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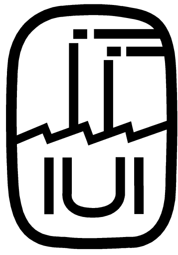

THE RESEARCH INSTITUTE OF INDUSTRIAL ECONOMICS

Working Paper No. 550, 2001

Changing Tides for the Welfare State - An Essay

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12/3, 2001-03-12

Abstract

Recent developments in society have generated misalignment between the welfare state and socio-economic conditions and preferences. This paper emphasis developments in the labor market and the structure, stability and preferences of the family, as well as macroeconomic changes. The latter include new patterns of short-term macroeconomic instability, economic growth and the internationalization of national economies. I deal both with developments that are exogenous from the point of view of the welfare state and with developments that may be regarded as endogenous behavior adjustments of individuals in response to the welfare state itself. Alternative welfare-state reforms are also considered.

JEL Classification codes: H00, H40, H50.

Keywords: welfare state, changes in labor market, changes in family.

(Changing tides)

A.L. For Musgrave Conference Volume

11/3, 2001

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CHANGING TIDES FOR THE WELFARE STATE*
– An Essay –

The welfare state is an inheritance from political responses to changes in socioeconomic conditions and preferences in the past. But the situation today is very different from that which prevailed when the welfare state was constructed. Still, it has turned out to be difficult to adjust welfare-state arrangements to new circumstances. The ensuing misalignment between the welfare state and contemporary conditions is the background for current discussions of welfare-state reforms. These are the issues focused on in this essay.

The socioeconomic background of the welfare state is well known. Industrialization meant that periods of work and non-work became more discrete and more random events than before (Piore, 1987; Atkinson, 1991). The resulting temporal desynchronization of an individual's consumption requirements and actual income flows created a need (justification) for new arrangements to reallocate income over his life cycle and to protect him against income risks. At the same time, urbanization reduced the family's ability to satisfy these needs, partly because family members of different generations often became separated geographically. Nor could the family alone satisfy the increased need for education and health care in industrial and urban societies. It is also well known that voluntary market solutions could not live up to these new needs because of myopic behavior and free riding of individuals, and because of well-known limitations in private insurance markets as a result of adverse selection, cream skimming, and moral hazard. This, of course, is the background for the (reasonable) assertion that the welfare state can be justified not only on distributional (social) grounds but also with reference to efficiency aspects (Barr, 1992). Moreover, we may speculate that destitution among minorities and specific individuals has become less socially acceptable over time. In this sense, social (political) preferences may have changed, perhaps

* I am grateful to Jon Dutrieux Anderson and Alessandra Bonfiglioli for help in collecting data. Anders Björklund, Peter Heller, Richard Musgrave and Solveig Wikström provided useful comments on a draft of the paper.

to some extent as a result of higher income and more widespread education. Meanwhile we may quarrel about whether social preferences of this type reflect altruism or "enlightened self-interest".

Macroeconomic instability in an industrial society, not least the depression in the 1930s, highlighted the need for income protection. Moreover, rapid economic growth during the first decades after World War II created the necessary economic resources to satisfy these needs to a considerable degree. Indeed, during these decades, welfare-state arrangements in many developed countries gradually changed from poverty relief and basic ("minimum") income support to broad income-maintenance programs and further expansion of tax-financed services in education and health. A number of socioeconomic features during the early postwar decades also contributed to making the welfare state both financially viable and reasonably well adjusted to the new needs. These features include a rather homogeneous labor force, full employment (mainly for men), quite stable families and favorable demography (a large fraction of the population of working age).

General franchise provided political channels through which the new needs could gradually be translated into concrete action, even though embryos of welfare-state arrangements already existed. When the modern welfare state was basically completed in the 1970s, it was mainly adopted to the needs of "standard" families with a male breadwinner and a housewife, though it also provided special arrangements to mitigate poverty for individuals and families without a regularly employed income earner. In several countries in Western Europe, job-protection legislation was added, in particular in the 1970s, as a complement to or a substitute for unemployment benefits and social assistance.

It is well known, however, that socioeconomic changes in recent decades have created new needs (justifications) for intertemporal reallocation of income and protection against new types of income risk. These changes have also contributed to new service needs that are not well met by traditional welfare-state arrangements. As in the case of industrialization and urbanization a century ago, the most important changes have taken place in the labor market and the family. Some socioeconomic changes have also undermined the financial viability of a number of traditional welfare-state arrangements. Important examples are demographic changes, new macroeconomic developments, including high and persistent unemployment in Western Europe, secular changes in long-term economic growth and internationalization of the economic system. I will also argue that the views ("philosophies") among voters and politicians about the proper relation between the individual and the state have changed in recent decades. Important examples are new views about an individual's responsibility for his own destiny and about his right and ability to exert free choice among alternative types of income protection and social services.

Several driving forces behind these developments may be regarded as exogenous from the point of view of the welfare state. Obvious examples are new technologies, advances in medicine and increased international economic integration. Other driving forces – including changes in demography, cohabitation patterns and the life cycle of individuals – are most realistically regarded as combined results of exogenous events and endogenous behavioral adjustments of individuals in response to the welfare state itself, including the effects of economic (dis)incentives associated with benefits and taxes.

In some countries, the dynamics of the political process may also have generated an "overshooting" of the welfare state, in the sense that voters would have chosen smaller aggregate welfare-state spending if incentives for political action had been more symmetric between beneficiaries and taxpayers. As argued by many observers, since benefits are often selective while taxes are usually general, the incentives of individuals belonging to special interest groups to exert political pressure for new favors are often stronger than the incentives of the general taxpayer to resist such favors. I have hypothesized elsewhere (Lindbeck, 1985 and 1994) that the *recursive* and *incremental* nature of the political decision-making process tends to accentuate this tendency, since different programs are no longer weighted against each other simultaneously.

When discussing these issues, it is important to keep in mind that economic behavior is influenced not only by economic incentives but also by social norms and individual ethics (internalized norms). In particular, I will hypothesize that norms inherited from the past often constrain the (dis)incentive effects in the short run. In a long-term perspective, however, these norms themselves may adjust in response to changes in economic incentives (Lindbeck, 1995). If this hypothesis is correct, the incentive effects of welfare-state arrangements, and their financing, would in some cases be stronger in the long run than in a short- and medium-term perspective. Such behavioral inertia may accentuate the earlier mentioned tendency to "overshoot" aggregate welfare-state spending since it is difficult for policymakers and voters to predict induced long-term changes in social norms when new welfare-state programs are launched.

These new developments constitute the background for this essay on "changing tides" for the welfare state. Both exogenous disturbances and endogenous behavioral adjustments are then considered. I discuss quite different "welfare regimes", hence different relative roles of the state, the family and the market for economic security and personal services.

Misalignment between the welfare state and social conditions does not mean that today's welfare-state arrangements have become obsolete or that voters turn their backs on the welfare state. According to opinion polls, the welfare state is still quite popular, even though there are specific complaints, and popular support for some narrowly targeted

welfare-state programs is often rather weak (Taylor-Gooby, 1996; Boeri, Börsch-Supan and Tabellini, 2000). But as we shall see, new socioeconomic developments and changes in values help explain why proposals for welfare-state reform abound and why some such reforms have already been initiated in a number of countries.

I begin by discussing changes in the labor market (section 1). Next, I deal with changes in the structure and stability of the family (section 2). The reason for focusing on these two institutions – the labor market and the family – is that they, alongside the public sector, are the basic providers of income and personal services, and hence well-being of individuals. I then turn to contemporary changes in the macroeconomy with important consequences for the functioning of the welfare state (section 3). Here, I deal with three macroeconomic features – short-term macroeconomic instability, economic growth and the internationalization of national economies. Some concluding remarks are offered in section 4.

1. Structural Changes in the Labor Market

1.1 Labor supply

What then are the most important examples of "changing tides" in the labor market from the point of view of the welfare state? With respect to *labor supply*, it is a commonplace that the aging of the population – a combined result of the baby boom in the 1940s, low birth rates since the 1970s and increasing longevity after retirement – threatens the financial viability of the welfare state, in particular the pension system. Indeed, birth rates in most European countries today are considerably below the reproduction level. The average birth rate in Western Europe (the number of children born divided by the average number of women of fertile cohorts) was only 1.47 in 1998 (U.S. Bureau of the Census). Life expectancy at age 65 in Western Europe has increased by slightly more than one year per decade after World War II, ranging from somewhat less than one year per decade in the Netherlands to more than 1.5 year per decade in France (United Nations Demographic Yearbook, 1949, 1960 and 1997). Instead of 45-50 years of work and 5-10 years of retirement half a century ago, a typical young individual today can expect to work for 30-35 years and be retired for about 17 years (OECD, 1998a).[1]

Most likely, the fall in birth rates is related to the higher costs of raising children (reflecting higher real wages) and the increased labor-force participation of females (Becker, 1981). Some welfare-state arrangements have also contributed to the fall in birth rates since it has become less important than earlier to have children in order to support oneself in old age;

[1] According to projections by the EU Secretariat, the rules in effect in the early 1990s imply that the average age-dependency ratio (the number of retirees relative to the number of individuals of working age) will increase by 50 percent between the mid-1990s and 2020 in the EU area (European Community, 1994).

pay-go pension systems, for instance, imply that the children of other families support me when I grow old. Government subsidies to education have also delayed the entry of individuals into the labor force. This has reduced the number of taxpayers, though the related accumulation of human capital per individual, and hence increased labor productivity, have counteracted (perhaps even reversed) the negative effects on the tax base. Welfare-state arrangements have also contributed to the rise in the number of pensioners via a lower statutory retirement age and more generous subsidies to early retirement. Moreover, subsidized health care is likely to have contributed to the rise in longevity. Government spending on pensions has been boosted by a tendency among politicians to add new types of benefits to existing pension systems, for instance, by allotting pension rights for compulsory military service, unemployment periods, the care of children, etc. These new costs have added to unavoidable cost increases in connection with the gradual "maturing" of pay-go pensions systems.

Since better health among elderly citizens usually enhances their ability to work, it may not be too far-fetched to deal with the financial difficulties of the pension system by raising the age of mandatory retirement (the "statutory" retirement age) or by reducing the subsidies for early retirement, or both. As an illustration of the potential importance of the latter type of reform, in the late 1990s, average labor-force participation in the EU in the 55-65 age group was only about 40 percent, ranging from 24 percent in Belgium to 88 percent in Iceland (OECD, 1999). Without policy actions that raise the average retirement age, it is obvious that pension schemes in most developed countries will require substantial increases in pension contributions (if pension benefits are fixed) or reductions in pension benefits (if the contribution rate is fixed).

The political power of cohorts close to retirement is one conceivable explanation why it has turned out to be difficult both to increase the statutory retirement age and to reduce subsidies to early retirement. It is not clear, however, why these cohorts would have such great political power. Some young and middle-aged individuals, of course, may be happy of not having to support their own parents individually in the future. Perhaps rather young cohorts also look forward to early retirement themselves. Indeed, with today's incentive structure in favor of early retirement, it is not surprising that a vast majority of individuals are anxious to retire quite early, often no later than at 60 – at least this is what opinion polls have found. Moreover, in all West European countries, unions and firms use early retirement, at the taxpayers' expense, as a way of cutting the work force in individual firms (when this is regarded as necessary) at the lowest possible cost to firms. A common argument for such policy action is that it is believed to reduce aggregate unemployment, which may be true in a short-term perspective.

Considering the wide variability in the capacity and willingness to work among the elderly, there is also a strong case for combining the removal of subsidies to early retirement with a more flexible retirement age (possibly with actuarial adjustments of yearly pensions). Elderly workers in poor health could then be referred to the sick or disability insurance system rather than to the pension system. Another, possibly complementary reform could be to allow the elderly to continue to work after receiving a pension (without subsidies to early retirement), hence partly uncoupling retirement and pension. Indeed, this is rather common in Japan, where employees are often able to continue working at reduced wages after receiving pensions (without much reduction in the latter) – either by performing new tasks in the same firm or by shifting to other firms.

Since fairly similar demographic problems exist in most countries in Western Europe, attempts to mitigate these problems via immigration of young and low middle-age workers would have to rely on immigrants from Eastern Europe and non-European countries. Though such immigration certainly makes sense from an economic point of view, we know from experience that ethnic conflicts may be triggered if the size or speed of immigration exceeds certain (unknown) limits. This is particularly likely to occur if immigration is thought to result in downward pressure on the wages of low-skilled workers or upward pressure on social-assistance spending. Such developments would also complicate the ambitions of welfare states to mitigate segregation and promote social accord. A likely future strategy of governments to deal with this issue would be to favor the immigration of skilled rather than unskilled workers.

Moreover, a shift to a fully funded, actuarially fair pension system may improve the financial stability of the pension system *in the long run*. The reason is that pensions would then be limited to the return on the pension funds. But in a short- and medium-term perspective such a shift is bound to create new financial problems for the government, since some "transition generations" would have to pay "twice" – by financing both their own future pensions and the pension claims of earlier generations of pay-go pensioners.

If individuals perceive only weak links (or no links at all) between contributions and benefits in an existing pay-go pension system, a shift to a fully funded system means that future generations will experience less distortion of work, and hence enjoy higher economic efficiency. This would also tend to improve the financial viability of the pension system via a larger tax base. But the same effect could, in fact, be achieved by establishing a tight link between contributions and benefits in the context of pay-go pension systems, provided these have individual ("notional") accounts (Lindbeck and Persson, 1999) This means that the main argument for a shift to a fully funded pension system, rather than to a pay-go system with strong links between contributions and benefits, is a desire to increase national saving and

hence the future capital stock (Feldstein, 1995; Kotlikoff, 1998). This is mainly an issue of reistributionz of income among generations – from current to future generations. Hans-Werner Sinn (1999) has argued that such a redistribution via forced saving is reasonable from a normative point of view since contemporary workers have deliberately chosen low fertility rates, and in this sense been slow in accumulating human capital. They should instead – so the argument goes – contribute to a faster accumulation of physical capital or financial claims on other countries via forced saving. Of course, the burden on a "transition generation" may be reduced if old pay-go pension claims are instead financed by government borrowing rather than by taxes. But then the desired increase in aggregate national saving may be jeopardized.

The case is stronger for a partial rather than a total shift to a fully funded, actuarially fair pension system, since diversification of the "portfolio" of pension claims is achieved in the latter case. Not only does the market risk differ between pay-go and funded pension systems – risk regarding the development of the tax base in the first system and capital-market risk in the second. The political risks also differ, and are probably greater in the case of pay-go systems, since property rights are likely to be stronger in fully funded systems with individual accounts. By combining the two systems, it would be possible to pool various types of market risks and political risks, and hence achieve a reduction in total risk (Lindbeck and Persson, 1999). The emergence of new types of capital-market instruments, which provide more options regarding the degree of risk exposure, has also strengthened the case for funded pension systems with individual accounts.

There are, however, political problems in connection with compulsory, funded pension systems. In particular, how should future politicians be prevented from intervening in the portfolio management of a pension fund created by the government, and from exercising voting powers in firms in which the fund has shares – in both cases to exert power or to influence election outcomes? Capital cannot be nationalized without risking a politicization of the national economy. The most promising way of minimizing this risk is probably to let each citizen choose among a number of competing private funds (and possibly also some competing public-sector fund) even when the pension system is compulsory and when pension contributions are amassed by the tax collector.

A problem with competing pension funds, of course, is that the dispersion of the distribution of pension benefits among individuals will be more uneven than with a single government-operated pension fund, since the latter tends to give the same rate of return to all individuals in a given cohort. Moreover, the administrative costs are likely to be higher, at least in countries with a reasonably well-functioning government administration. But adherents of a pluralistic society may be willing to pay a price, in terms of both greater dispersion of the distribution of pensions and higher administrative costs, in order to enhance

the survival of a pluralistic society, since political interventions could then be kept within bounds.

The rise in labor-force participation of women also has important consequences for the functioning of the welfare state. The EU average of labor-force participation among adult females (age 15-64) has increased from 42 percent in 1960 to 58 percent today, ranging from 44 percent in Italy to 75 percent in Denmark (OECD, Historical Statistics, 1960-1995; Eurostat, 1998a). The background is well known: rationalization of household work, improved education of females relative to men, fewer children per family and probably also increased preferences among females for economic and social independence. It is true that some factors have operated in the opposite direction, hence discouraging female labor-force participation. In particular, do-it-yourself tasks have been stimulated by the gradual increase in the relative price of purchased household services, as explained by "Baumol's law" (Baumol, 1967). Moreover, in the same way as tariffs favor autarky rather than international trade for a nation, income and consumption taxes favor autarky for the household (do-it-yourself) rather than purchases of services in the open market (Lindbeck, 1988). Evidently, in the case of females, these two negative effects on labor-force participation have been overridden by the above-mentioned positive effects (in contrast to the case of males).

By boosting the tax base, increased labor-force participation of females obviously helps finance the welfare state. But it also increases the political pressure for welfare-state spending aimed at helping individuals, mostly females, to combine family life and working life. So far, only a few countries, such as the Nordic nations, have developed elaborate systems of income transfers to families during parental leave and generous subsidies to child care and old-age care outside the family (OECD, 1998a). This is reflected in employment statistics. While the public-service sector accounts for about 25 percent of total employment in the Nordic countries, the average for Western Europe is about 18 percent. (OECD, 1960-1995). In the United States, where taxes are relatively low and the dispersion of wages relatively wide, market purchases of such services (including arrangements provided by employers) are instead relatively large. As a result, while the number of individuals (officially) engaged in personal services in the private sector is only 5-6 percent of the labor force in Western Europe, it is about twice as large in the United States (Elfring, 1988, Table V.3).

Up to a point, subsidies to child care and old-age care outside the household can be justified on efficiency grounds, since they counteract the earlier mentioned tax distortion in favor of household work. More specifically, in the case of small families, this tax distortion discourages the exploitation of returns to scale in child care and old-age care. However, in some Nordic countries, for instance Sweden, such subsidies are now higher than required to

compensate for the tax distortion, at least in the case of families with more than one child. This, of course, means that the government-imposed distortion changes sign.

Subsidized child care outside the household may also promote investment in human capital, at least for children in families with low income and little education. Indeed, there is empirical support for this view (Leibowitz, 1996, Heckman 1999). There may also be an externality argument for subsidies to children in such families, in terms of mitigating social misbehavior later on in life. The issue becomes more complex, however, if we add political complications. For instance, it has been observed in many countries that politicians often have a tendency to combine such subsidies with highly arbitrary rules and costly regulations about the conduct of child care with respect to the physical premises, including space and construction, administration, types of toys, curriculum, etc.

An increase in part-time work also has important consequence for the welfare state. Indeed, part-time work averages about 17 percent of total employment in Western Europe, ranging from 6 percent in Greece to 39 percent in the Netherlands (Eurostat, 1998b; OECD, 1998b). Part-time work is a rather natural choice among adults with small children. But this arrangement is accentuated by tax distortions, since progressive taxes with joint assessment of family income raise the marginal tax rate on the "second" income-earner, who is often a woman. In some countries, this tax distortion is further accentuated by the construction of the social-benefit system, as benefits are reduced if the second adult in a family decides to work longer hours in the open market.

1.2 Labor demand

Recent changes on the *labor-demand side* are also important for the functioning of the welfare state. For instance, how can we guarantee that future pension reforms, designed to boost the labor supply of elderly workers (in the age group 55-70), will actually result in increased employment rather than higher unemployment for such workers? Economists typically react to this question by suggesting policies that encourage lower relative wage rates or reduced payroll taxes for this group of workers. The first alternative is not easy to implement in the context of collective bargaining because incumbent workers, "insiders", who often dominate union policies, may regard such wage adjustments as underbidding of prevailing wages. As an alternative, the government may encourage elderly workers to sign individual wage contracts, for instance, by no longer favoring collective bargaining contracts. But insiders may be able to resist this as well. First, they may have sufficient political clout to prevent such legislation at the outset. Second, they often have market powers to prevent individual outsiders from underbidding wages by threatening to harass potential underbidders or by refusing to cooperate with them in the production process (Lindbeck and Snower,

1988). Lower payroll taxes for elderly workers are perhaps a more realistic alternative than lower relative wages as a way of boosting labor demand for this group. But insiders might use their political powers to resist such policies as well.

In a similar vein, how can we prevent increased labor supply of women from resulting in higher unemployment for this specific group? In the United States, this problem has been solved by the invisible hand, mainly in the market for private services, whereby the demand for female labor has expanded. In the Nordic countries, a corresponding increase in labor demand for women has been brought about via the visible hand of increased government service production. Both "hands" have thus far been tied on the European continent.

Moreover, it is rather generally agreed that the widening of the dispersion of earnings in the United States and the United Kingdom in the 1980s and early 1990s, and the widening of the distribution of unemployment (in percentage points) in many countries in Western Europe, is a result of changes in the composition of labor demand in favor of high-skilled workers. Although some observers have referred to increased international competition for labor-intensive products, the most generally accepted explanation is certainly that during this period, Tinbergen's (1975) celebrated "race between technology and education" was won by the former. Dennis Snower and I (Lindbeck and Snower, 1996) have emphasized a third explanation, namely that the ongoing reorganization of firms, including the decentralization of authority and initiatives, has favored the demand for *versatile* workers, i.e., individuals who are able to face up to increased responsibility (often due to idiosyncratic characteristics). This explanation is consistent with the observation that wage dispersion has recently increased also *within* narrowly defined educational groups, professions and job categories.[2]

This development also makes centralized wage bargaining relatively less attractive to firms, since the reorganization of work increases job heterogeneity. It thus becomes difficult to acquire appropriate information about job characteristics on the central level and hence also to set appropriate wages from an efficiency point of view. Since centralized wage bargaining often results in a squeeze of wage differentials, shifts to more decentralized bargaining are likely to accentuate the tendencies toward wider wage dispersion (Lindbeck and Snower, 2001a). However, since relative wages would then be better adjusted to the composition of demand and supply of various types of labor (more "market-conforming" wages), tendencies toward a wider dispersion of job opportunities and unemployment are likely to be mitigated.

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[2] A hard-line believer in the technological explanation is perhaps tempted to argue that the reorganization of firms is simply a subset of technological change. Even with this terminology, the explanation in terms of reorganization of work would still be of interest in clarifying *what type* of technological change is behind the recent widening of the dispersion of earnings and job opportunities. This explanation also emphasizes the role of versatility rather than just technical skills.

There is no doubt that these developments in the labor market complicate the egalitarian ambitions of the welfare state. So far, however, in countries with elaborate welfare-state arrangements, the dispersion of the distribution of *disposable* income has increased considerably less than the distribution of earnings (Gottschalk and Smeeding, 2000; Atkinson, 1999b, 2000). On this account, the welfare states in Western Europe have had some success in counteracting tendencies toward a wider dispersion of income.

The standard policy prescription to counteract tendencies toward a wider dispersion of wages is to stimulate education and training of low-skilled workers by selective education subsidies so that the supply of high-skilled rises relative to the supply of low-skilled workers. To begin with, this would stimulate social mobility, thereby also enhancing equality of opportunity, since some previously low-skilled workers would become high-skilled. The long-term effect of selective education subsidies on social mobility is a more complex matter. It is stimulated by greater economic resources for investment in education among families with low factor income, which has been characterized as a shrinking "distance effect" in the literature (Hassler et al., 2001). But this effect is counteracted by a negative disincentive effect on education because of smaller wage differences.

General educational subsidies (to all income groups), as opposed to targeted subsidies to low-skilled individuals, have even more complex effects on social mobility. It has been argued by Hassler et al. (2001) that such subsidies tend to stimulate education among the well-to-do more than among other groups, since the former use larger resources than other groups for education. However, it has been argued by others (Nickell and Bell, 1997) that a rise in the general level of education helps individuals to adjust to changes in the composition of labor demand in favor of high skills. This is likely to dampen tendencies to increased relative wages for high-wage groups when the composition of labor demand shifts in the favor of the latter group. Perhaps better education also makes workers more versatile, which would further mitigate tendencies toward a wider dispersion of wages as a result of the reorganization of work. However, to the extent that versatility depends on an innate idiosyncratic ability to accept responsibility, take initiatives and cooperate with others, education and training will not be sufficient to prevent a widening of the dispersion of earnings and job opportunities in connection with the contemporary reorganization of work within firms.

Recent changes in *types* of labor-market contracts have also contributed to more heterogeneity in the labor market. Nowadays, there is a bewildering mixture of permanent ("indefinite") work contracts, fixed-period (temporary) work, project work, bonus systems, stock options, etc. For instance, while workers on fixed-term contracts were probably quite few in Western Europe during the first decades after World War II, the current EU average is

13 percent, with the highest figure for Spain (33 percent) (Eurostat, 1998a). By allowing fixed-term contracts, the hiring of outsiders is likely to be boosted in business upswings. However, as pointed out by Bentolila and Bertola (1990), temporarily employed workers also function as an "employment buffer" for insiders, which further strengthens their job security and market power.

1.3 The unemployment experience

It is well known that during the last quarter of the 20th century, Western Europe has been less successful in promoting full employment than in mitigating tendencies toward a wider dispersion of disposable income – presumably partly because of its highly institutionalized, centralized and regulated system of wage formation, which would be expected to constrain relative wage flexibility. This has not only undermined the welfare state financially. It has also sharpened the insider-outsider divide in society – contrary to the idea that the welfare state should contribute to social integration.

Moreover, while traditional welfare-state arrangements protect pensioners quite well against income risks, such risks have instead begun to increase for young and elderly workers and their families – via high unemployment in the former group and dropout from the labor force in the latter (partly via early retirement). During the last two decades of the 20th century, the youth unemployment rate (individuals in the age group 15-24) has typically been about 15-20 percent in most countries in Western Europe. Exceptions are countries with well-developed apprentice systems, such as Austria, Germany and Switzerland, where the rate has oscillated between 5 and 10 percent. Spain and Italy are extreme cases in the opposite direction; their rates have recently hovered in the interval of 20-30 percent. As mentioned earlier, *employment* rates for elderly workers (55-64 years old) have become as low as 40 percent in the EU as a whole (OECD, 1999).

The reverse causation, from the welfare state to unemployment, is a more controversial issue. It is unavoidable that both equilibrium unemployment (the natural rate or the NAIRU) and unemployment persistence (prolonged deviations from the equilibrium rate) may be accentuated by certain types of welfare-state arrangements. Obvious examples are high subsidies of non-work, such as generous and long-lasting unemployment benefits, social assistance ("welfare" in US terminology) for unemployed workers without work requirements, and poverty traps in connection with means-tested benefits. There are certainly strong ethical (distributional) justifications for such benefits. But the more generous the benefits and the longer they may be kept, the greater the risk that they reduce active job search and job acceptance, in particular when administration is lax – a well-known example of moral hazard. Sufficiently generous subsidies of non-work may also raise the wage costs

for low-skilled workers by boosting the reservation wage, with similar unemployment consequences as in the case of (sufficiently) high minimum wages. However, there is a stronger element of "voluntary" unemployment in the former than in the latter case. These general comments are not very controversial. What *is* controversial is the quantitative importance of these employment effects, and hence the intensity of the conflict between ambitions to provide income support in connection with non-work and a desire to fight long-term unemployment.

The consequences of job-security legislation are an even more complex issue, since such legislation increases the costs of both hiring and firing workers, with ambiguous *direct* effects on the average unemployment rate over the business cycle. More specifically, this type of legislation tends to stabilize (un)employment at the level that happens to exist. If the economy is initially close to full employment, unemployment tends to be stabilized at a low level; this was the situation in most West European countries in the period 1955-1975. The welfare implications are grimmer if unemployment is high initially, for instance, as a result of a recent negative macroeconomic shock, such as in the period 1975-2000. In this case unemployment was stabilized at a high level.

But this is not the end of the story about the unemployment consequences of job-security legislation. Since the market power of "insiders" (incumbent workers) in the labor market is augmented by such legislation, wages are boosted and the demand for workers reduced. If these negative indirect effects on labor demand are sufficiently strong, the *average* unemployment rate over the business cycle would increase even if the direct effects are not negative, or even positive (Lindbeck and Snower, 2001b). Legislation that enhances the bargaining power of unions will accentuate these effects – for instance, laws and regulations that extend collective agreements to non-union workers and non-union firms, and that facilitate sympathy strikes, blockades and picketing. I then assume that unions are more concerned about the welfare of insiders than of outsiders.

Regardless of whether job-security legislation increases equilibrium unemployment or not, there is no doubt that it increases unemployment persistence, i.e., that movements either away from or toward the equilibrium unemployment rate decelerate. Indeed, I have argued elsewhere that the prolonged period of high unemployment in Western Europe during the 1980s and 1990s had more to do with high unemployment persistence than with an asserted increase in the equilibrium unemployment rate (Lindbeck, 2001).

Unemployment persistence may be the result of behavioral adjustments of either outsiders or insiders, or both. It is well known that outsiders' possibilities of returning to work tend to fall by the length of their unemployment spells. This is one reason why both job-security legislation and long-lasting unemployment benefits tend to increase

unemployment persistence. Losses in skills and self-confidence also reduce the re-employment of outsiders. It is often also hypothesized that low investment in real capital during prolonged periods of recession result in sluggish demand for labor in the aftermath, which may also reduce the demand for labor and contribute to unemployment persistence. But adjustment of insider behavior can also contribute to unemployment persistence. One conceivable mechanism is that insiders will use their market powers to push up wages in a subsequent business upswing without much concern for the employment prospects of outsiders, which reduces the willingness of firms to hire workers.

Unemployment persistence may be further accentuated by endogenous changes in the work ethic and social norms in conjunction with long periods of mass unemployment. In a short- and medium-term perspective, ethics and social norms in favor of work, and against living on benefits, are likely to constrain the disincentive effects on work of labor-income taxes and subsidies of non-work. But this inertia is likely to recede if a large fraction of the population is unemployed for long periods of time, assuming that social norms are upheld by the approval or disapproval of employed workers. Thus, the greater the number of individuals who live on benefits, the more socially accepted we would expect this way of life to be (Lindbeck, 1995; Lindbeck, Nyberg, Weibull, 1999). Here, then, is another potentially important mechanism behind unemployment persistence. This is reflected in common talk about "unemployment cultures", although we do not know much about the quantitative importance of this asserted phenomenon.

Needless to say, some welfare-state arrangements may instead *reduce* structural unemployment. The most obvious example is the school system. An upgrading of general skills among low-skilled workers presumably helps them to get jobs, at least if there are effective wage floors because of high minimum wages or high reservation wages due to generous transfers to individuals out of work. Thus, the existence of wage floors, which in themselves may contribute to unemployment among unskilled workers (if the floor is high enough), strengthens the case for policy actions to improve the education and training of low-skilled workers.

Reduced payroll taxes for low-skilled workers is another strategy to boost their employment prospects in the case of rigid money wages. But since such subsidies are reduced when the individual acquires more skill, they necessarily imply increased implicit marginal taxes on investment in human capital. This, of course, may be counteracted by higher education subsidies. In this sense, employment subsidies and education subsidies are complements rather than substitutes.

So-called active labor market policy might also be expected to mitigate structural unemployment via better matching between jobs and workers, which is likely to reduce both

the equilibrium unemployment rate and unemployment persistence. A large number of studies, however, indicate that the quantitative effects of such policies are quite limited (Calmfors, Manning and Saint-Paul, 1998; and Katz, Stanley and Kruger, 1998).[3] One specific problem with so-called "active" labor-market policy is that it facilitates the manipulation of unemployment statistics. Simply by putting a book in the hands of all unemployed workers, and calling them students or trainees, "open" unemployment could in principle be reduced to zero without any increase in regular employment. Moreover, not only workers with early retirement but frequently also "discouraged" workers are often removed from labor-force statistics. This means that the employment situation in a country is often better described by the fraction of individuals of working age who are employed – "employment rates" for short -- than the unemployment rate. While these rates were about the same, approximately 65 percent, in most OECD countries in the early 1960s, the figures have recently diverged considerably. In the United States and the Nordic countries, the rates had reached the interval 70-77 percent by the end of the 1990s, while the EU average had fallen to about 58 percent.

The exclusion of outsiders from the labor market is accentuated by a weakening of their social network. The division of workers into insiders with good and stable jobs and outsiders with recurrent periods of (often prolonged) unemployment, or work in the informal sector, also has wide repercussions outside the labor market. Since outsiders have smaller economic resources than insiders, they are often forced to abstain from social activities enjoyed by others. Moreover, many important welfare-state entitlements and subsidized services are tied to current or previous work, which contributes to the exclusion of outsiders from such welfare-state arrangements. In particular, youngsters without a foothold in the labor market often have to rely on quite ungenerous, often means-tested social assistance – when they do not live on handouts from their parents. Here then is a clear example of a conflict between incentives and distributional aspects. On the other hand, when expected future benefits are (positively) tied to work, such benefits have positive incentive effects on work, which counteracts various work disincentives of taxes and means-tested benefits.

Conditions in the housing market may also contribute to social exclusion. There is always a general tendency toward segregation in the housing market based on income differentials. A specific type of segregation may arise, however, in urban housing markets with rent control and a related housing shortage (excess demand for apartments), i.e., a

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[3] It could be that these studies underestimate the long-term positive employment effects of such policies. More specifically, it is at least conceivable that unemployed workers involved in active labor-market programs, such as training and public works, do not lose their skills and work habits as fast as do openly unemployed workers. If so, active labor-market policy may make the supply of skilled labor more elastic in *subsequent* booms,

division between housing-market insiders, with direct apartment contracts, and housing-market outsiders without such contracts. In this situation, apartments are mainly acquired via personal networks and black market transactions. Low-income groups, including many young people and immigrants, then have particular difficulties in securing direct apartment contracts. We would also expect a positive correlation between being an outsider in the labor market and the housing market.

The punch line of this discussion about new tendencies in the labor market is that the welfare state has a long way to go in order to adjust to changing tides in the structure of the labor market.

2. Changes in the Family

2.1 Household types and life cycle

The ambitions of the traditional welfare state to protect male-breadwinner families against income losses explain its emphasis on full employment, unemployment insurance, sick-leave insurance and pensions for the breadwinner and his survivors in case of death. Recent changes in household structure, life cycle, and values make this type of welfare state less relevant than it used to be. In particular, the male-breadwinner household now constitutes less than a third of families in most developed countries (Mclanahan, Casper and Sorensen, 1995, Table 11.3). Two-earner households constitute (on average) about 40 percent of households in the Nordic countries and about 25 percent in Southern Europe (Italy and Spain), with other countries in Western Europe in-between, usually about 30 percent (Luxembourg Income Statistics). Single-parent households now average 14 percent of households in EU countries, ranging from 7-8 percent in Greece and Spain to 23 percent in the UK (Eurostat, 1998b).

While two-earner households exhibit relatively little poverty, it is well documented that households with a single adult, in particular with children, are highly exposed to economic distress, and even poverty. For instance, child poverty in one-earner households is often three or four times as frequent as the corresponding rates in two-earner households (Mclanahan, Casper and Sorensen, 1995; Bradbury and Jäntti, 2001). A basic reason is that labor-force participation among single adults with children is low in most countries. Another reason is that returns to scale in household service production cannot be exploited in such households. Moreover, there are no adult household members with whom to pool income risk. Indeed, besides long-term unemployment, single parenthood seems to be the most

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thereby contributing to lower structural unemployment in later upswings. So far, there is not much systematic empirical information about such conceivable long-term effects.

important socioeconomic factor behind poverty, including child poverty (Esping-Andersen, 1999, pp.161-163).

Although explanations of the rise in single parenthood are manifold, it is obvious that various welfare-state arrangements also have an impact. There is a strong ethical case for government support to single parents – in fact, females account for 84 percent in Western Europe (Eurostat, 1998b) – not least to mitigate child poverty. But it is unavoidable that women then find it financially easier to become single mothers, via childbearing as well as divorce – an obvious example of moral hazard of welfare-state policies. It is also likely that social norms against being a single mother have weakened in recent decades. There is probably mutual causation in this case: while weaker norms against being a single mother result in more of them, more single mothers are likely to weaken the norms.

The generosity of welfare-state support to single motherhood differs considerably among countries. On the European continent and in the United States, such support is usually modest, and mainly confined to transfer payments. In the Nordic countries, not only are transfers more generous; they are also combined with priority for single mothers to receive strongly subsidized child care outside the household. The latter, of course, helps explain the high labor-force participation of single mothers in these countries. For instance, more than 80 percent of single mothers in Sweden worked in the early 1990s, while the EU average was 68 percent and the figure for the British Isles only about 50 percent. The situation in the United States is not much different, about 45 percent (Gornick, 1994). The question of how the issue of single motherhood should be dealt with politically is a complex and controversial issue. The policy trend is to require them to work or acquire education and training, which often presupposes subsidized child care.

Another aspect of the increased heterogeneity of households is a tendency of individuals to choose a less “linear” *life cycle* between education, work and non-work than earlier. Specifically, individuals tend increasingly to shift back and forth between periods of work, studies, sabbatical, work abroad, etc. One explanation may be that higher income in society results in increased diversity of individual “life projects”, similar to the way increased income results in more diversity of product demand. But it is also likely that *preferences and attitudes* are gradually undergoing change in the sense that individuals want to realize idiosyncratic life projects with given income. Such “individualization” of preferences may be a result of higher education and/or demonstration effects from other countries. It is clear that traditional welfare-state arrangements, based on the assumption of a linear life cycle, are too inflexible to satisfy the needs and desires of individuals today to finance periods of non-work for reasons other than bad health, unemployment or old age.

Moreover, pensions are often tied to income earned late in working life, such as in the last ten or fifteen years of work. In a society with income fluctuations over the life cycle, sometimes with particularly high income early in life, such arrangements are not appropriate. From this point of view, there is a stronger case than before to tie pensions to lifetime income, or lifetime contributions, rather than to income late in working life.

Increased family instability in many countries after World War II has also created problems for social-insurance entitlements. The traditional system was largely designed to protect widows and their children. But since females increasingly have their own income from work, the need for special social-insurance benefits for widows has declined. Here a delicate normative issue is how fast pension rights for widows should be phased out. (In Sweden, out-phasing has been so rapid that many widows – a group with little political clout – have become severely disadvantaged). Instead there is a growing social problem for divorcees when one partner (usually the woman) has not yet accumulated much pension claims. The reason is that pension claims are usually not split between spouses in the event of separation – even less so between other types of cohabitants. In some cases, this is bound to create economic hardship in old age for at least one partner. Here, then, is another example where contemporary welfare-state arrangements are not well adjusted to today's social conditions.

Recent socioeconomic changes also have important implications for housing policy. Greater instability of family structure – due to divorce, remarriage, changes in cohabitation patterns and ambitions among the young to set up housekeeping on their own – has made rent control, with a resulting "housing shortage" (excess demand for housing), a more severe social problem than earlier. Unstable families require a flexible housing market, which presupposes equilibrating rents ("market rents") with a reserve of empty apartments (of a few percent) at every point in time.

2.2 Individual responsibility

Another idea that seems to be gaining popularity among politicians involves encouraging greater individual and family *responsibility* – a parallel to the increased responsibility recently given to individual workers in reorganized firms. This tendency may be seen as a reaction against the paternalistic notion that the government, in popular jargon, should take care of an individual from "cradle to grave". One example concerns the earlier discussed proposals to shift, completely or partially, to fully funded pension systems with individual accounts and individual choice of portfolio manager. A more radical proposal, designed to give the individual more responsibility for his own income security, is to replace the many different types of welfare-state arrangements currently in effect with a unified

system of *compulsory saving* with individual accounts and “drawing rights” (Fölster, 1999; Orzag and Snower, 1999). The characteristic feature of such a system is that an individual would be allowed to draw on his account before retirement for certain specified purposes, such as education, sabbatical, sick leave and unemployment. What remains in the account at the time of retirement would determine the size of his pension. Thus, an individual would have greater freedom than today to reallocate welfare-state entitlements over the life cycle according to idiosyncratic preferences. This reform fits nicely both with individuals’ desire to choose a less linear life cycle than before and with suggestions to create more individual responsibility. For the time being, the most obvious real-world example of such a system is the central provident fund in Singapore.

The new emphasis on “work-fare” rather than “welfare”, not just for single mothers, is another of attempt to boost individual responsibility. More generally, politicians and policy advisors seem to be increasingly sympathetic toward shifting away from policies that subsidize non-work. There is a tendency either to take a neutral stance regarding the choice between work and non-work (as in the case of lump-sum transfers) or, more frequently, to adopt policies that actively promote work (as in the case of employment subsidies or tax credit for low-wage groups).

Even leaders of traditional leftwing parties, such as the UK Labor Party, have recently emphasized the individual’s responsibility for his own economic situation. Some leaders of the Democratic Party in the US, including the Clinton Administration, have expressed the same view; indeed, this vision is behind the 1997 social assistance reform in the United States – designed to abolish “welfare as we know it” in President Clinton’s words. Though macroeconomic efficiency would clearly be improved by such a shift, the consequences for the financial position of the government are less clear.[4]

2.3 Welfare-state services

I have already pointed out that changes in family structure – in particular, the growing incidence of two-earner households and single-parent households – are bound to increase the demand for new types of welfare services, such as child care and old-age care. Baumol’s law certainly will raise aggregate health-care and old-age care spending as a share of GDP. It is also conceivable, though far from established that increased longevity and advances in

[4] The effects depend partly on the elasticity of labor demand with respect to real wage costs. While some authors, such as Sinn (2000), have argued that the financial position of the government will improve, others such as Burtless (1994), assert that the opposite is likely to be the case.

complex and resource-intensive medical care tend to work in the same direction.[5] Moreover, old-age care needs cannot be fully transformed into effective demand without an expansion of old-age care insurance or tax-financed old-age care. To satisfy varying individual needs and preferences, and to allow considerable freedom of choice, insurance systems are required at least as a complement to tax-financed, rationed old-age care.

Another potentially important future problem in the health sector is how to use emerging genetic information about individuals. Should this, and will it, be used to differentiate health insurance premium and priority among individuals in hospital queues?

In some countries, again notably the Nordic nations, subsidies to welfare services are currently much higher when produced in the public rather than the private sector. As a result, personal (human) services – education, health, child-care and old age care – have largely been socialized in these countries. But the tax system favors home production of services *in general* – including repairs, cleaning and gardening. As a result, while the production of personal services in these countries has moved from families to the public sector, a number of "material services" have shifted from the market to the household (Lindbeck, 1988). Karl Marx would have been surprised by this combination of socialized household production of personal (human) services and a shift of various material services from the market to the household – at the same time that manufacturing production has remained in the private sector.

It is not obvious why governments in some countries thus appear to have created near-public-sector monopolies for important personal services. One conceivable explanation is that such policies tend to change the distribution of income to the disadvantage of high-income families that choose to buy non-subsidized private services, at the same time as they have to pay taxes to finance services for others. They then have to "pay twice" (Besley and Coate, 1991; Blomquist and Christiansen, 1995). Another explanation may be that public-sector service monopolies make it easier for politicians and public-sector administrators to control type, quality and distribution of such services. But why would a majority of voters support such arrangements, which largely do away with individual freedom of choice in these areas? Maybe only a small minority of voters are concerned about freedom of choice for services such as child care and old-age care, in particular if most families are basically content with the quality of government-produced services. The absence of freedom of choice may be a serious concern only for a small minority of voters, including those adhering strongly to the *principle* that individuals should be free to choose.

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[5] A study in Sweden suggests that the *per capita* cost of in-house health care is about six times higher during the six last years of life than for the average citizen (Lagergren and Batljan, 2000). Indeed, individuals above 75 years of age account for a very large fraction of total health spending.

However, higher income and better education as times go by are likely to increase households' interest in obtaining more individually adjusted services and hence more individual freedom of choice in the future. Again, this would be a parallel to the observed high income elasticity of demand for product variability in the case of private goods and services. As a result, welfare states that favor public-sector service monopolies are likely to be less and less in touch with the values of a large number of their citizens.

As we know, it is not difficult administratively to combine freedom of choice with subsidies to "social services". Service checks (vouchers) allow households to buy services wherever they like, or to cash the checks and take care of their own children or elderly parents themselves. A usual argument against such reform is that it may increase institutional segregation along the lines of parental income and education. But if there is considerable housing segregation, service vouchers will give low-income families living in geographical areas with poor service institutions a chance to acquire services from better institutions in other geographical areas – today a privilege mainly confined to the rich. Vouchers may then, in fact, contribute to institutional *desegregation* of education and old-age care services.

But vouchers may certainly give rise to segregation in the school system in terms of *ability* – "meritocracy" – since public-sector schools may lose some of their best students. However, the net effect of vouchers on public-sector schools is not necessarily to harm their quality since increased competition is likely to stimulate *all* schools to improve their efficiency and adjustment to children's needs and parents' wishes. Indeed, a comprehensive study in Sweden suggests that the quality of education in public-sector schools has been stimulated by competition from private schools, so called "free schools" (Bergström and Sandström, 2001). It is not obvious why the case for freedom of choice, competition and innovation (experimentation) should be weaker in these areas than in the case of ordinary consumer goods. There is, however, a difficult political question of whether individuals should be allowed to *add* cash payments to the vouchers to obtain more expensive education for their children.

Contemporary changes in information and communication technology (ICT) are also likely to have important consequences for public-service production. Trivially, ICT reduces the individual's costs of acquiring information about public-sector activities, including rules concerning social insurance and welfare-state services. The Web also enables individuals to learn from the experiences of others regarding specific public-sector services, evaluated from the consumer's point of view. ICT also makes it cheaper to administrate individually adjusted, and hence more differentiated, social insurance systems, including both pension systems with individual accounts and compulsory saving with individual drawing rights.

Moreover, new fora gradually emerge on the Internet whereby individual citizens can express their opinions not only about goods in the private sector, but also about specific public-sector services – such as child care, education, health care and old-age care at specific institutions. An individual will be able to air his views not only on the Web site of politicians and public–sector institutions, but also at non-government sites: virtual communities, news groups and chat groups managed by independent agents. When many individuals openly express their views in cyberspace, politicians and public-sector administrators will find it difficult to neglect complaints and suggestions (Lindbeck and Wikström, 2000).

In other words, the Internet is likely to enhance the individual's "voice option" regarding public-sector service. This is important since voting is a very inefficient way of voicing opinions about specific public-sector services, such as a particular school or child-care institution. After all, general elections only enable an individual to comment on broad "packages" of policy measures proposed by political parties or individual candidates. A better voice option via the Internet would be even more powerful if it were accompanied by an expanded exit option. Correspondingly, an exit option is more valuable if the individual is well informed, for instance via the Web. Thus, voice options by way of the Web and exit opportunities by way of voucher systems are highly complementary mechanisms.

2.4 Family orientation vs. service orientation

The developments discussed above – concerning family structure, life cycle and values – challenge both the family-oriented, transfer-heavy welfare states on the European continent and the more public-service-oriented welfare states in the Nordic countries. The former type of welfare state infringes on the ambitions of females to participate in the labor market, and hence also to achieve more independence in relation to the "male breadwinner".[6] The fact that birth rates today are not higher in these countries than in countries with higher labor-force participation among females suggests that low labor-force participation among females is no guarantee for high fertility. The availability of child care outside the family is likely to mitigate the conflict between female labor-market participation and child rearing (Esping-Andersen, 1999, pp. 67-72).

Generally speaking, the Nordic welfare states are better adapted than family-oriented welfare states to the ambitions of females to participate in the labor market. But the "cost" is high tax rates and, in reality (though not by necessity), also strongly restricted freedom of households to choose a service provider. In practice, these countries also exhibit strong

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[6] Child care by parents and other relatives is important in all countries. Esping-Andersen (1999, p. 64) reports that such child care accounts for about 30 percent of total child care in Denmark, 50 percent in the US and 83 percent in Britain – and probably the lion's share also in Germany, Italy and Spain.

gender segregation in the labor market – a concentration of females in the public sector and men in the private sector. For instance, in Sweden 51 percent of the female labor force work in the public sector, and 73 percent of the employees in this sector are females (Statistics Sweden).

Some advocates of Nordic-type welfare states regard generous transfers to households as instruments for making individuals less dependent on the labor market – a "de-commodation" of individuals in Marxian jargon (Polanyi, 1944). But somewhat paradoxically, it is precisely in this type of welfare state that married (and cohabiting) women are actually "commodized", since their high labor-force participation makes them *directly* dependent on the labor market (Esping-Andersen, 1999). Moreover, a common assessment is that families with two adult labor-market participants often find that time is extremely scarce, a point made forcefully long ago by Burenstam Linder (1970). Married females have adjusted to this dilemma not only by working part-time but also by cutting the number of hours of work in the home as compared to housewives (Esping-Andersen, 1999, p. 629).

The question of what would be an appropriate strategy for welfare-state reforms from a normative point of view depends, of course, on what type of society we strive to realize. For instance, ambitions among females to participate in the labor market cannot be satisfied unless households obtain outside services for child care and old-age care. One way of achieving this is through a US-type strategy of high flexibility (and wide dispersion) of relative wages, possibly combined with negative income taxes associated with work (such as "work-in-benefits" or tax credit to individuals with small earnings). Another way is the Nordic strategy of generous subsidies to child care and old-age care outside the household. In turns out that total social spending (public-sector *plus* private) does not differ dramatically between these two types of countries even though the proportions between government and private financing and provision differ considerably (Forsell *et al*., 2000; Esping-Andersen, 1999, pp.175-178).

3. Macroeconomic Developments: Instability, Growth and Internationalization

3.1 Short-term macroeconomic instability

Recent experiences of *short-term* macroeconomic fluctuations in developed countries also provide interesting lessons for the welfare state. The traditional Keynesian view, of course, was that generous welfare-state arrangements help reduce cyclical fluctuations since disposable income is held stable by the "automatic fiscal stabilizer". This theory is still relevant in the case of modest business cycles. However, recent experience, for instance in

Finland and Sweden, suggests that the automatic fiscal stabilizer may turn into an automatic de-stabilizer in the case of *huge* negative macroeconomic shocks. In particular, this may happen in countries where the budget balance is very sensitive to changes in macroeconomic activity, which is the case in countries with highly ambitious welfare-state arrangements. There are at least two reasons for such a destabilizing effect. If the budget deficit and, as a consequence, public-sector debt explode, lenders may lose confidence in the government's ability to service the galloping debt. They then require higher – possibly much higher – interest rates, with restrictive macroeconomic effects as a result. The crowding out of private spending may then be much larger than that predicted by traditional static Keynesian (IS-LM) models (where the crowding-out effect can never be larger than the initial stimulation of aggregate demand via a higher budget deficit).[7]

Another reason why galloping government debt during a recession may have restrictive rather than expansionary macroeconomic effects on the national economy is that households may lose confidence in the government's ability to grant promised welfare-state entitlements. A predicted effect is a rise in the household saving rate – possibly an even stronger rise than according to the "Ricardian equivalence" hypothesis. This also tends to deepen a recession.[8]

In the case of both lenders and potential beneficiaries of transfer payments, the asserted restrictive effects of galloping government debt are related to destabilization of expectations. It is conceivable that recent experiences of galloping public-sector debt have made both types of agents more aware of these and other political risks. In this sense, private agents have become more forward looking than before – perhaps even without having read the literature on rational expectations! All this means that the harmony which used to be assumed between the welfare state and macroeconomic stability, in the Keynes-Beveridge tradition, has been shattered to some extent (Lindbeck, 1997a).

3.2 Economic growth

The fall in long-term economic *growth* from the mid-1970s is another important macroeconomic experience of considerable relevance for the contemporary welfare state. The large increase in the budget deficits in most developed countries in the 1970s and 1980s is most realistically perceived as the result of this slowdown. While the development of the tax base became more sluggish, various welfare-state entitlements continued to expand since they

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[7] In the early 1990s, real interest rates on private loans in Finland and Sweden increased to 10-15 percent.

[8] Again, the severe macroeconomic crisis in Finland and Sweden in the early 1990s is an example. For instance, in the early 1990s, the household saving rate increased from *minus* three to *plus* 9 percent, which corresponded to a fall in aggregate demand for domestic output by about 7 percent. The difficulties in stimulating household consumption via budget deficits in Japan in the 1990s may be a similar phenomenon.

are often based on earlier macroeconomic development. This experience simply illustrates that the financial viability of the welfare state in a medium-term perspective is crucially related to the macroeconomic growth rate.

But what about the possibility of reverse causation – from the welfare state to long-term economic growth? The most obvious example of *positive* growth effects, at least during a period of transition, is probably government subsidies to investment in human capital – education, training programs and health care (though perhaps not in the case of retired individuals). It is also generally believed that income protection contributes to social accord, and that this in turn promotes economic growth by preventing disruptive social conflicts. Indeed, there is some empirical support for this hypothesis (Alesina *et al*., 1996). It has also been argued by Hans-Werner Sinn (1996) that increased income security provided by various welfare-state arrangements promotes economic growth, since entrepreneurs will incur smaller risk. This cannot possibly be a decisive point. The big risk for entrepreneurs involves losing their equity capital, and welfare-state arrangement or taxes do not compensate for such risks. As a rule, the probable alternatives for entrepreneurs are to start a new firm or accept becoming an employee rather than living on welfare-state benefits, such as unemployment benefits or social assistance.

The most widely quoted welfare-state arrangement with *negative* effects on GDP growth, at least during a period of transition, is probably the introduction of pay-go social insurance systems, since the overcompensation to the first generations of pay-go pensioners increased their consumption and hence reduced aggregate saving. Moreover, as pointed out, in particular by Martin Feldstein (1995), existing capital-income taxes are likely to have depressed physical capital formation over a number of years. Various asymmetries in such taxes also distort the allocation of investment among sectors and firms, with negative effects on economic growth. Similarly, progressive taxes on earnings are likely to have reduced the incentives to invest in human capital, hence counteracting the positive effects of various educational subsidies on such investment. The net effects of these changes would be expected to be negative for economic growth, at least during a period of transition.

I would also hypothesize that these effects will be particularly pronounced if welfare-state egalitarianism spreads to the business sector. An example is attempts by the government to squeeze profits as part of redistribution policy, since real investment then tends to fall. If the government, as in Sweden during the 1960s and 1970s, responds to such a fall by selective subsidies to ailing firms, the allocation of resources is bound to be distorted, and economic efficiency and (at least during a period of transition) the growth rate to decline. A

combination of double taxation of profits, high wealth taxes and high inheritance taxes is also likely to harm the entry and expansion of small firms.[9]

The basic issue, however, is not whether the welfare state *as a whole* boosts or retards economic growth, but rather at what level of welfare-state arrangements, and related financing, the negative effects of additional spending start to dominate the positive effects. This way of looking at the issue is evidently based on the observation that the marginal disincentive effects of explicit and implicit taxes increase with the initial rates, and the assumption that the growth-enhancing effects of additional welfare-state spending do not rise indefinitely by higher government spending. This is the background for the familiar hypothesis of a non-linear (concave) relation between welfare-state spending and economic growth, with an internal maximum point. It is also generally understood that the consequences of welfare-state arrangements (and their financing) for economic growth depend crucially on the *exact design* of these arrangements – a point forcefully made, for instance, by Atkinson (1999a).

The non-linearity of the effects of government spending on economic growth lends doubtful value to many linear regressions of this relation in the literature. Any chance of discerning the consequences of government spending on economic growth in countries with high spending requires a sample restricted to such countries, usually with rather high per capita income. However, because of the complex relation between government spending and economic growth, and the many factors that may influence the latter, we should be skeptical of all highly aggregate studies in this field.[10]

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[9] Indeed, in Sweden during the 1960s and 1980s, tax rates on capital investment by owners of small firms were often close to, or even higher than, one hundred percent in real term. I have hypothesized that this "extension" of redistribution policies to the business sector was an important explanation for the slow growth in Sweden relative to other countries during the last quarter of the 20th century (Lindbeck, 1997b).This policy was gradually abandoned in the late 1980s and early 1990s.

[10] Recent studies, which are confined to countries with high per capita income, include Fölster and Henrekson (2000). Both studies report a strongly negative and quite roust negative relation between public-sector spending and economic growth. [*] I am grateful to Jon Dutrieux Anderson and Alessandra Bonfiglioli for help in collecting data. Anders Björklund, Peter Heller, Richard Musgrave and Solveig Wikström provided useful comments on a draft of the paper.

[10] According to projections by the EU Secretariat, the rules in effect in the early 1990s imply that the average age-dependency ratio (the number of retirees relative to the number of individuals of working age) will increase by 50 percent between the mid-1990s and 2020 in the EU area (European Community, 1994).

[10] A hard-line believer in the technological explanation is perhaps tempted to argue that the reorganization of firms is simply a subset of technological change. Even with this terminology, the explanation in terms of reorganization of work would still be of interest in clarifying *what type* of technological change is behind the recent widening of the dispersion of earnings and job opportunities. This explanation also emphasizes the role of versatility rather than just technical skills.

[10] It could be that these studies underestimate the long-term positive employment effects of such policies. More specifically, it is at least conceivable that unemployed workers involved in active labor-market programs, such as training and public works, do not lose their skills and work habits as fast as do openly unemployed workers. If so, active labor-market policy may make the supply of skilled labor more elastic in *subsequent* booms, which may then keep down structural unemployment at that time. So far, there is not much systematic empirical information about such conceivable long-term effects.

3.3 Internationalization

How much then has the welfare state been influenced by the gradual internationalization of markets? It is self-evident that the ability of governments to control domestic interest rates has dwindled, and that as a result the risk of higher interest rates has increased in the case of galloping public-sector debt. It is also obvious that the possibilities of taxing capital much higher in one country than in other countries have recently receded considerably, and that this may generate “downward tax competition” in the case of capital-income tax rates. Revenues from capital taxes, however, usually comprise only a few percent of total government tax revenues. Thus, the main problem with the loss of national autonomy in capital taxation is not that it becomes more difficult to finance the welfare state. Negative consequences for domestic capital accumulation are a more severe problem. This is the case, in particular, for small and medium-sized firms that cannot easily borrow on international capital markets.

The consequences of increased internationalization of product and labor markets are more complex. To the extent that the internationalization of product and labor markets is responsible for the recent widening of the distribution of earnings in some countries, it has certainly become more difficult to realize egalitarian welfare-state ambitions. A long time ago, Gunnar Myrdal (1968) pointed out that countries with generous welfare-state arrangements and strongly egalitarian ambitions could be expected to pursue quite restrictive immigration policies in the case of low-skilled individuals. The planned enlargement of the EU is likely to increase the pressure for immigration of low-wage workers to Western Europe. Against this background, some authors, such as Hans-Werner Sinn (2000), have suggested that benefits for immigrants from areas outside Western Europe should be tied to the benefit levels in their home countries, rather than their host country. A motive is to reduce downward benefit competition among West European countries.

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[10] The effects depend partly on the elasticity of labor demand with respect to real wage costs. While some authors, such as Sinn (2000), have argued that the financial position of the government will improve, others such as Burtless (1994), rather assert that the opposite is likely to be the case.

[10] Child care by parents and other relatives are important in all countries. Esping-Andersen (1999, p. 64) reports that such child care accounts for about 30 percent of total child care in Denmark, 50 percent in the US and 83 percent in Britain – and probably the lion’s share also in Germany, Italy and Spain.

[10] In the early 1990s, real interest rates increased to 10-15 percent on private loans in Finland and Sweden.

[10] Again, the severe macroeconomic crisis in Finland and Sweden in the early 1990s is an example. For instance, the household saving rate increased in the early 1990s from *minus* three to *plus* 9 percent, which corresponded to a fall in aggregate demand for domestic output by about 7 percent. The difficulties to stimulate household consumption via budget deficits in Japan in the 1990s may be a similar phenomenon.

[10] This policy was gradually abandoned in the late 1980s and early 1990s.

[10] Recent studies, which are confined to countries with high per capita income, include Fölster and Henrekson (2000), who report a strongly ntive and quite roust negative relation between public-sector spending and economic growth.

So much for capital and (low-skilled) labor. It is more difficult to judge whether national autonomy has dwindled much, or is likely to do so in the future, in the case of taxation of human capital. Certainly, several factors have increased the mobility of human capital: internationalization of firms (including increased importance of multinational firms), improved knowledge of foreign languages among younger generations and better information about conditions in other countries. Thus, the risk that countries with high and strongly progressive taxes will face a brain drain has certainly increased. While countries have some control of immigration of low-skilled workers through quantitative regulations, attempts to counteract emigration of high-skilled individuals have to rely on other methods, including economic incentives. An individual's choice of country of residence, however, does not depend mainly on *marginal* tax rates, but rather on his *total* tax burden relative to *total* benefits received. It is mainly this relation governments should consider when worrying about brain drain in connection with welfare-state policies. However, it is too early to say whether much more coordination and centralization of welfare-state and tax arrangements among rich countries are necessary in order to limit brain drain and downward tax competition in the case of human capital.

There is, however, another way of looking at the increased obstacles for national governments to raise taxes in a more internationalized world economy. For instance, these obstacles may be seen as protection of minorities against threats of being "robbed" by a majority. Considering various "imperfections" in the political process, also in democracies, these obstacles may alternatively be regarded as protection of a majority of voters against non-representative politicians trying to exert ever more political powers.

Closer international integration of labor markets has also strengthened the case for making social insurance entitlements internationally transferable – a parallel to attempts to make occupation pensions transferable among production sectors in the domestic economy. One way of bringing this about is to base entitlements on individual accounts that the individual can take with him when shifting his domicile from one country to another. While such accounts are typical for fully funded benefit systems, internationally transferable *notional* accounts can be constructed in the context of pay-go systems.

4. Concluding Remarks

From the point of view of the welfare state one important development in the labor market is concerns changes in demography. The most pressing policy adjustment in this context seems to be arrangements that raise the average pension age and facilitate employment of workers in the 55-70 age group. There is a strong case for policy measures that mitigate the emerging insider-outsider divide in society, for instance, by reducing the

market power and privileges of insiders and by enfranchising outsiders. Additional policies that enhance more flexible relative wages and higher labor mobility would also help mitigate unemployment persistence.

Changes in the labor market are clearly intertwined with changes in family structure. I have emphasized the well-known shift from "one male-breadwinner families" to a structure dominated by two-earner families, combined with a high frequency of families with a single adult. The most important consequences of these developments for the welfare state are perhaps new needs for personal services outside the household. Increased family instability, greater heterogeneity of life cycles and greater diversity of needs for income protection and personal services also have important consequences for the welfare state. In the long run, political pressure for greater freedom of choice concerning types of income protection and personal services will probably also emerge. The ICT revolution provides new tools for such individual adjustments, based on a combination of stronger voice and increased exit options of individuals by way of voucher systems.

Changes in the macroeconomic environment also require adjustments of welfare-state arrangements. There is certainly a case for making the budget balance less sensitive to large macroeconomic changes – if we are concerned about the destabilization of expectations among lenders and households. The traditional economist's concern about disincentive effects that harm economic efficiency and economic growth should also be taken seriously, at least in countries with high marginal tax rates and highly asymmetric taxes for different sectors and different production activities.

How then have countries with different welfare regimes responded to "changing tides" for the welfare state? In most countries, not much has yet been done to adjust the welfare state to new income risks and new service needs. The Nordic countries are an exception in the case of support of families with small children. This is an important explanation as to why labor-force participation in these countries is as high as in the United States, where it is kept up by wide wage dispersion and relatively low taxes for potential buyers of private services. In one important respect, however, the Nordic countries have moved closer to the welfare-state regimes on the European continent: benefits have recently been tied more closely to contributions already paid, rather than constituting "citizens' rights" independent of contributions.

In the UK, there has been a pronounced shift from universal to means-tested benefits. Levels have also been reduced considerably, for instance, in the unemployment benefit system. In the United States, the level of social protection fell gradually during the 1970s and 1980s. For instance, the value of social assistance (aid to families with dependent children, AFDC) dropped to a quarter of average earnings by 1989, and the percentage of unemployed

workers receiving insurance benefits declined from about 70 percent in the mid-1970s to 33 percent in 1989 (Moffitt and Jovanovic, 1990, p. 210). During the same period, the minimum wage dropped to less than 40 percent of average earnings. Thus, there has been some dismantling of the welfare state in both major Anglo-Saxon countries.

Countries on the European continent, emphasizing transfers rather than services, have instead continued to expand transfers during the 1980s. Recently, however, some of these countries have reduced the generosity of certain benefit systems, such as in the case of early retirement (Italy and Holland).

One explanation for the difficulties in adjusting welfare-state arrangements to new socioeconomic conditions and new values is, of course, that the demand for new arrangements has to compete with established programs for which there already exist interest groups, often with strong political influence. In line with Khaneman-Tversky-type theories, it is also natural to assume that voters who lose benefits that they already have will be more perturbed than are voters who do not secure new benefits. Hence the risk of losing votes among the former is probably greater than possibilities of gaining votes among the latter. The outcome is either that new arrangements will not develop in response to new demands (the situation in the UK and in most countries on the European continent), or that new arrangements are *piled* on top of the old ones, resulting in very high tax rates (the Nordic "solution").

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