The Viability of the Welfare State*

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1 Introduction

The welfare state is a late 19th-century invention. A lot has been written about it — pro and con. The case for the welfare state is that it protects its citizens against the consequences of risks beyond their control.\footnote{See Agell (1999).} The case against the welfare state is that it blunts incentives and reduces productivity. The economic performance of many welfare states has been poor. There has been a rapid run up in unemployment in most Western European welfare states in the past 20 years. When properly measured, many Western European welfare states have much higher rates of unemployment than are reported in the official statistics. Incentives to withdraw from work, to go underground, to evade taxes, to retire early and not to produce are high.

Immigration levels are also high in many European countries. There are serious problems with immigrant assimilation created in part by welfare state policies. There is slow growth in human capital — a vital ingredient for a modern economy. In addition, there are low rates of business formation, weak incentives for entrepreneurship and low levels of research and development. There are high taxes on labor and, in many countries, on capital. Poverty traps are often created that discourage work.

The forces creating the pressure on the welfare state are globalization and an inability to tax internationally mobile factors of production. The increase in the unpredictability in trade and technology, the increasing openness of economies and the secular bias against unskilled labor in trade and technology are also the forces that create the demand for the welfare state as an insurer against risk, and as a protector against the reduced wages that the unskilled experience when the demand for their skills is reduced. As economies become more open, it is much more difficult to shelter workers and firms from the rigors of the market. And in fact, less sheltered economies like the U.S. and U.K. have shown substantial increases in wage inequality and social inequality due, in part, to these trends.

In the current environment, a premium has emerged for flexibility and responsiveness
of economies. High levels of workforce skill and a regulatory environment that supports change allow economies to benefit from new opportunities. An economic order that was well adapted to the more stable and predictable environment of the 1950’s and 1960’s and that had a large role for unskilled labor to play has become dysfunctional in the early 21st century. The opportunity cost of security and preservation of the status quo — whether it is the status quo technology, the status quo trading partner or the status quo job — has risen greatly in recent times. While reforms have been made in Europe, they have mostly been small scale in nature. Europe has to run and not walk to keep up with the pace of global change, and it is barely even walking, although by European standards, it is rapidly reforming.

Not all welfare states have lagged, or at least they have not all lagged in the same way. It is fruitful to examine differences in economic performance among different welfare states. This is the topic of the paper. The key to a successful welfare state lies in devising proper incentives to encourage actors at all levels of the economic system to respond to the new opportunities. In principle, a welfare state can provide the proper incentives for productivity and at the same time afford a measure of security and dignity for its citizens. But it has to respect the operation of incentives.

2 Themes of this paper

This paper develops five broad themes. First and foremost, people respond to incentives, and their responses are often very strong. It is very dangerous in designing laws and regulations to underestimate the ingenuity of economic agents in pursuing their self interest.

Second, the debate about the welfare state often poses a false dichotomy. It compares the U.S. (or the Anglo-Saxon bloc of countries) to Europe. It frames the debate as a choice among systems in place. The U.S., Canada, the U.K., Australia, and New Zealand are, of course, welfare states. They have made their share of mistakes in devising incentives and protecting their workers. The relevant issue is not whether Europe should adopt the Anglo-
Saxon model, or whether the Anglo-Saxons should adopt the European model. Rather, it is which features of the welfare state reduce inequality and provide insurance against uncertainty in an efficient way.

Third, the term “welfare state” is far too broad. At least four models are often mentioned (see Sapir, 2006) and these categories are surely too crude. (1) There is the Nordic/corporatist model (Scandinavia, Finland, Netherlands), which provides high level of security for workers, heavy reliance on active labor market policies, low inequality, high levels of taxation of labor income, relatively low levels of taxation of capital income, very high levels of education and high levels of government activity, generous grants that are not means tested, high levels of wage compression, centralized unions and high levels of concentrated unions and wage setting.

Then there is the Continental model (Austria, Belgium, France, Germany and Luxembourg). Its features are heavy reliance on insurance-based nonemployment benefits and old-age pensions, strong unions that are not all centralized, lots of regulation, inflexibility in labor markets and compressed wage distributions. It shows a marked inability to adjust to change.

A third model is the Mediterranean model (Italy, Spain, Portugal, Greece). It is characterized by reliance on employment protection (lifetime jobs), with union-covered sectors with compressed wages, concentrated spending on old-age pensions and high segmentation of entitlements and status.

Finally, there is the Anglo-Saxon model (United States, Canada, United Kingdom, New Zealand and Australia). It is characterized by social assistance only in the last resort, low levels of job protection and minimum wages, high levels of cross-section wage inequality, considerable social spending on old-age pensions, and high levels of segmentation of entitlements and status.

For close observers of the welfare state, these four categories are far too broad in many respects. For example, Ireland is a corporatist state often lumped into the Anglo-Saxon
camp.² It has strong incentives, especially for capital. It also has a lot of wage coordination. The four categories of welfare state are thus, at best, a rough cut.

Fourth, comparing alternative economic systems is a dangerous practice. Different baseline and terminal periods can produce very different ratings of the performance of any economy. Yesterday’s success is often today’s failure. Recall the love affair with the Dutch Polder model 10 years ago that still lingers on in some quarters. There was an even earlier fascination with Japan and, earlier yet, a fascination with the U.S.S.R.

Many European think tanks and the OECD have embraced the “Nordic model” or the closely related “corporatist model”. For example, the recent 2006 OECD Jobs Report (OECD, 2006), which updated the influential 1994 OECD Jobs Report (OECD, 1994), trumpets the “corporatist model” as being coequal in efficiency with the Anglo-Saxon model. An influential paper by Andre Sapir (2006) of the Bruegel Group made the same endorsement, and has had a big effect on the European discussion. This praise is echoed by Jeff Sachs (2006) in a recent column in Scientific American:

> Half a century ago, the free-market economist Friedrich von Hayek argued that a large public sector would threaten democracy itself, putting European countries on a “road to serfdom.” Yet the Nordic states have thrived, not suffered, from a large social welfare state, with much less public-sector corruption and far higher levels of voter participation than in the US. . . . Von Hayek was wrong. In strong and vibrant democracies, a generous social-welfare state is not a road to serfdom but rather to fairness, economic equality and international competitiveness.

Swedish’s economic performance in the past decade has been impressive. So has that of Finland. Denmark’s “flexicurity” system promotes job mobility. It gives generous unemployment benefits and, at the same time, provides sanctions to promote rapid return to work among the unemployed. It has attracted a lot of attention among the policy pundits. The

²Ireland has centralized bargaining in trade unions.
recent fascination with Scandinavia is typical of a mentality of many policy analysts who look to a working model as a system for adoption, rather than looking at basic principles that transcend any economy to explain the successes and failures of a particular model. This paper looks at those basic principles to draw general lessons from many models rather than to extol the virtues of one system currently in place in comparison with any other system.

Fifth, I make a basic methodological point that affects the way analysts should use and interpret the available evidence. A large literature on the European welfare state relies on arbitrarily constructed indices to examine incentive effects of different policies. Many of these studies claim to prove that the incentives (“institutions”) that basic economic theory suggest should matter do not in fact matter. These conclusions are a statistical mirage. They are consequences of using bad data. When incentives are properly measured, they matter, and they matter a lot.

Students of Latin American labor markets have measured the costs of regulation more carefully than students of the European welfare state. Latin America has experienced more dramatic regime changes and policy shifts than any that have occurred in Europe. The Latin American data clearly show strong adverse effects of perverse incentives.

3 The plan of the rest of the paper

The rest of the paper proceeds in the following way. Given the current romance with Nordic and corporatist models, I look at their performance and the performance of welfare states more generally. It is useful to examine long-run trends to supplement the short-run time series that attract so much attention in policy discussions. Nordic performance is not impressive, especially if one looks at long run trends. Policies in place often conceal rather than solve problems and create problems for the future. Problems of flawed measurement create serious problems in making meaningful comparisons across alternative systems. Long-run trends in skill accumulation, in attitudes toward work, in research and development, in adop-
tion of new technology, benefit dependency, and dependence on government employment are not encouraging and portend serious problems in the future for many quarters of Europe, even for Scandinavian Europe.

4 The performance of the European welfare state in the past 20 years

First consider the labor market. A new OECD Jobs report, released in 2006 (OECD, 2006), shows that some of the reforms suggested in the 1994 Jobs Report (OECD, 1994) have been implemented. It claims that those reforms partially account for the improved state of European labor markets. European unemployment rates post-1994 are lower but they are still very high. See Figure 1, which plots the “open” (official) unemployment rates over time. Starting in the early 1980s, the overall Western European OECD unemployment rate rose. It has not fallen to its previous level. However, unemployment appears to be much lower in corporatist Europe. This has led to calls by some to adopt the corporatist model as a way to conduct economic policy. Average productivity growth is lower in the EU than in
A recent study by US and European researchers found that since 1976, the wage and benefits returns to long-term employees in France have been consistently lower than in the US. The authors conclude that "in a low-mobility country such as France, there is little gain in compensating workers for long tenures because they tend to stay in the firm for most... of their career. In contrast, [in] a high-mobility country such as the United States... firms are induced to pay the premium... to avoid losing their most productive workers." In fact, the long-term workers in France tend to earn 3.05 times less per each extra year they stay with the firm than their American counterparts.

Studies by the Stockholm Institute and the IZA institute in Berlin reported similar trends for Sweden and Germany. So instead of benefiting workers with longer tenures, social partnership agreements ironically lead to the under-payment of more skilled employees. This explains at least in part why the majority of unionised skilled workers in Ireland take any opportunity to exit their 'protected' jobs for the business sector, leaving the less skilled segment of our labour force in the unionised employment.

The chart below shows the effects of the labour market restrictions on productivity growth rates in the euro area relative to that of the countries with more flexible labour market arrangements. Since 1996, the cumulative effect of the productivity gap between the two groups stands at 13.4% in favour of the more flexible labour market arrangements. Amongst the latter, the US workers have gained 31.1% in their productivity relative to 11% in the eurozone since 1996.

Source: OECD Reports.

Consider, in particular, the performance of one of the “Nordic miracle” countries—Sweden—the Nordic country most often studied. It has recently seen improvement in its economic performance after the deep recession of the early 1990s. However, its recovery is not strong. Placed in historical perspective, the story of Sweden is one of relative decline and a mild recent recovery. Figure 4 shows the decline in PPP–adjusted GDP per capita in Sweden as a percentage of the OECD average since the Second World War. Sweden has shown secular decline, which has only recently been arrested, and its recent boom is modest in historical perspective. Figure 5 reveals that, until recently, it was growth in government employment that fueled Swedish employment growth. Figure 6 shows that growth in employment, adjusting for population, lags the U.S. and the OECD excluding the U.S.

Sweden is far from being a basket case. Capital taxation there is relatively low and was cut substantially in the reform of the early 1990’s. Levels of education are high. The international trade sector is competing effectively in world trade, especially in the Information
Figure 3: Real GDP Growth. Source: OECD Reports.

Figure 4: PPP-Adjusted GDP per Capita in Sweden as Percent of OECD Average. Source: Davis and Henrekson (2006).
Figure 5: Cumulative Employment and Population Change in Sweden, 1950–2004.

Source: Davis and Henrekson (2006).


Source: Davis and Henrekson (2006).
and Computer Technology (ICT) sector, though it is dominated by a few big successful companies. Sweden’s world leadership in information technology comes largely from the success of a few established firms.

The partial reforms instituted in the Swedish economy in the past decade were effective. A lot of Swedish (and Finnish) growth is recovery growth—a rebound from a depression as deep as anything in the 1920s and 1930s. However, since the crisis of the early 1990s, Sweden has moved toward increasing incentives. This has helped to fuel growth.

Sweden has moved towards a more incentivized state. The introduction of incentives is an important ingredient of recent Swedish performance. However, a recent study concludes that there is still a lot of scope for reform and improvement in Sweden.³

Focusing on Sweden or the Nordic countries neglects the most vibrant European economy—Ireland. Compared to Ireland, a country not often mentioned as a model for Europe by policy pundits, but much admired by many smaller Eastern European countries, the growth in employment in Sweden has been very limited. See Figure 7, which contrasts the GDP per capita growth of Ireland with that of the Nordics, and Figure 8, which contrasts Irish and Nordic civil employment growth and Figure 9, which compares Irish and Nordic productivity growth rates.

Put in context, the Swedish miracle is not so miraculous. Ireland substantially reduced taxes on capital, raised its educational stock and opened itself up to world trade. It is heavily unionized and follows a corporatist model. It was proper attention to incentives that produced the Irish miracle. Unlike the recent economic recoveries of Finland and Sweden, the Irish experience cannot be interpreted as a rebound from a deep depression in the 1980s. The Irish economy was stagnant for decades before the 1980s. As occurred in the reforms in Sweden, the U.K., New Zealand, Australia, Chile and Ireland, social partners cooperated in a time of crisis. It is important not to underrate the value of crises in producing reforms. The question is, can one avoid crises and still make meaningful reforms? I return to this

The implosion of the welfare state

In 1970, Sweden's level of prosperity was one quarter above Belgium's. By 2003 Sweden had fallen to 14th place from 5th in the prosperity index, two places behind Belgium. According to OECD figures, Denmark was the 3rd most prosperous economy in the world in 1970, immediately behind Switzerland and the United States. In 2003, Denmark was 7th. Finland did badly as well. From 1989 to 2003, while Ireland rose from 21st to 4th place, Finland fell from 9th to 15th place.

Together with Italy, these three Scandinavian countries are the worst performing economies in the entire European Union. Rather than taking them as an example, Europe's politicians should shun the Scandinavian recipes.

Jobs

While a poorly performing economy such as Belgium's was able to create 8% new jobs between 1981 and 2003, Sweden and Finland were unable to create any jobs at all in over two decades. Denmark did a little better because it "activated" its labour market by making it more "flexible." It became easier for employers to fire people. For workers in the construction industry the term of notice was reduced to five days. Unemployment benefits were restricted in time, while those who had been unemployed for a long time and young people found they could lose benefits if they refused to accept jobs, including low-productivity jobs below their level of training or education. The result is that productivity growth in Denmark is lower than in Sweden and Finland.

These draconian measures reduced the unemployment rate, but did not eliminate the cause of unemployment, namely the total lack of motivation on the part of employees and employers resulting from the extremely high taxation level. Despite the painful measures, the growth of Danish productivity and prosperity has been substandard. Disappointment in Danish politicians is one of the reasons for the rise of the far right.

Weak government, bad government

Why are the Scandinavian countries doing such a bad job, despite their Protestant work ethic and devotion to duty? The main cause is the essence of the nanny state: its very high tax level. Between 1990 and 2005 the average overall tax burden was 55% in Finland, 58% in Denmark and 61% in Sweden. This is almost one and a half times the OECD average.
question, but I first examine the official statistics that are the basis for the recent praise of the Nordic model more closely.

5 Understanding what the statistics reveal and conceal

The official statistics on Nordic welfare states are highly distorted. The lower levels of unemployment found there are misleading and conceal deep problems in those societies. Consider active labor market programs which are widely regarded in policy circles as a source of success of Nordic (and other) economies. There has been a substantial commitment to expenditure on active labor market programs (ALMP) in many European countries and especially in corporatist Europe. Figure 10 shows that ALMP programs account for more than four percent of GDP in some corporatist economies. The OECD (OECD, 2006) and many commentators have endorsed these programs in their official publications. They attribute lower unemployment in the Nordic areas in part to ALMP.

A large array of studies surveyed in Heckman, LaLonde, and Smith (1999) and Martin and Grubb (2001), as well as more recent studies, show that ALMP programs at current levels of funding have at best minor long term effects on wages and employment. Most do
not survive a cost-benefit test. Few programs lift most participants out of poverty. A recent paper by Forslund and Krueger (2008) shows that none of the recent recovery of the Swedish economy can be attributed to ALMP programs.

ALMP accounting boosts reported Swedish GDP in a spurious way. Persons in training programs are counted as government employees and their wages are counted in Swedish GDP. This artificially inflates employment figures. Adjusting “open” unemployment by disguised unemployment produces a very different image of the performance of corporatist Europe compared to the performance of the U.S. than the image given in the official dialog on the success of the Nordic model. Figure 11 shows that, adjusting the padded statistics boosts corporatist unemployment rates by a full four percentage points. Adjusting European unemployment rates for ALMP substantially increases true European unemployment rates.

ALMP programs that conceal unemployment are only part of the reason for lower “open” Nordic unemployment rates. Europe, and Nordic Europe in particular, has many more persons dependent on government programs than the U.S. Consider just one program. Expenditure on disability is much higher in the EU than in the U.S. In Holland, at its peak, some 14% of all potential workers were collecting disability insurance. On top of the high expenditure on ALMP, expenditure on disability commands a substantial chunk of OECD
Figure 11: Open and Full Unemployment.

Figure 12: Differences between Open and Full Unemployment, 1998-2004 averages.
Figure 13: Disability related expenditures (%GDP) in 1900, 1999.

expenditure. See Figure 13. The data for 2004 show that disability take-up rates among potential able-bodied workers reach levels as high as ten percent in many countries. See Figure 14.

More generally, dependency rates for social programs are much higher in the EU and the structure of dependency is different. Participation in welfare and transfer programs in the EU tends to be much more long-term than in other welfare states. In many EU states, the rate of dependency on transfers is high, and has increased. Participation in a variety of welfare state programs has produced lower rates of employment in many OECD countries. They reduce unemployment by buying people out of the workforce. When the data are adjusted for employment subsidies, the true employment rate of the corporatist states substantially declines (see Figure 15). The effects on Western welfare state employment rates are substantial (see Figure 16).

A larger fraction of the EU and especially corporatist EU employment is in the government sector (see Figure 17). Government employment is an index of regulatory activity and also in most sectors government employment is not productive although measurement of productivity in governments activity is a tricky issue.
Figure 14: Non-employed disabled workers (% of labor force).

![Chart showing non-employed disabled workers across different countries.](source)


Figure 15: Open and Adjusted Employment Rates in a Subset of European Countries.

![Chart showing open and adjusted employment rates from 1998 to 2004.](source)

Figure 16: Differences between Open and Full Employment rates, 1998-2004 averages.


Figure 17: Public Sector Employment Share.

Figure 18: Total marginal tax wedge on personal income, including consumption taxes (% of income) for a single worker earning the average production wage without children (US: no cons. taxes available).

The growth in dependency on government creates a serious problem of political economy in democratic welfare states. If one adds current dependents to government workers, one sees that there is considerable inertia to protect the status quo. Moreover, to finance the high level of benefits and the ALMP programs, tax rates are high. See Figure 18. The total share of spending on government is substantial, although it has begun to decline. See Figure 19. The disincentives for work and the timing of work over the life cycle and investment in human capital are substantial. Retirement benefits are perverse at a time when the population is ageing. It has been estimated that, in Denmark, for the median person, 75% of the taxes are repaid in benefits but both taxes and benefits distort margins throughout the lifecycle at many margins.\(^4\) Incentive schedules often create poverty traps.

There is an inverse relationship between the size of the government sector and the growth of GDP. See Figure 20. It turns out on closer analysis that transfers are the culprit, and not government expenditure per se. Recognition of the often harmful role of a large government sector, has led to trends in the OECD against public spending as is evident in Figure 19.

Education is a major determinant of long run employment and unemployment. More

\(^4\)See Bovenberg, Hansen, and Sørensen (2008).
grow. The Belgian tax rate is 9% higher than the OECD average and 15% higher than the tax level in the US and Japan. If continental Western Europe does not change its policies, its relative impoverishment today will soon turn into absolute pauperisation. Its tax structure is not adapted to the challenges of globalisation. Taxes on production are the opposite of import taxes. They double Europe’s production costs and, in doing so, halve its productivity. Like protectionism they lead to distortions in world trade, but they do so in the opposite direction. Ever more rapidly, continental Western Europe is losing its semi labour-intensive sectors to countries where productivity is even lower than in Western Europe. This move from high productivity to low productivity countries is a waste. It is not only a catastrophe for Western Europe’s employment. It is also bad for the world at large because the highly productive production apparatus and infrastructure of Western Europe is not used to its full capacity. This leads to less than optimal global labour division and wealth creation. Politicians must realise that economic growth is not brought about by fiscally punishing productive citizens, nor by collective impoverishment and social welfare cuts, but by cutting taxes and bureaucracy. Ireland has shown that it can be done and how to do it.

Figure 19: Public spending as a % of GDP.

Source: OECD (various reports).

Figure 20: Correlation of growth and public spending - 30 OECD countries, 1960-2005.

Source: OECD Economic Outlook, Mullally (2006)
According to a separate survey by the Times Educational Supplement, only 11 of the world’s top 50 universities are found in the EU, and 8 of those are in the UK. An average of 23% of people in the EU aged 25-64 have tertiary-level education, compared with 44% in Canada, 38% in the US, 31% in Australia and 37% in Japan. Looking just at younger age groups (i.e. reflecting current policies rather than previous policies) shows that the EU is still lagging behind its key competitors. This crucially reflects the fact that the US spends far more on education than Europe does by making use of private as well as government funding. Only two universities in Europe would get into a list of the top one hundred and fifty in America for the size of their private endowments.

As Chris Patten argued in a recent speech: “To be clear and blunt, much of our higher education system is in severe difficulties; our research base is threatened; we are losing many of our best researchers; we face more not less competition in the knowledge business; and there are consequences for our future as an economy and a civilisation.”

Falling productivity

The combination of high regulation with weakness in science and higher education has meant that Europe’s historic productivity catch-up with the US between the Second World War and the 1980s has gone into reverse. Educated workers are more adaptable, innovative and easily employed. Educational expenditure per student in tertiary education (college) is much lower in the EU than in the U.S. The relatively low rate of educational attainment in the OECD countries is due to (a) high progressive taxation of income with reduced incentives to acquire skills; and (b) exclusive reliance on public sector resources to support education at a time when government resources are limited and fees are not charged and little reliance on the private sector as an engine of revenue as in the US. Student fees are a source of revenue and screen into schooling students with high demand for it. Joint ventures with business are limited. Sweden partially offsets this disincentive by generous subsidies to education. However, this policy runs the risk of training people for British, U.S. and Canadian jobs.

Participation in generous welfare states leads to erosion of the work ethic and withdrawal from participation in the social compact. There is evidence of cohort drift in welfare participation. Those cohorts who have lived a greater fraction of their lives under the generosity of the welfare state come to accept its benefits and game the system at higher rates. Martin Ljunge (2006) has studied the use of sick leave for three cohorts of Swedes. The incentives to use the system have been the same for forty years. Yet as Figure 23 reveals, the take-up rate at the same age has increased for recent cohorts. This is a serious long-term problem for the
European welfare state. Problems of an eroding work ethic are compounded by the lack of assimilation of many immigrant populations. In truth, the welfare state creates inequality, and has self-perpetuating features.

6 Bad measures lead to weak conclusions; good measures lead to strong conclusions

The OECD and many students of European economic performance analyze the effectiveness of alternative economic systems by relating performance to various *ad hoc* measures of the incentives created by institutions. There is a large literature on cross-country panels that uses these measures to explain variation in European unemployment and other issues (see, e.g., Blanchard and Wolfers, 2000; Layard, Nickell, and Jackman, 1991). The countries studied are very heterogenous and the time series analyzed are typically very short. Many measurements of institutions are indices formed for entire countries. These studies do not analyze incentive effects on firms and workers at the levels at which the incentives operate. The analyses are conducted at aggregate levels using a “representative agent” framework that ignores basic heterogeneity in society. Such evidence is fragile and unreliable.
It would be fruitful for students of OECD labor markets to follow the lead of students of the Latin American labor market and quantify the costs and incentives of institutions governing labor markets (see the papers in Heckman and Pagés, 2004). Such studies would reveal the quantitative insignificance of the reforms made in Europe in the past decade. Scholars of Latin America have collected micro data on costs, employment, wages and turnover in their countries. Latin American countries have conducted many extreme policy experiments, which can teach lessons that can be transported elsewhere. Policy instability in the region produces some very crazy economic experiments with much greater variability than any natural experiments or policy experiments that have been observed in Europe. Many of these natural experiments are plausibly exogenous. From these experiments we can learn about the basic economics of incentives. Consider the substantial variation in labor costs in Peru in the last decade associated with various Fujimori governments. Figure 24 shows the range of variation in non-wage costs due to policy shifts in Peru from the first quarter of 1987 to the first quarter of 1997.

Using these and other data, the costs of institutions (unions, labor market regulations, severance payment schemes, minimum wages) can be quantified and estimated on microe-
Economic models of firms. Translating regulations into costs allows analysts to summarize a variety of features of labor market institutions using an interpretable cost schedule. The cost data can be used to estimate the impact of regulation on the labor market. In the best studies, the analysis is highly disaggregated and applied to the firm or industry level.

Studies that measure labor cost precisely establish that labor demand curves are downward sloping, i.e., higher labor costs mean fewer workers demanded. This relationship has been found for economies around the world. The elasticity of demand for labor with respect to wage is $0.75$ Regulations, unions and many institutions raise labor costs and reduce employment. A 10% increase in labor costs leads to a 7% reduction in employment. Contrary to folklore that many embrace because it is politically convenient to do so, binding minimum wages reduce employment as do payroll taxes that are imposed in countries without wage flexibility. The current practice of using *ad hoc* measures of the costs of institutions on highly aggregated statistics from very heterogenous countries is guaranteed to produce the finding that “institutions don’t matter” when in truth they do.

7 Payroll taxes

Payroll taxes reduce employment unless they are offset by public benefits that offset the tax cost, by downward wage adjustment or both. Payroll taxes are a substantial fraction of total labor cost in most modern welfare states. Disemployment effects of payroll taxes depend on what economists call “pass-through.” How much of the cost of a payroll tax is borne by firms and, therefore, how much disemployment is there, depends on how flexible wages are, and on how wisely funds are spent (do workers value the benefits?). One cost of corruption and bad governance is that firms bear a greater share of their payroll tax. This reduces employment.

8 Studies of union reforms corroborate the value of disaggregated studies

Consider the benefits of redefining the role of unions. Reforms of this nature have been put in place and analyzed using data at the individual plant level (see Nickell, Wadhwani, and Wall, 1992; Pencavel, 2004). These studies show the value of exploiting local knowledge and incentives. The more decentralized the locus of collective bargaining, the more economically productive is the worker-firm relationship and the less rent-seeking behavior there is by unions. Public policy toward unions should be even-handed and not favor one party over another. Governments should allow parties to set the rules and not impose uniform rules on all bargaining pairs.

One important exception to this rule is that, in times of crisis, it is possible—as in wartime—for centralized unions to act in the public interest and hold down wage demands. This observation motivates in part the claim of a “U” shape in optimal union density, i.e., that the best social arrangements are 0% union or 100%. Studies of unions find little evidence that monopoly unions operate in an enlightened fashion in the long run (see Pencavel, 1999).
They can operate constructively in the short run in times of crisis but maintaining the cooperation in a period of sustained success has proved to be difficult.

Pencavel (1999) documents the effect of union reforms in the U.K. that moved bargaining to the local level. They raised productivity of firms (union and nonunion). The moral of Pencavel’s study is not to get rid of unions, but to change the union-firm relationship to focus on creating incentives to enhance productivity locally. Reforms in the union sector were complementary with product market reforms (see Pencavel, 1997, 1999). Uniform wage setting in Italy (south and north), East Germany and Northern Sweden that is not sensitive to local demands leads to high rates of unemployment in lower productivity regions.

9 The burden of regulation

Many economies around the world operate under a heavy burden of regulation. These regulations raise adjustment costs of labor and promote inflexibility. Regulation leads to sluggish employment responses. Employment protection laws that are popular in LDCs and in the Mediterranean welfare states reduce labor mobility. Deregulation raises mobility and flexibility. Regulation reduces employment overall, but raises employment for protected workers. It produces a protected enclave of insiders.

Moreover, as noted by Nicoletti and Scarpetta (2003), product market and labor market regulation are highly correlated. (See Figure 25.) This array of regulations reduces innovation and impairs adoption of technology. (See Figure 26.) Regulation reduces entry of firms.6 (See Figure 27.) These barriers have substantial long-run, perverse effects on growth in productivity.

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Figure 25: Product Market Regulation and Employment Protection Legislation


Figure 26: Internet Usage and Employment Protection.

10 The inequality argument for the welfare state re-examined

A principle argument in support of welfare states is that they reduce inequality and promote social inclusion. In practice, the welfare state often excludes people, creates inequality, and reduces competitiveness. The incentives in place often retard immigrant assimilation and reduce inclusion. The rigidities of the welfare state raise lifetime inequality. Cross sectional inequality (over people at a point in time) is much larger in the U.S. than it is in Italy. The gap in lifetime inequality is much less (Flinn, 2002). Incentives to protect the status quo reduce mobility over the life cycle, and in other aspects of social life.

11 Crisis is the Mother of All Welfare State Reforms

The political economy of the welfare state is rigged against reform because so many persons are its beneficiaries. Reforms that have occurred in most states have been quite modest. More drastic reforms are needed. Most of the reforms that have been put in place have come...
in the wake of an economic crisis. There is little internal capacity for democratic societies to reform themselves without a crisis. The welfare state can survive if incentives are adjusted.

In principle, as economists have long noted, society can undo one distortion with another. However, devising such incentives is complicated. The social system is delicate and the essential details required to offset one distortion with another are not really known well enough to plan with precision. As sixty years of political economy has shown, it is easy to create perverse incentives, and there are many examples.

12 Summary

This paper seeks to elevate the discussion of the welfare state beyond the level of endorsing one system over another. I have presented the essential features that underlie the success of aspects of many different systems. Systems that respect the basic incentives of economic life are the most successful.

Incentives include rewards for production of output, for creation of new ideas and institutions; for work rather than politicking; incentives to seek jobs when economic conditions favor reallocations (e.g., sanctions in the Netherlands and Denmark); incentives to invest as opportunities arise, to venture, to build for the future; and incentives to move when economic conditions call for it (as in the flexicurity system).

Long-run trends in Western welfare states are not favorable even in the Nordic countries. This is especially clear once we move beyond the distorted statistics. High levels of taxation, protection and generosity of benefits erode the dynamism of a society. They build a culture of dependency that erodes innovation. They create a level of complacency that erodes the work ethic and mutes incentives to invest in skills and in the larger society. They create a system that protects the status quo and is very difficult to change except when a crisis emerges. In many states (e.g., Ireland, Finland, Holland, and Sweden) changes occurred only in moments of crisis.

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7See, e.g., Atkinson and Stiglitz (1980).
There is much room for creative policy innovation. One can create incentives for mobility, but at the same time give workers some security as in the Danish “flexicurity” system. One can create incentives to work (WTC, UK; EITC, US) and not participate in welfare. Such incentives boost productivity and raise levels of well-being and social integration. One can use social insurance accounts that insure, but at the same time introduce flexibility into the system.

The welfare state is a relatively new creation. It is not surprising that early versions of it sometimes created perverse incentives. Such perverse incentives are not intrinsic to it. Innovation, reform and experimentation will improve it. Attempts at reform and regulation should respect the power of incentives and promote efficient social insurance.
References


