Leeson (forthcoming) take a similar approach. Building on a traditional Austrian approach to the business cycle (Hayek 1931, 1941; Mises 1996, esp. chap. 20), they argue that government creates

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1. One group of authors, perhaps the most prominent among them being Robert Putnam (1993, 2000), stresses the “embeddedness” of social capital, which for them means “features of social organizations, such as networks, norms, and trust, that facilitate action and cooperation for mutual benefit” (Portes 1998, 18). See Portes 1998 for a critique.

2. We are aware that some economists are reluctant to accept the term *social capital* (see widely quoted articles by K. J. Arrow and R. M. Solow in Dasgupta and Stiglitz 1999). However, we believe their critique rests on an exaggerated adherence to neoclassical concepts of physical capital. Once the strict assumptions of this approach are relaxed (for example, by taking into account the subjective value of one’s actions—or, in Ludwig von Mises’s terms, the actor’s “psychic profits and costs”—a substantial part of the criticism disappears. For more, see Chalupníček 2008.

“artificial” trust or distrust, thus generating fluctuations in social-capital accumulation similar to the changes in investment that result from altering the market interest rate. In both cases, government interference scrambles market information signals. People, the “social capitalists,” then have difficulty distinguishing between trustworthy individuals with reliable ways of interacting and untrustworthy individuals with unreliable ways. If the government creates a false expectation of greater trust (for example, by declaring its backing of one of the parties), it can cause the second party to invest too much in this relation (and thus create “overinvestment”).<sup>3</sup> In the opposite case, it can create distrust, causing people to invest too little and making them lose potential benefits from unconsummated transactions. By generating such fluctuations, the government can “add” or “remove” trust from various private activities or individuals, or it can interfere with them by its own activity and crowd them out. In financial markets, the government in most cases obtains more favorable loan conditions than any other potential borrower. The most common explanation attributes this advantage to the government’s power to tax.<sup>4</sup> As a result, it crowds out private investments that cannot compete. Similarly, some studies of crowding-out in the area of private philanthropy explain it with reference to private charities’ reduced effort to raise funds from individuals after they receive a government grant (see, for example, Andreoni and Payne 2003).

Another theoretical explanation pertains to social capital. We might argue that private provision of “public goods” involves serious free-rider problems. In the absence of government, communities usually find a workable and efficient way to provide these services (see Beito, Gordon, and Tabarrok 2002 for an overview). To eliminate free riders, they set up a complex net of self-enforcing rules—that is, rules that do not require external (governmental) enforcement (Telser 1980). In game-theoretic jargon, these rules help to overcome prisoner’s dilemma problems connected with the provision of public goods (Ostrom 2000).

Observable holdings of social capital—for example, one’s engagement in social networks—have an important signaling potential and help to prevent free riding *ex ante*. According to Leeson, to eliminate possible problems of cooperation, each party can screen the other for signals that indicate its credibility. “Successful screening does, however, require two things: easily observable attributes or activities—signals . . . , and signals with an appropriate cost structures . . . that are cheap for cooperative types to send but expensive for cheaters to send” (2005, 79). The “cost structure” of signals based on social capital is obvious because the creation of such capital is connected with certain costs and because it is lost in the case of cheating (which serves also as an *ex*

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3. Even if general surveys (using questions such as “Do you trust your government?”) show in many countries relatively small trust in a particular government or a particular politician, people usually believe “in the system” as such and behave accordingly (for example, they invest in government bonds in spite of lower yields).

4. See Benjamin Friedman’s (1978) extensive discussion of the crowding-out and crowding-in effects of government deficit financing.

post punishment for the cheating party), thus constituting “selective incentives” (Olson 1965).

After the government steps in, these systems of self-enforcing rules break down in many cases, and the voluntary provision of public goods collapses. Such a breakdown may happen because of interference with information signals through the creation of artificial homogeneity; for example, when membership in a social network is compulsory, the membership’s information signal ceases to convey any information about the members’ credibility. After such intervention, the society becomes “fractionalized” (Leeson 2005, 87): ties between individuals in the particular social network are lost or weakened as the trust based on the information signaled by membership deteriorates.

Thus, government action is in many cases self-fulfilling: expected failures of private systems lead to interventions that cause their real failures (Ikeda 1997). Nathan Glazer complains, for example, about government social policy’s effect on personal social ties: “In our efforts to deal with the breakdown of these traditional structures [which he earlier describes as being ‘located in the family primarily, but also in the ethnic group, the neighborhood, the church’], our social policies were weakening them further and making matters in some important respects worse. . . . Our efforts to deal with distress are themselves increasing distress” (1988, 3).

## Friendly and Fraternal Societies

We turn now to an analysis of the institutional setting and functioning of *friendly* or *fraternal societies*—voluntary organizations that provided diverse kinds of “social insurance”—with emphasis on health insurance. We rely on four main sources about these societies: J. M. Baernreither (1889), P. H. Gosden (1961), and Simon Cordery (2003) with regard to English friendly societies; and David Beito (2000) with regard to U.S. fraternal societies.

The first friendly societies evolved from other kinds of mutual associations, such as medieval guilds, and the first fraternal societies in their modern form appeared in England at the end of seventeenth century (Gosden 1961, 2; Cordery 2003, 13).<sup>5</sup> The nineteenth century was the golden age of friendly societies in England. At that time, friendly societies were officially defined as “institutions ‘whose object is to enable the industrious classes, by means of a surplus of their earnings, to provide themselves a maintenance during sickness, infirmity and old age’” (Gosden 1961, 15). The term *friendly societies* covers a wide array of associations that used various insurance methods. The oldest and simplest were “dividing societies,” in which members contributed to a common fund that after a time was divided among the members who survived (Baernreither 1889, 172). Some friendly societies accepted only members of

5. See also Gosden 1973, chaps. 1 and 2, on the early history of the friendly societies.

a particular trade (“particular trade societies”) or living in a specified area (“local town societies”); some were established and endowed by local gentry or clergy (“patronized societies”). Others specialized in the provision of burial insurance (“burial societies”) or experimented with “individual accounts” for their members (“deposit friendly societies”). The friendly societies’ variety and flexibility led Baernreither to the conclusion that “[a]ny one can make provision in the friendly societies for himself or his family, in the manner that suits himself best” (1889, 428).

The number of members of each local country society was usually small, reaching tens or at most hundreds of individuals (Gosden 1961, 18). In the usual cases, only the men of certain occupations were admitted, but in some cases the insurance covered their families as well. The societies provided their members with insurance against disability to work (Baernreither 1889, 164). The membership included for the most part lower-middle-class workers and skilled artisans, who paid regular levies, and “for most wage-earning men there existed at least one society to which they could, if they so chose, attach themselves” (Cordery 2003, 70). The members themselves managed the societies; those in charge were selected by rotation or, later, by voting. Until the 1820s, “virtually all friendly societies were local in their organisation” (Gosden 1961, 17), which caused large local differences and, more important, made friendly societies vulnerable to adverse conditions and actuarial risks. As a result, many local societies failed because of “too much benefit for too little contribution” (Gosden 1961, 95).

In such circumstances, it is not surprising that a tendency toward centralization prevailed. This tendency gave rise to the emergence of “affiliated orders,” two of the most important being the Independent Order of Oddfellows–Manchester Unity (established in 1822) and the Ancient Order of Foresters (established in 1745, reorganized in 1834). The orders were characterized by four features (Beito 2000, 1): an autonomous system of lodges, a democratic form of internal government, a ritual, and the provision of mutual aid for members (and usually also for their families). Over time, as many local societies joined the orders, the societies’ membership skyrocketed.<sup>6</sup> The orders had a hierarchical structure: lodges, to a large extent independent; districts of lodges, serving as “an intermediate court of appeal, and as a supervising authority over the lodges” (Baernreither 1889, 379); and the central body or headquarters. With regard to insurance, the lodges “did not become mere branches of the central organisation, they maintained full control over their own sick funds and management expenses, but . . . a central funeral fund was established” (Gosden 1961, 27),<sup>7</sup> and in some cases lodges could even override the central body’s rules and

6. Baernreither provides these data based on official statistics: for Oddfellows, “[a]bout fifty years ago [i.e., around 1835] it numbered 781 lodges, with 47,638 members; at the end of 1886 there were 4,351 lodges, with 617,587 members.”; for Foresters, “[i]n 1845 it numbered 1,456 courts [a different term for a lodge], with 65,909 members; at the end of 1886 it had 5,007 courts, with 667,570 members” (1889, 218). These numbers include members in colonies.

7. In some cases, there were central funds to help individual lodges overburdened with claims for sick



decisions (Beito 2000, 60). Besides the actuarial importance of a greater pool of members, other advantages included more skilled management, more transparent rules, and, perhaps most important, the possibility of transferring benefits to a different part of the country or even to the colonies if the worker moved (Gosden 1961, 78). It was mainly the affiliated orders that spread, through their branches, the idea of fraternalism to the United States, where it reached its apex in the 1920s, when roughly every third adult American male belonged to a fraternal society (Beito 2000, 2).

The idea of insurance itself did not always appeal to an average English workman of the early nineteenth century. The members “[c]ertainly . . . sought insurance against particular contingencies, but they were seeking much more than this, they were seeking those social and convivial activities which membership was expected to afford” (Gosden 1961, 20). This conviviality took various forms in local village societies, among the most common being regular meetings (usually monthly with compulsory attendance), annual or biannual feasts, or Club Days and processions; later, the affiliated orders also had complex rituals, many of them kept secret.<sup>8</sup> The main aims of these activities were to create a feeling of unity or belonging, to help members to get to know other members, and to get them to participate in the society’s management. Collection of contributions was also a part of the meetings. The conviviality was the societies’ most important generator of social capital.

The use of alcohol at the societies’ meetings illustrates the importance of conviviality to the societies (claims of excessive drinking were among the main charges leveled against friendly societies by their opponents). Many local village societies were formed “around ale houses” (Gosden 1961, 18), and they used inns or public houses as their meeting hall, usually because there was no other suitable place where they could meet regularly (Cordery 2003, 25). Many societies paid “the rent of the room by buying a pre-arranged quantity of ‘loge liquor’” (Gosden 1961, 11). For the money paid, not only did they receive the room and the liquor, but they also made their meetings more attractive to ordinary villagers and fostered the creation of greater amounts of social capital.<sup>9</sup> Simple monetary rent payment would not have produced these benefits. Gosden notes “plenty of cases . . . where clubs spent so heavily on drink that they collapsed, [but] attempts to restrict the merrymaking could apparently have much the same effect” (1973, 24). When left alone, the societies gradually discovered the right amount of merrymaking to keep both their members and their funds.

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benefits, but their usage was rare and limited to prevent moral hazard on the part of lodges (Baernreither 1889, 282).

8. An order’s secrecy and frequent changes of passwords also helped to prevent deterioration of social capital among members, who had to be in contact with each other to keep their information channels open.

9. Alcohol, in certain amounts, can serve as a “catalyst” of social interaction. On the direct monetary effects of convivial drinking, see Peters and Stringham 2006. On the disruptive effect of alcohol prohibition on small-town life in the United States in the 1920s, see Murphy 1997, chap. 2.

All providers of insurance have to cope with two major problems, *moral hazard* and *adverse selection* (Hemming 1984). The first term describes changes in the insured individual's conduct owing to changes in his motivation (being insured, he will not bear the full costs of his actions), resulting in higher-risk exposure than occurs without insurance. The second term refers to high-risk individuals' greater tendency to subscribe to insurance, which raises the price of insurance and eventually leads to the breakdown of the insurance market. Even if certain market tools can help to fix this "market failure" (Akerlof 1970), it is usually asserted that such tools cannot be used in social insurance (especially health insurance) because of the "peculiar character" of this market (Arrow 1963). Notwithstanding these theoretical objections, the societies' entrepreneurial spirit found a way.

With regard to moral hazard in sick insurance, the usual market solution is to make the insured individual bear at least a part of the damage. Then, even if one is insured, the costs of sickness are still great because the insurer does not pay the whole forgone wage.<sup>10</sup> In addition, the friendly societies eliminated moral hazard by appeal to "the common good" or "friendship." Because the members of a local society or lodge knew each other and circulated in the same social milieu, it was difficult for them to free ride on each other (and to deceive friends). Conviviality and rituals helped to boost this "sense of belonging" (Alborn 2001). Members receiving sick payments also had to observe a "certain mode of life" (Baernreither 1889, 290). Owing to a high degree of decentralization, the local societies or lodges could use local knowledge. All three authors we rely on for information also refer to "visiting committees" as the most powerful tool of supervision, consisting of members (usually selected by rotation, thus eliminating the principal-agent problem) who visited the sick. These visitors not only checked the appropriateness of sick payments, but also helped members during their sickness, thus creating further social capital. The societies also applied rules to prevent fraud and corruption (for example, requiring two officers to countersign benefit claims), and in some cases the ultimate penalty for a deceptive member was expulsion. By this action, the member lost not only all future benefits, but also the social capital he had accumulated with the society's members.<sup>11</sup>

The societies in some cases also employed their own doctors. Such "lodge practices" later became the main reason why the medical profession stood against the friendly societies. Lodge managers checked the necessity of sick benefits for particular members because they wanted to save money and prevent moral hazard, but they also wanted an effective treatment that would get members off the sick payments as soon as possible. Prevention of moral hazard was also the main reason why even in affiliated orders the individual lodges kept control of their sick insurance. Burial insurance,

10. According to an official report cited by Gosden (1961, 201), the societies paid their sick members on average about one-third of the amount they would have earned at work.

11. On the role of social capital in the prevention of fraud, see Lisa Bernstein's (1992) analysis of the diamond traders in New York City.



which does not suffer from the moral-hazard problem as sick insurance does, was centralized.

Similar creativity was applied to the problem of adverse selection. The insurance provided by the societies was never a purely actuarial business, but rather expressed a mixture of actuarial and “social” considerations. All societies formally refused applicants who were younger or older than a certain age, had serious or chronic health problems, or were employed in extremely risky occupations (especially mining and railway work). In practice, however, the situation was probably different. Because all members of the local village society or local lodge derived benefits from social capital, they were willing to accept members who were uninsurable under strictly actuarial requirements. Considerations of solidarity in a small community also played an important role.<sup>12</sup> We have some evidence about such practices from lodges of affiliated orders. For example, Baernreither notes that when accepting new members, many lodges considered age, “good character, and a medical certificate of health. On the latter point, however, many lodges are lax” (1889, 377).<sup>13</sup> Beito writes about a black fraternal hospital in which “it was rare for anyone to be disqualified for preexisting health conditions” (2000, 187).

The problem of age was in part solved after better actuarial data started to be available. Before the mid-nineteenth century, the societies had no tool for estimating how much they should charge an older person joining the society, and they solved the problem by imposing minimum and maximum age limits (usually eighteen and forty years) for applicants. After they gained access to more reliable data, they differentiated the premiums and allowed older or younger persons to join.

Of many high-risk occupations, only miners (and sometimes railway workers) met obstacles when joining a regular society.<sup>14</sup> A traditional view claims that miners were forced to remain uninsured and bear the immense risks of their occupation, but according to more current research, miners created their own societies in most cases.<sup>15</sup> The premiums they had to pay were higher than those in other societies,

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12. For example, at the Manchester Unity of Oddfellows, “no less than 15 to 20 per cent of the members do not claim their benefits” (Baernreither 1889, 255). Some lodges also created special funds to subsidize the premiums (or time in school or hospital) of members who were too poor to pay full amounts (Baernreither 1889, 67).

13. This practice cannot be explained by principal-agent problems between lodges and central bodies of affiliated orders because, as noted earlier, the individual lodges were responsible for their own sick funds.

14. See Gosden 1973, 59, on the relations between friendly societies and various minority groups.

15. John Benson provides data showing that during the second half of the nineteenth century, approximately 30 percent of English coal miners belonged to registered friendly societies, “but nearly every worker seems to have been a member of at least one local unregistered Friendly Society” (1978, 415). In many cases, the insurance for miners was paid for in part by the employer. Other sources of funds for these societies were contributions from their founders and honorary members (gentry, clergy, upper-middle-class citizens) and contributions from the public in case of mine catastrophes (Baernreither 1889, 407). Contrary to popular belief, the situation in Prussia was similar, where miners’ insurance associations served as a model for Bismarck’s system of compulsory insurance. According to available data, “over 80 per cent of . . . workpeople employed in the mines and salt works of the kingdom [of Prussia]” were members of miners’ funds before the establishment of Bismarck’s compulsory system (Dawson 1912, 5).

reflecting their higher risk of disability. Whether one views this situation as “unjust” or not, it is necessary to realize its implications. Because the miners’ risk premium was higher, their equilibrium market wage was higher relative to other occupations. The higher risk is then reflected in higher prices of coal. If the rest of the society is forced to bear the higher risk of miners through compulsory and equalized insurance, price distortions ensue (causing a higher-than-optimal quantity demanded for coal and for miners).

Even the poorer members of society could get insurance within the fraternal movement. Most friendly societies offered graduated premiums entitling subscribers to various levels of benefits. Other societies specialized in providing low-cost insurance; among the most popular were burial societies. The poor also had other means of insurance, for example, assistance from their children. Nevertheless, a certain part of the population could not get any insurance at all and had to rely entirely on Poor Law support. Failure to insure everyone was some contemporaries’ main objection against the system of friendly societies (Baernreither 1889, 427), but the picture does not seem to be so gloomy if we take into account the dynamic element of the system’s evolution. The poorest people had an interest in insurance, and as the population’s wealth increased, they were able to obtain it over time. As a consequence, the number of people on Poor Law rates steadily decreased.<sup>16</sup> In the beginning, mainly lower-middle-class workers were able to pay full premiums to the societies, but the membership gradually changed. Beito (2000) adduces one piece of evidence after another to show that in the first decades of the twentieth century, the poorest part of the population benefited the most from fraternalism.<sup>17</sup>

The societies’ relations to the state were influenced by their specific ideology. Instead of accepting an external ideology (religious or political), many societies created their own “ideology of independence.” The overwhelming majority of societies were not explicitly religious and did not care about their members’ church affiliation (Beito 2000, 27ff.). Clergy often accused the affiliated orders of “Deism” because they did not refer to Jesus in their rituals (Gosden 1961, 168).

Even greater standoffishness can be found in the societies’ stance toward politics. Baernreither claims that “from politics . . . all the friendly societies rigidly abstain” (1889, 397). In the United States, “‘politics’ was one of the dirty words of fraternalism” (Beito 2000, 130). In general, the societies entered the political arena only when politics threatened their interest (Gosden 1961, 65; Beito 2000, 165). Although Cordery tries to show that this traditional view of friendly societies as generally apolitical bodies underestimates their political engagement, he admits that compared to trade unions or representatives of Owenism, the friendly societies’ political

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16. According to Gerhard Ritter, the number of people receiving poor relief in England and Wales decreased from 5.7 percent to 2.5 percent of the population between 1850 and 1900 (1986, 136, n. 16).

17. A similar situation can be seen today in the Third World’s self-help movements, for example in education (see Tooley and Dixon n.d.).

activity beyond the “defense of voluntarism and respectability” (2003, 5) was negligible (58ff. and 81).<sup>18</sup>

The societies’ avoidance of religious or political appeals may seem surprising because, like conviviality, a common religious or political ideology can produce cohesion among the members.<sup>19</sup> But requiring a common ideology had disadvantages. First, by defining themselves ideologically, the societies excluded potential members, which entailed higher costs and greater actuarial risks. External ideology was also a potential source of conflict that might lead to a breakup.<sup>20</sup>

Most societies’ ideology can be characterized by the words *self-help* and *independence*, both “tempered with civility” (Baernreither 1889, 30). Self-help stood in opposition to charity, which in those days always had uncomfortable connotations for a workingman, and even “patronised societies” in most cases eventually shifted the management to the workers (177).<sup>21</sup> The societies used their conviviality and ritual practices to maintain this ideology and spread it among new members. Education played an important role, teaching members how to “practise thrift and providence and care for the future” (20). Membership in such a society also signaled respectability, thrift, and self-confidence. Fraternal societies were usually only one of the sources of income in time of need, when “working-class families relied on . . . networks in which mutual sharing and lending played key roles and to which access was granted and denied according to family reputation” (Cordery 2003, 103; see also Fafchamps 1992). Membership in a friendly society was crucial in keeping a good reputation (Cordery 2003, 102). Thus, it served as a “key,” opening access to other social networks necessary for survival.

The state’s relation to the friendly societies shows a different pattern. In England, we see two distinct periods, with a transition in the 1830s. Before this time, friendly societies were looked upon with a certain suspicion because for many external observers they were indistinguishable from trade unions, whose credit among the general population was low. The prevailing feeling on the part of legislators and other influential persons was paternalism (Gosden 1961, 159). Some went as far as to

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18. A complementary explanation of why the societies disregarded the state as a potential source of help stresses some working-class members’ fear that the state was too much under the influence of “big business” or the rich (Thane 1999).

19. There is an extensive body of literature on religious (especially Christian and Jewish) institutions’ effect on human behavior—for example, extending the individual’s time horizon by consideration of “afterlife consumption” (Azzi and Ehrenberg 1975; in this sense, religion itself contains aspect of insurance) or eliminating free riding by establishing a common goal (Iannaccone 1992) or by positing the existence of an omniscient judge, God.

20. So even “[i]ndividuals who were bitter rivals politically could coexist under a common fraternal banner” (Beito 2000, 30). This nonpolitical aspect of fraternalism creates a challenge for Putnam’s theory of social capital, in which spheres of voluntary and public activities are supposed to be much more interwoven. We thank Daniel J. D’Amico for this point.

21. Beito draws a distinction between hierarchical relief (charity) and reciprocal relief (fraternalism) (2000, 18).

suggest compulsory membership and direct state supervision of the societies. A strong belief prevailed that the societies might be used to reduce the number of people on Poor Law support. For various reasons, these proposals' impact was limited, mostly because of the lack of actuarial data and information about existing societies and the lack of power to enforce the proposals (Gosden 1961, 161). By the time the missing information became available, the public attitude had changed, and after the 1830s the "English public . . . had the courage and strength" (Baernreither 1889, 143) to give the societies relatively more freedom.

Regarding their relation to the state, friendly societies had a choice: they could register and become subject to state regulations or remain unregistered and almost completely out of the government's reach. Many societies chose the latter option. In 1872, the estimated number of friendly societies in England and Wales was thirty-two thousand, with a total membership of approximately 4 million; only thirteen thousand (40 percent) of the societies were registered (Gosden 1961, 2, 7).

The refusal to register had its price. In 1875, the list of privileges accorded to registered societies had seventeen items (Brabrook 1885), including the right to hold land, power to admit members under twenty-one years old, exemptions from stamp duty, power to invest with the National Debt Commissioners at an interest rate above the market level, and, most important, legal recognition that allowed the society to sue and to obtain legal protection against fraud and corrupt officers. Owing to these benefits, the number of registered societies doubled between 1801 and 1872 (Gosden 1961, 2), and many unregistered societies disappeared because they were seriously disadvantaged.

The registration of friendly societies was carried out first by local authorities; later, with the establishment of the office of the registrar of the friendly societies in 1846, registration became centralized. The requirements to obtain and keep registration varied over time, but the main one persisted almost unchanged in the nineteenth century: the registrar limited the purposes for which the societies could spend their funds. Thus, "it was quite illegal for any registered society" to spend the funds on conviviality activities, including alcohol (Gosden 1961, 17). Some societies got around this ban by disguising conviviality expenses as "management expenditures," but for others the restriction was a main reason for their remaining unregistered: they considered such practices "essential if they were to hold their membership" (Gosden 1961, 118; see also Baernreither 1889, 301). Nevertheless, the decisive step toward ending the use of a society's funds in this way came not from the registrar, but from the affiliated orders, who in some cases became leaders of the temperance movement. It seems that at this time (after the 1870s) the orders no longer relied on the old-fashioned forms of conviviality that had been a precondition of successful development for the local and country friendly societies.

Conviviality declined in importance for at least two reasons. First, the accumulation and maintenance of social capital was costly, not only in terms of expended

resources, but also because of the relatively tight social controls.<sup>22</sup> Various forms of capital (physical, financial, human, and social) were, given the general scarcity of resources, to some extent substitutes.<sup>23</sup> At the beginning of the process of industrialization, workers usually lacked other forms of capital, and in order to keep premiums low, they had to rely on social capital. Over time, some workers became richer, and they could afford to join more expensive centralized societies in which conviviality was no longer important, such as “national societies” that operated exclusively through the mail or “ordinary societies” that had a network of local door-to-door agents gathering subscriptions (Cordery 2003, 82).<sup>24</sup>

Second, conviviality declined because of the registrar’s interventions, wherein “[s]tate regulation . . . separate[d] sociability and insurance by legislating specifically on the latter, thereby marginalizing the social aims of friendly societies” (Cordery 2003, 85). By his disapproval of convivial activities, the generally respected registrar<sup>25</sup> sent a signal to societies and its would-be members that conviviality was generally expendable or even harmful because it supposedly led to “excessive” expenditures and moral deterioration of members.<sup>26</sup>

A second crucial area in which the registrar applied his authority pertained to the societies’ financial stability. Starting in 1819, local registering authorities required that each registered society’s tables and rules be “approved by ‘two persons at the least, known to be professional actuaries or persons skilled in calculation’” (Gosden 1961, 96). The registered societies later became subject to revaluations every five years (using their own tables, but approved by the registrar). A traditional view of the friendly societies stresses their fragile financial position in the last decades of the nineteenth century and uses official data collected by the registrar as proof (Gilbert 1965, 555). For example, the data published by E. W. Brabrook, then the chief registrar, in 1885 indicate that “1,537 societies showed a surplus, and 5,030 a deficiency” (27). However, the relevance of these statistics may be questioned. Brabrook admits that he took only one-sixtieth (picked by random selection) of all the data available to the registrar, but even if he had worked with the whole sample, his data

22. Emery and Emery (1999) do not hesitate to call many of the societies’ activities “intrusive.”

23. This claim does not deny that in certain social settings the various kinds of capital can be complementary (Coleman 1988; Lin 2001, esp. chap. 8; Chalupníček 2008).

24. However, as Cordery notes, even in the case of the most important centralized “ordinary society,” Hearts of Oaks, there remained “some uncertainty whether this [supply of medical attendance to members] was based in locally organised medical clubs or administered centrally” (2003, 82). So the generally accepted conclusion about the centralism of these societies may be overstated.

25. In spite of general mistrust toward the state and its institutions, many fraternalists had high expectations regarding the state’s actions. For example, “many members [wrongly] believed their society would be subsidised by the government if it went bankrupt” only because “their societies were registered” (Cordery 2003, 92).

26. Societies that did not register kept the conviviality as they liked, but besides being disadvantaged because they did not have access to benefits and the state’s catering to registered societies, they faced public pressure, supported by the registrar’s uncompromising attitude toward conviviality, to keep a respectable image and not be viewed simply as drinking clubs (Cordery 2003, 89ff.).

would be seriously incomplete. The registrar collected the data by sending forms to registered societies, but the return rate was quite low, barely reaching 60 percent in the best years, and even in these cases the returned forms were often incomplete (Gosden 1961, 13). Each form was filled in by the societies themselves, and even if the registrar tried to check each one, he could hardly do so even in a minority of all cases. Moreover, many societies remained unregistered and thus not under the registrar's authority. Therefore, it is problematic to derive general conclusions from such an incomplete set of data. Brabrook himself was aware of this problem: "It must be borne in mind, however, that nothing is more elastic than the contract made by a Friendly Society with its members; no error more easy of remedy if found out in time than one existing in the original terms of such contract. Hence the words 'insolvency', 'rottenness', and the like, which we sometimes hear freely used as describing the general condition of Friendly Societies, are utterly out of place" (1885, 29).

Among contemporary authors, George Emery and J. C. Emery, who analyze the financial statements of the Independent Order of Odd Fellows (IOOF) in the United States and Canada between 1860 and 1929, come to a similar conclusion that the "nineteenth-century British actuaries used a problematic valuation-method appraisal" (1999, 84). According to Emery and Emery, an IOOF lodge "was more likely to meet with financial difficulties during its early years of operation [that is, before it gained a reputation] rather than in later years when its membership was aging" (81).

As compared to commercial insurance, friendly and fraternal societies could monetize the benefits their members derived from social capital within the society and, if the need arose, could charge the members higher premiums quite flexibly. All societies generally tried to avoid the creation of large financial reserves, which they regarded as contrary to the idea of fraternalism, too much resembling the banking business and opening the door to corruption (Beito 2000, 131). At that time (given the demographic conditions), pay-as-you-go seemed to be the best practice, and even the state insurance proposed in England and realized in Germany relied on it.

The requirement of actuarial evaluation illustrates more a general problem of state certification (see Klein 1998) because the latter spread artificial (dis)trust among fraternalists, strengthened by self-fulfilling expectations. When a society was marked as "in deficit," members (especially young and prospective ones) might leave the society for a "better" one. As a result, the society in "deficit" often failed. Because many of them were low-premium societies insuring the poorest, this regulation might reinforce adverse selection, leaving the poor uninsured and uninsurable (Beito notes the similar impact of American regulations [2000, 141]). It was perhaps these considerations that led Brabrook and his contemporaries to stress their reservations. Unfortunately, later authors usually took note of the alarming data but ignored the accompanying caveats.

An ultimate claim against the friendly or fraternal societies might be, If they were so competitive and entrepreneurial, why did they almost disappear? In fact, their near demise was the culmination of a longer process of decline, revealing a great deal about



the dynamics of state interventionism in the social sphere because state intervention of some sort can always be included on the list of possible reasons for the decline of private organizations.<sup>27</sup>

In spite of its waning importance for the individual lodges of affiliated orders, conviviality was still important enough to prevent them from shifting further powers to their central bodies. Around 1900, the English state was running a social insurance scheme that was voluntary and not very successful.<sup>28</sup> The influence of commercial insurance companies was growing, but still relatively weak. They were not real competitors because most of them focused only on life and burial policies, leaving sick insurance to the friendly societies (Alborn 2001, 564).

In 1911, the National Insurance Act (NIA) introduced compulsory sick insurance for the overwhelming majority of the English population. The factors that led to this law are described in detail elsewhere (Ritter 1986).<sup>29</sup> We describe here only a general outline. David Lloyd George, the reform's creator, was converted to the idea of compulsory insurance after a visit to Germany in 1908 (Hennock 1987, 168). His proposal suited many interests. Politicians saw compulsory insurance as a way to decrease the number of people on Poor Law support and to save public funds. Progressive intellectuals were influenced by the incoming wave of Fabianism and ridiculed the friendly societies as old-fashioned and based on self-interest. Many clergymen did not forget old resentments.<sup>30</sup> But perhaps the most influential group behind the NIA was the "medical establishment" (Green 1985).<sup>31</sup> David Green's work describes with many details the fight between the friendly societies, which were trying to secure good-quality health care for their members at reasonable prices, and

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27. Other reasons usually include the growing costs of health care (which at that time most friendly societies covered only in part, if at all), growing opportunity costs of free time (because of increasing options for how it might be spent), and economic downturns (see Gosden 1973; Emery and Emery 1999). We do not deny the importance of these phenomena; however, the question we ask is: If the friendly societies were able to deal with similar challenges in the past, for the most part successfully, why could they not cope with them later on?

28. When voluntary state-operated insurance started in England in 1865, it utterly failed and played only a "wholly subordinate part" as compared to that of friendly societies (Baernreither 1889, 345). More than a decade later, Bismarck decided not to rely on voluntary insurance in Germany and in spite of "the absence of the active pressure of popular demand" (Dawson 1912, 2) imposed compulsory insurance on everybody in order—in Bismarck's own words—"to bribe the working classes, or, if you like, to win them over . . . to regard the State as a social institution existing for their sake and interested in their welfare" (qtd. in Dawson 1912, 11). It is an irony that William Henry Beveridge described compulsory insurance, supposedly a defense against socialism, as follows: "In giving to each one in social security according to his needs, Britain is nearer to the communist formula than is Soviet Russia" (1948, 297).

29. Cordery (2003) sees as one of the driving forces behind the English social legislative in general "a blossoming of social investigation which revealed extensive poverty" in the second half of nineteenth century. See Hayek 1954 and Mises 1972 on the social scientists' ideological bias against capitalism.

30. Some clergymen had pushed for compulsory membership in friendly societies since the beginning of the fraternal movement (Cordery 2003, 16). The societies also created competition for the church in some respects (providing an alternative source of income, bringing with them greater choice of leisure activities, and creating an alternative meeting platform for villagers).

31. A similar battle, though with a different result, was fought between American fraternal societies and the American Medical Association. See Beito 2000, 109ff.

the doctors, who later organized in the British Medical Association. The doctors condemned advertising and canvassing in particular or competition in general if it “left them worse off financially than they desired,” and they spoke about the “cos-termonger-physic” (28) when a friendly society decided to look for an alternative practitioner if the existing one did not carry out his duties properly or became too expensive. Most of the doctors saw the NIA as a way to end such practices. “[T]he doctors felt strongly that conditions they had accepted in the marketplace should not be imposed on them by the state” (108). Heavy campaigning and lobbying left the NIA very favorable to them. “[T]hey freed themselves from lay control, insinuated themselves into the machinery of the state, and nearly doubled their incomes” (114) at the expense of their customers—individual patients and friendly societies members.

Decisive resistance to the NIA might have come from the public, which still believed in fraternalism, and from the societies themselves, as it had several times in the past, but this time it did not come. Lloyd George presented the NIA to the public as an extension of old fraternal virtues. His “General Explanatory Memorandum” about the NIA praised fraternalism and promised to avoid all shortcomings of the German model (bureaucracy, malingering) through known and time-tested means that the societies had used for decades (Hennock 1987, 188). He promised that friendly societies would play a major part in the realization of the compulsory scheme and offered them a financial share of the value of benefits paid (Cordery 2003, 171).<sup>32</sup> In return, the societies that wanted to participate in this scheme had to be open to all applicants and had to remove “obstacles such as oaths and signs” (Cordery 2003, 171). In spite of warnings, they accepted this offer. Early proposals for the NIA basically gave the societies a monopoly in the sphere of health insurance and guaranteed them an inflow of new members. In the end, however, this outcome did not occur. In June 1910, industrial insurance companies decided to step in, and through skillful lobbying they persuaded Lloyd George to limit the societies’ privileges and to allow the companies to compete (Gilbert 1965). They proved to be better equipped for this competition, and most friendly societies were fortunate simply to retain their original members.

The friendly societies failed for three main reasons. First, they did not have a network of door-to-door agents to get new subscriptions, whereas commercial companies did. Second, because of the regulation they had previously approved, they could not insure infants, but commercial insurance companies could (Cordery 2003, 171). Thus, with the arrival of later generations who had no previous experience with fraternalism, friendly societies lost their battle, and after decades of flourishing they began to decline (Alborn 2001, 588). Finally, and perhaps most important, by submitting to the state, they lost what was most precious about them. Green notes that state insurance “attended only to the material dimension, and in separating the cash

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32. The compulsory system was designed to be subsidized by the state: the worker paid a premium of four (old) pence a week, the employer paid three, and the state paid two.

benefits from the moral and educational role of the societies destroyed their essence” (1999, 24). After the NIA, the “secretaries [of a friendly society were] simply being converted into State officials,” as one of their representatives complained as early as 1914 (qtd. in Whiteside 1999, 31). According to Emery and Emery, it was precisely the “moral ideology of friendly societies [that] made their insurance provisions more efficient than those of commercial insurers, not less” (1999, 65). William Henry Beveridge himself, whose ideas had influenced Lloyd George and who was considered the authority on unemployment insurance in England at the time, was well aware of this problem and admitted that “any official however competent and kindhearted” cannot bring about the virtues of self-help. He even criticized the NIA for blurring the character of the friendly societies and “industrial life offices” and claimed that the friendly societies should have remained a “select body in the community qualified for self-government” after enactment of the NIA (1948, 267, 296).

When Beveridge engineered the nationalization of health care through the National Health Service in 1948, he hoped to “preserve room . . . for friendly societies” (Alborn 2001, 566), and he even hoped that the scope of their activities could be extended.<sup>33</sup> By this time, however, they were only a shadow of their past selves and unable to conduct this task.

Note that the transition from the friendly societies to a state-operated health insurance system in Great Britain did not happen directly (owing to the good reputation that the societies enjoyed among the public and some politicians and to general hostility to government management), but through the intermediary step of private insurance companies, which made it easier for the state to nationalize the whole industry later.

If there was anything positive about this development, it was the lesson that it taught to the American fraternal movement. Fraternal societies faced a similar temptation in 1912 and the following years, when the American Association for Labor Legislation came up with a model of compulsory health insurance that combined elements of the German and the British systems. But U.S. fraternalists found powerful allies in commercial insurance companies and in some labor unions, and with English, French, and German experiences in mind, they resisted (Beito 2000, 146ff.). According to Beito, the passage “from fraternalism to state paternalism” in the United States was postponed, but not for long. The general ideological climate was changing, and the societies were losing on many fronts. New and expensive hospital regulations, a tax code favoring fringe benefits and leading to the rise of third-party payment systems, desegregation, federal and state funding of nonfraternal projects, federal restrictions on immigration are only a few of the challenges the U.S. fraternal movement

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33. “One hundred and fifty years ago these democratic non-political organizations for Mutual Aid were encouraged by the State and enabled to do what then seemed most important . . . providing financial security against misfortune. Now they should be enabled and encouraged, by a suitable widening of powers, to lift their sights and enlarge their scope beyond monetary insurance to provision of services and neighbourly mutual aid” (Beveridge 1948, 309).

faced in the 1920s and 1930s. Many of them might have been solved, as others had been in the past, but the societies found themselves caught in new traps of their own making. In the first decades of the twentieth century, the societies had pushed for legislation that regulated their enterprise—for example, by forbidding them from insuring whole families, writing group insurance, or combining insurance with bank deposits—because it was believed that these restrictions would help them in competition with other insurance providers (Beito 2000, 215). They wanted to protect themselves “from the corrosive effects of ‘commercialism’” (215), but instead they lost their flexibility, entrepreneurial spirit, and zeal. Once the innovators and pathfinders, they became dependent on the state to defend their vested interests. Finally, the crisis of the 1930s and World War II hastened the demise of fraternalism in its former scope.

## Conclusion

The fraternal movement united hundreds of thousands of individuals through a widespread and dense network of social relations. In England, friendly and fraternal societies were present in almost every village. In the United States, more individuals belonged to at least one such society “than [to] any other kind of voluntary association, with the possible exception of churches” (Beito 2000, 2). In Europe, their presence seems to have been rarer, but this impression may reflect only the lack of research in this area.<sup>34</sup> Even in Britain, the relatively small amount of scholarly work about them by historians and other social scientists led Cordery to conclude that “[s]uch oversight is surprising” (2003, 1).

In spite of their importance, the friendly societies disappeared astonishingly quickly, usually within a couple of decades. This development shows how fragile voluntary institutions may be when confronted with state power. The development and decline of fraternalism have similarities to the development and decline of other social networks based on trust and reciprocity, raising important and disturbing questions about the possibility of partnership between the nonprofit sector and the state.<sup>35</sup>

Without doubt, the friendly societies were a unique solution to problems that people of a particular time had to face. Our purpose here is not to advocate the revival of the fraternal or self-help movement as it existed a hundred years ago. Instead, we seek to explain the creative entrepreneurial nature of this movement and reveal the tools and institutions its proponents used to overcome problems connected with the insurance they provided.

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34. We know that the fraternal movement was not limited to the Anglo-Saxon countries, but was present in continental Europe as well. Cordery also notes that British friendly societies are traceable “to mutual benefit societies brought to London in the 1680’s by Huguenot refugees from France” (2003, 13).

35. See Ostrom and Gardner 1993 on self-governing irrigation systems in Asia; Gruber and Hungerman 2005 on crowding-out effects between state and private charity during the Great Depression; and Leeson 2005 on the negative influence of implanted colonial institutions on Africa’s economic growth.

As is well known, in most of the developed countries today, the state dominates this area of life. The rise of the state and simultaneous decline of voluntary means of provision of so-called public goods are among the most characteristic features of modern economic history. It is difficult now to say without ambiguity which way the causality runs, whether the decline of voluntary action came first and the state only subsequently filled the vacant space or the state interventions undermined the roots of the voluntary action, which later withered away. Our examination of the history of British friendly societies suggests that the latter scenario is probably closer to reality, but more research must be done in economic and sociological theory and in the history of voluntary movements to provide a more definitive answer.

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