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What can the welfare state accomplish? An introduction

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In recent years, the *Swedish Economic Policy Review* has covered several timely policy issues, such as European unemployment, the significance of fiscal deficits, the lessons from recent experiments with comprehensive tax reform, and the pros and cons of the coming European Monetary Union. For many reasons, we feel that it is appropriate for this issue to address challenges facing the welfare state.

1. The changing views on the welfare state

By the late 1960s, Sweden was one of the richest countries in the world. Growth was rapid, despite a relatively high tax-to-GDP ratio. At the same time, the distribution of income was even and an extensive social-insurance system provided income protection from cradle to grave. Unemployment remained spectacularly low, and there was a close link between unions' attempt to have an egalitarian (solidarity) wage structure and the government's emphasis on active labor market policies. Solidarity wage policy was supposed to promote structural change by driving low-productivity sectors out of existence, while extensive training and mobility programs were supposed to speed up the reallocation of redundant workers.

This rosy image of the Swedish model has changed dramatically in recent times. According to a growing number of voices, the welfare state in Sweden and elsewhere is in serious trouble. As a corollary, it is often argued that there is time for fundamental rethinking and reshaping of old habits and institutions.

Some concerns undoubtedly derive from observations that are specific to the Swedish experience. During the early 1990s, Sweden faced the most severe economic downturn since the 1930s. GDP fell by 5%, unemployment increased dramatically, and the government deficit skyrocketed. According to many observers, Sweden's slide down the OECD GDP ranking suggests that Sweden finally paid the

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price for a long time neglect of economic incentives and an obsession with income equality and social protection. Likewise, the increase in unemployment, which now seems to be of a permanent nature, is often interpreted as proof that generous unemployment benefits and active labor market policy bolster unions' wage demands.

Another common claim is that many of the implemented policies have been ineffectual in accomplishing their prime objective, redistribute income. Already two decades ago, Nobel Laureate Gunnar Myrdal complained that high marginal tax rates had created such strong incentives for high-income earners to exploit a variety of tax-avoidance schemes that the tax system no longer redistributed income. The tax system may have looked egalitarian, but in practice, taxpayers could restore the incentive structure by perfectly legal manipulations of their wealth portfolios.

2. The external constraint

The discussion about the welfare state has ingredients that clearly goes well beyond the Swedish experience. A large public sector and extensive welfare systems are no longer characteristics that are genuinely Swedish. Throughout Western Europe there is a heated discussion about overburdened social insurance systems, the disincentive effects of high tax wedges, and to what extent existing job-security legislation and minimum wage laws impose wasteful rigidities in the labor market. These issues are important, and they represent true challenges for those who believe that the government ought to shoulder a fair number of responsibilities.

Even so, one can argue that the biggest challenge of all derives from ongoing changes in the international environment. In the years after 1944, when Sweden's Social Democrats adopted a program that proposed a far-reaching equalization of income and an elimination of the hierarchies that created inequities between the working poor and the wealthy capital owners, international economic relations were carefully monitored and regulated. Labor mobility was very low, and Sweden's *Riksbank* had to approve all transactions in foreign currency. In this not too distant past, external constraints were not perceived as binding constraints on domestic redistribution policy.

Today few governments can ignore the international reactions to domestic economic policy. In presenting a new tax package, it may come lightly for a Finance minister to dismiss the counter-arguments from the political opposition. But it may be much harder to ignore the instant verdict that international financial markets provide. The ever closer integration of the markets for goods, services, labor, and capital suggests that the efficiency cost of redistributive tax and transfer policies has increased. As production factors such as skilled labor and capital become increasingly mobile, it gets more costly on the margin to finance a large public sector—an argument that seems to indicate that the optimal size of government is bound to decrease.

Moreover, it is often argued that the tendency toward a smaller government will be reinforced by the forces of international tax competition. In the competition for scarce production factors, countries have an incentive to undercut the tax rates of their neighbors. This may easily lead to a situation where individual rationality produces a suboptimal collective outcome. Tax rates may be competed down to the levels where there will be insufficient revenue to fund important public programs. There will be a market failure in the form of under-provision of public goods.

Finally, basic international trade considerations suggest that increased competition from low-wage countries will be a disadvantage for those at the lower end of the wage distribution. For those who believe that the government should promote a more equal income distribution, this creates a serious dilemma. By increasing the dispersion of market wages, international trade tends to increase the demand for additional redistribution. But at the same time, the very same forces of international mobility increase the efficiency cost of redistribution.

In such a situation, when the traditional redistributive tools of taxes and transfer may become increasingly ineffective and when income inequality appears to be increasing, it is quite natural that many politicians look out for novel policy instruments that are associated with a more favorable efficiency-equity trade-off. It is also quite natural that educational policy and the issue of whether labor market training improves future-earnings opportunities has caught the political limelight. Although it may have become more difficult to tax the rich and to give transfers to the poor, a flexible educational system may prevent people from becoming poor in the first place.

The welfare state's future and the design of its institutions are issues that will preoccupy policy-makers for a long time. To nurture informed debate, this issue of the *Swedish Economic Policy Review* is entirely devoted to discussions on various aspects of the welfare state.

3. The articles in this issue

In "The welfare state: a theoretical framework for justification and criticism," **Agnar Sandmo** develops a broad organizational framework for discussing the welfare state. He reviews classic arguments about the government as a device to overcome market failures due to externalities, public goods, and increasing returns. He discusses the rationale for income redistribution, explaining the link between risk aversion and egalitarian preferences. There is also a treatment of why private insurance markets may fail and of the costs and benefits of compulsory social insurance. The optimal size of the public sector is such that the marginal benefit from correcting market failures and redistributing income matches the marginal efficiency cost from taxation. Sandmo explains the intuition, and he compares the conflicting policy prescriptions that derive from the optimal taxation and public-choice traditions.

Toward the end of the paper, Sandmo elaborates on dimensions of the welfare state that have been largely ignored in academic literature. He observes that the standard private/public dichotomy neglects the fact that a large amount of goods and services are produced by a third sector, *civil society*, which comprises transactions conducted within families and by voluntary organizations and other informal groups. He discusses the usefulness of distinguishing between the welfare of individuals as consumers and as workers. Finally, Sandmo touches on the controversial policy implications that follow from the empirical observation that utility seems to depend on relative—and not absolute—income and consumption. The implied negative-consumption externalities between people is another illustration that the *invisible hand* of the market might need some collective guidance.

Income redistribution has been a major goal of the Swedish welfare state. In "Income distribution in Sweden: what is the achievement of the welfare state," **Anders Björklund** reviews a large body of empirical evidence. In contrast to some recent arguments, Björklund concludes that the Swedish welfare state has been quite successful in reducing inequality. The distribution of yearly disposable income (net of income taxes and social benefits) is more equal in Sweden than in most other countries, and there are indications that inequality was much reduced in the years when welfare spending expanded rapidly.

It is often argued that annual-data usage creates a downward bias in the measurement of inequality. But Björklund shows that the redistributive property of income taxes and transfers seems to remain when the concept of income is extended from yearly to long-run (10-20 year averages) disposable income. Also, recent research on father-son earnings correlations in various countries suggests that higher intergenerational income mobility does not compensate for the higher inequality of yearly income found in a country like the U.S. The sons of low-wage Swedish fathers appear to have brighter prospects for social advancement than their U.S. counterparts.

A common objection to applied studies of income distribution is that they ignore behavioral responses to the tax-and-benefit systems under scrutiny. Another objection has to do with the fact that one often is confined to rely on tax-return data, which is an imperfect indicator of true economic income. This is particularly so in a country like Sweden, where a steeply progressive income tax used to give high-wage individuals strong incentives to invest their assets in forms that were very imperfectly monitored by the tax authorities. But it is far from clear that these omissions are serious enough to jeopardize Björklund's punch lines.

Joel Slemrod's article "How costly is a large, redistributive public sector" examines the empirical evidence on the efficiency costs of taxation. He distinguishes between two approaches to assess these costs, bottom-up and top-down. The bottom-up approach is rooted in the standard microeconomic tool kit; it relies on information about the size of behavioral elasticities to quantify the excess burden of taxation. Slemrod reviews the lessons learned from tax changes in the U.S. since 1981. He concludes that the seemingly large response of the taxable income of high-income individuals to tax changes primarily reflects a temporary response of the timing of income and that the more permanent elasticity of taxable income is much smaller. Thus Slemrod conjectures that the marginal excess burden is small, and probably no more than 20-25 cents per dollar of tax revenue.[1]

The top-down approach rests on the idea that the efficiency cost of taxation is of such magnitude that countries with a large public sector should exhibit a significantly poorer macroeconomic performance than countries with a more moderately sized public sector. But after reviewing the recent literature on cross-country growth regres-

[1] In his comment, Peter Englund argues that because the excess burden is a non-linear function of the tax rate, and because tax rates in Sweden are higher than in the U.S., the marginal excess burden per unit of tax revenue is most probably larger in Sweden than in the U.S. See also Agell et al. (1998).

sions, Slemrod concludes that the aggregate evidence is inconclusive and marred by methodological problems. There is no robust evidence suggesting that countries with a comparatively large public sector grow at a slower rate. He ends by arguing that increased globalization need not lead to smaller governments. Although globalization may increase the efficiency cost of taxation, it may also increase the demand for social insurance against the uncertainties inherent in an open economy. While the former effect points to a smaller public sector, the latter actually points to a larger one.

Hans-Werner Sinn's article "European integration and the future of the welfare state" examines the long-run threats to the welfare state created by increased economic integration. As production factors and people become more mobile, fiscal competition will increase. In Sinn's words "...the EU states would have to act like firms that must always bear in mind the mobility of their customers when they make product and pricing decisions." Eventually the EU states will have to reduce redistributive taxes and scale back on welfare programs. A positive aspect of this process is that it will help to cut the fat within the welfare state. But Sinn argues that the downsizing of the welfare state may go too far. For the classic reasons outlined by Sandmo, the welfare state can serve a useful role in improving the market. Also, some amount of income redistribution can be motivated for reasons of social insurance and because it creates a positive migration externality for neighboring countries.[2]

To safeguard these desirable aspects of the welfare state, Sinn proposes fundamental tax reform. He advocates taxing capital income on a cash-flow basis, which would provide an instant and complete tax relief for new investments. By punishing disinvesting firms and rewarding investing ones, this would prevent the erosion of capital-income taxation. To maintain redistributive taxation of labor income, Sinn suggests taxation according to the nationality principle, which implies that taxpayers must pay redistributive taxes to their home country, irrespective of their country of residence (the U.S. has applied this principle for a long time). But cash-flow taxation and the nationality principle have their administrative and practical drawbacks. If these drawbacks become insurmountable, Sinn concludes

[2] Because skilled workers will migrate *from* the country, and unskilled workers will migrate *into* the country, domestic redistribution policy will tend to reduce the relative supply of unskilled workers in neighboring countries. As a consequence, foreign-wage differentials tend to get smaller.

that there is no option but to create a strong federal European structure to prevent harmful tax competition.

One of the most crucial issues for the redistributive branch of the welfare state is whether the trend toward greater wage inequality, observed in recent years, will continue in the future. In "New technology and trade: a threat to low skilled workers," **Robert Feenstra** discusses the reasons for the increased wage gap between skilled and unskilled workers, observed in many countries since the 1980s. Two common explanations for the increasing wage gap are increased competition from low-wage countries and technological change. Feenstra argues that labor economists, who downplay the international trade argument, have ignored the impact of outsourcing on the within-industry skill composition. As firms in developed countries move repetitive assembly-line activities to developing countries, the relative demand for unskilled labor will decrease. This within-industry effect is quite similar to what happens when firms replace unskilled labor with computerized production processes.

Feenstra conjectures that outsourcing will continue rapidly in the future, spurred by improved communications and transportation technology. If European and U.S. firms are to remain competitive in world markets, they must exploit the cost advantage from locating in Eastern Europe and Mexico. The implication is that relative demand for unskilled labor will continue to decrease in the future, implying a gradual but steady deterioration of low-skill wages. A not uncommon policy response to this scenario is to advocate protective trade policy. But Feenstra argues that politicians who follow this route will do more harm than good. The gains from globalization are of such a magnitude that they, at least in theory, allow the winners to compensate the losers. While there are problems in designing compensation schemes that are efficient and feasible from an administrative point of view, Feenstra concludes by discussing recent proposals to introduce wage subsidies directed at the lowest paid workers.

But there are ways to combat inequality other than using taxes and subsidies. In the concluding article, "Widening wage differentials and long term unemployment: is education and training the answer," **Lisa Lynch** revisits the case for educational initiatives. She argues strongly that education and properly designed training programs have an important role to play in ameliorating the disruptive effects of trade and technological change for low-skilled workers. Such measures may also serve to narrow wage inequality more generally.

Lynch reviews the theoretical arguments suggesting that too little education occurs if the market is left on its own. Liquidity constraints imply that workers may have trouble financing general training. Imperfections in the labor market may discourage skill formation in a broad sense; in a bargaining situation, when firms capture part of the marginal productivity of skilled labor, there will be a disincentive for workers' human-capital accumulation. An alternative source of training is provided directly by the employer. But because there is a risk that newly trained workers will be hired away, there will be a bias toward non-portable firm-specific training.

On the empirical side, Lynch discusses several studies (from various countries). According to these studies, workers and firms substantially gain from education and training investments. For government training programs, intended to beef up the human capital of the disadvantaged and of the long-term unemployed, she notes that the evidence is mixed and less encouraging. While some types of programs appear to have been successful, there are also indications that certain programs have had a negative impact on the earnings of the participants. Lynch concludes that training and education matter, but that they are not a stand-alone remedy for all inequality and long-term unemployment problems.

4. Conclusions

What will the European welfare state look like 30 years from now? Judging from the poor track record of many well-known social- and economic-change forecasters, the only thing that we can expect with some certainty is that it will look rather different from what we expect today. But to paraphrase Mats Persson's comment on Agnar Sandmo, if the contributors to this volume are not the best persons to prepare us for these surprises, who else are?

References

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