“What Has Happened to the Inefficient Welfare State?”

Peter H. Lindert, University of California - Davis

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National Academy of Social Insurance

Six conclusions:

(1) The welfare state is not an endangered species. There is no “race to the bottom.”

(2) The “free lunch puzzle:” OECD experience shows that the real-world welfare state package delivers a “free lunch:” longer life and more equality with no loss of GDP. How can this be?

Six conclusions, continued

(3) To add to the puzzle, there are several policy realms where the US reliance on competitive markets seems superior to West European practice (NB: West Europe, not welfare states).

Six conclusions, continued:

(3), continued -- But those European mistakes are --

- •• not due to the safety nets for the poor, the sick, and the elderly; but instead consist mainly of
- •• protections against competition, such as job protection laws, over-regulation, etc.
- •• These problems are severe in the Mediterranean, France, Belgium, not the North.

Six conclusions, continued:

(4) Advantage welfare states:

- Better tax mix,
- investment in mothers' careers,
- health insurance and health care,
- government that's harder to buy, and
- *perhaps* ALMP.

Six conclusions, continued:

(5) What about the coming pension crisis?

OECD experience in 1980s and 1990s showed how public programs will probably be adjusted in the 21st century:

Less support per elderly person, but no change in tax share and no cuts in real absolute pensions.

Changes <u>must</u> be made to balance budgets, though there might not be any effect on GDP.

Six conclusions, continued:

(6) The “trade-off” between equality and efficiency is false. Every country in the world can both improve equality and improve efficiency.

Some definitions used here:

Social transfers = these kinds of tax-based government spending:

- basic assistance to poor families;
- unemployment compensation;
- public pensions (excluding those for government and military employees);
- public health expenditures; and
- housing subsidies.

Some definitions used here, continued:

Welfare state = these social transfers exceed 20% of GDP, in a democracy.

(Public education is <u>ex</u>cluded here, and is studied separately.)

(Anti-market policies are also <u>ex</u>cluded here.)

Little change in the welfare-state club since 1980:

Using social transfers/GDP=20% as a crude border of the welfare state, the number of welfare states has been stable or rising since 1980.

- Ireland dropped out, Switzerland joined in.
- In Eastern Europe, the Czech Republic, Poland, and perhaps Hungary have become democratic welfare states.

The free lunch puzzle: OECD experience shows no negative effective of greater social transfers on GDP.

- So said most past estimates.
- So say my estimates, which introduce some statistical improvements.

(See *Growing Public*, Volume 2, and data in http//www.econ.ucdavis.edu/faculty/fzlinder)

There are good reasons for this result.

(a) Real-world welfare states did not commit the blunders we so often imagine.

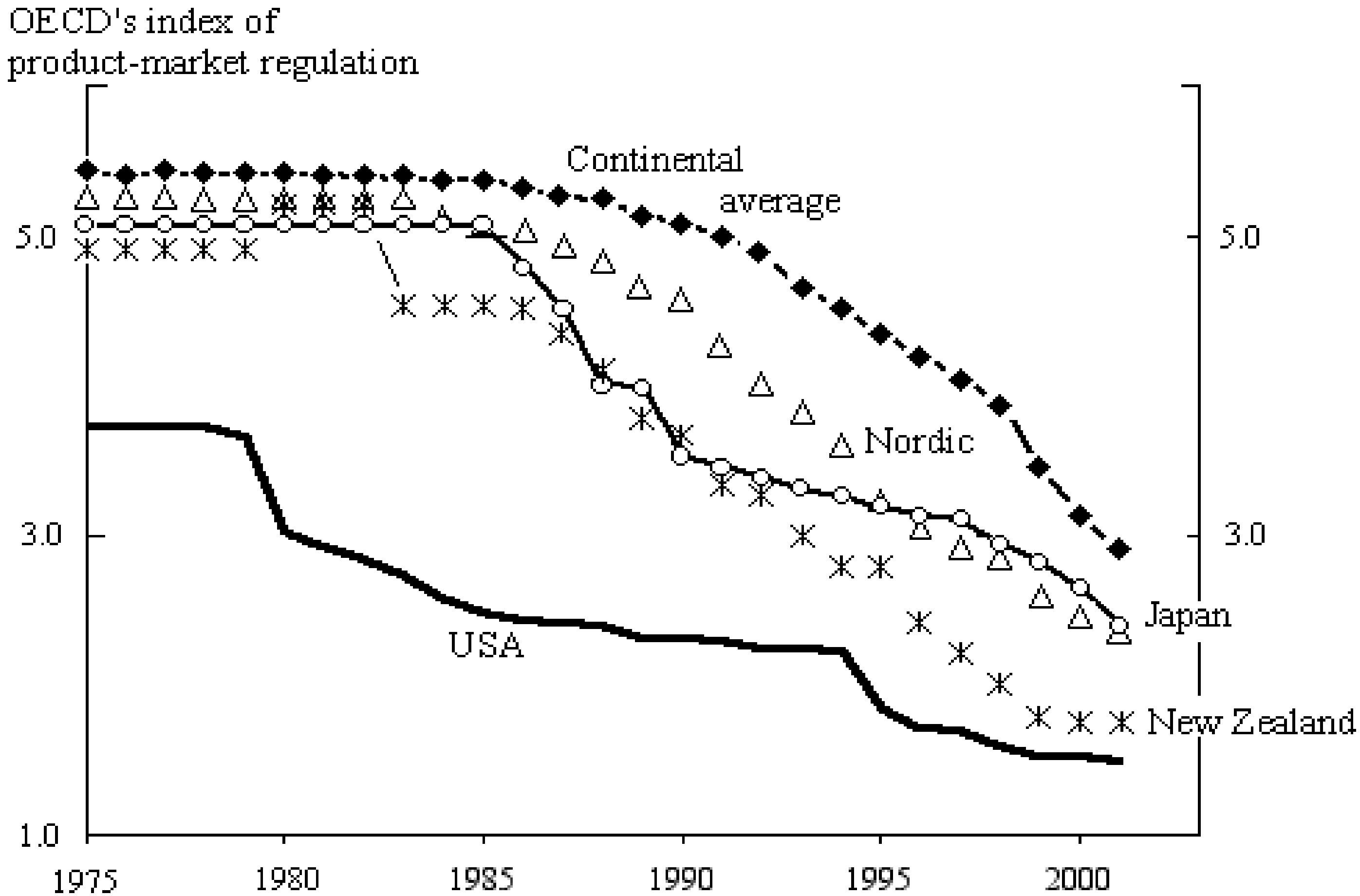
(b) Rather, all countries make policy mistakes, and West Europe's mistakes do not center on the welfare state.

Let's add to the puzzle temporarily by turning first to economic policy areas where the US free market approach looks more efficient.

Advantages of U.S.A., over Western and Southern Europe –

- competition in higher education.
- competition in main product markets.
- Western and Southern Europe's other barriers to competition, especially employee protection laws (EPLs), and product over-regulation. EPLs protect jobs of senior males at the expense of career development for youths and women.

Figure 1. The Restrictiveness of Product-Market Regulations, 1975 - 2001



EPLs have raised the Unemployment rate for youth, delaying careers.

In 2002,	EPL strictness	Uyouth / Umen
Greece	3.8	4.2
Italy	3.3	3.8
Ireland	1.3	1.7
Denmark	1.6	1.6

Women experience similar career delays:

In 2002,	EPL strictness	U_{women} / U_{men}
Greece	3.8	2.4
Italy	3.3	1.8
Ireland	1.3	0.8
Denmark	1.6	1.2

Who discourages the poor from working?

Doesn't Europe's more generous unemployment compensation cut work? Yes, it does.

So said a rich past literature, and my estimates agree.

Yet the effects on GDP are small.

And offsetting the negative effect of basic unemployment comp are some interesting counter-currents on work incentives.

- The politicized discussion of work incentives for the poor has missed a work disincentive experiment in the low-budget countries.

Exam Question #1

- In which case was a poor single mother given the <u>least</u> incentive to get a job?

(a) U.S.A. under Reagan

(b) U.S.A. under Clinton

(c) Britain under Tony Blair

(d) Sweden's welfare state today

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Which institutions deserve the credit for the drop in US welfare case load? EITC? Tough love of the 1996 reform? Macro-economy?

EITC definitely raised work participation, though it cut hours somewhat (Eissa-Hoynes 2006). This feature caused imitation of EITC in UK, France.

Both EITC and the 1996 toughness helped, says Blank (2000, 2002).

Who has a more pro-growth mix of taxes?

<u>Exam Question #2</u>

Which of the following tax rates is **<u>not</u>** higher in big-government welfare states than in the US?

(a) tax rate on corporations, capital, and top property incomes

(b) tax rate of labor income

(c) tax rate on general consumption (sales tax, for example)

(d) sin taxes (on tobacco, alcohol, gasoline)

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Other GDP effects of social policies

Advantages of welfare states over USA include --

- Above all, public health: US health insurance has more bureaucracy, higher administrative costs, saves fewer lives. US is trapped by its history: health care is tied to your job, Medicare shifts too much care from the young to the old, and prices are not controlled.
- Support for mothers' careers in Northern Europe.

Other GDP effects of social policies, continued

Advantages of welfare states over USA, continued --

- Support for mothers' careers in Northern Europe.
- Cleaner government (see Transparency International, and even the freedom indexes)
- *Maybe* ALMP (active labor market policy for the unemployed). This is tough to test, though.

The pension crisis in the 21st century: Will it kill the welfare state?

Three familiar sources of pension trouble

- Aging too fast, especially in Japan, Italy

- Asking for trouble with early retirement policy (all Mediterraneans, France, Belgium, Germany)

- Asking for trouble with overall government deficits (Japan, US -- not welfare states)

Getting older gracefully

- As the elderly share rises, something has to give. Pensions per elderly person cannot rise as fast as income per worker.
- All countries must make their (pensions per old person) rise more slowly than (income per employed person).

Getting older gracefully, continued

Who must make <u>only</u> <u>small</u> pension adjustments?

- Immigration countries outside Europe, Norway, Sweden, Japan

Who must make <u>bigger</u> adjustments?

- Continental Europe, including Switzerland

Getting older gracefully, continued

But this fact is <u>not</u> worse for public or “pay-as-you-go” (PAYGO) pensions. An older population must slow down its pension growth even without any public pensions.

Switching to funded and privatized pensions has no effect on the degree of adjustment needed. It just shifts pensions away from the poor.

Getting older gracefully, continued

- Funded systems are no more politically stable than PAYGO. History shows how easily PAYGO has replaced funded systems (e.g. U.S. Social Security 1935).

- Some OECD countries in the 1980s and 1990s have already pointed the way to the likely political adjustment in the 21st century: lower support per elderly, no change in tax share

  (e.g. Sweden's formula since 1998).

Conclusion: The "trade-off" between equality and efficiency is false.

There is <u>no</u> <u>need</u> to give up equality to improve growth. We know this both from statistical analysis and from common sense.

The common sense is revealed by a simple political "reality check." Ask yourself:

What country do you know where the political system has used all opportunities to promote both growth and equality?

“Europe does not have to adopt the American model; it certainly can have something distinct from it, say ***a system of efficient competitive markets coupled with extensive but efficient redistributive programs and social protection.*** Northern European countries are moving in this direction, but the major European countries [France, Germany, Italy, and Spain] are far from it.” -- Alberto Alesina, Harvard University