Chapter 7

The Viability of the Welfare State[1]

James J Heckman

Introduction

The welfare state is a late 19th century invention. Its provisions for economic security are now accepted as rights in many countries. Franklin Delano Roosevelt proclaimed 'Freedom from Want' as one of his Four Freedoms. The Universal Declaration of Human Rights adopted by the UN goes further in guaranteeing the right to work, the right to a standard of living with adequate health and well-being, including food and medical care in the event of an emergency. Many perceive such social rights as an integral aspect of a well-functioning state, and covered under the rule of law.

The case for the welfare state that motivates these proclamations is that it protects its citizens against the consequences of risks beyond their control (Agell 1999). The case against the welfare state is that it blunts incentives and reduces productivity. Supporting this point of view is that the economic performance of many welfare states has been poor. There has been a rapid run-up in unemployment in most Western European welfare states in the past 20 years. When properly measured, many Western European welfare states have much higher rates of unemployment than are reported in the official statistics. Incentives to withdraw from work, to go underground, to evade taxes, to retire early and not to produce are high.

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

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

In the current environment, a premium has emerged for flexibility and responsiveness of economies. High levels of workforce skill and a regulatory environment that supports change allow economies to benefit from new opportunities. An economic order that was well adapted to the more stable and predictable environment of the 1950s and 1960s and that had a large role for unskilled labour to play

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has become dysfunctional in the early 21st century. The opportunity cost of security and preservation of the status quo – whether it is the status quo technology, the status quo trading partner or the status quo job – has risen greatly in recent times. While reforms have been made in Europe, they have mostly been small-scale in nature. Europe has to run and not walk to keep up with the pace of global change, and it is barely even walking, although by European standards, it is rapidly reforming.

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

Themes of this chapter

This chapter develops five broad themes. First and foremost, people respond to incentives, and responses are often very strong. It is very dangerous when designing laws and regulations to underestimate the ingenuity of economic agents in pursuing their self-interest, the responsiveness of the economic system and the broader consequences of regulation on all members of society. Many advocates of the rule of law promote principles like universal economic security, the right to organise trade unions or the right to a minimum standard of living without accounting for the economic costs of such provisions. The rights granted to some, if they are enforced, often reduce the welfare of others. For example, trade unions often raise benefits to members at the cost of higher prices for consumers, lower profits for shareholders, and lower wages for non-union workers. The welfare state often benefits insiders at the expense of outsiders (Lindbeck and Snower 1989).

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

Thirdly, the term 'welfare state' is far too broad. At least four models are often mentioned (see Sapir 2006) and these categories are surely too crude.

(1) The Nordic/corporatist model (Scandinavia, Finland, Netherlands), which provides a high level of security for workers, heavy reliance on active labour market policies, low inequality, high levels of taxation of labour income, relatively low levels of taxation of capital income, very high levels of education and high levels of government activity, generous grants that are not means tested, high levels of wage compression, centralised unions and high levels of concentrated unions and wage setting.
(2) The Continental model (Austria, Belgium, France, Germany and Luxembourg). Its features are heavy reliance on insurance-based nonemployment benefits and old-age pensions, strong unions that are not all centralised, lots of regulation, inflexibility in labour markets and compressed wage distributions. It shows a marked inability to adjust to change.
(3) The Mediterranean model (Italy, Spain, Portugal, Greece). It is characterised by reliance on employment protection (lifetime jobs), with union-covered sectors with compressed wages, concentrated spending on old-age pensions and high segmentation of entitlements and status.
(4) The Anglo-Saxon model (US, Canada, UK, New Zealand and Australia). It is characterised by social assistance only in the last resort, low levels of job protection and minimum wages, high levels of cross-section wage inequality, considerable social spending on old-age pensions and high levels of segmentation of entitlements and status.

For close observers of the welfare state, these four categories are far too broad in many respects. For example, Ireland is a corporatist state often lumped into the Anglo-Saxon camp.[2] It has implemented

2 Ireland has centralised bargaining in trade unions.

strong incentives, especially for capital. It also has a lot of wage coordination. The four categories of welfare state are thus, at best, a rough cut.

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

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

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

Sweden's economic performance in the past decade has been impressive. So has that of Finland. Denmark's 'flexicurity' system promotes job mobility. It gives generous unemployment benefits and, at the same time, provides sanctions to promote rapid return to work among the unemployed. It has attracted a lot of attention among the policy pundits. The recent fascination with Scandinavia is typical of a mentality of many policy analysts who look to a working model as a system for adoption, rather than looking at basic principles that transcend any economy to explain the successes and failures of a particular model. This chapter looks at those basic principles to draw general lessons from many models rather than to extol the virtues of one system currently in place in comparison with any other system.

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

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

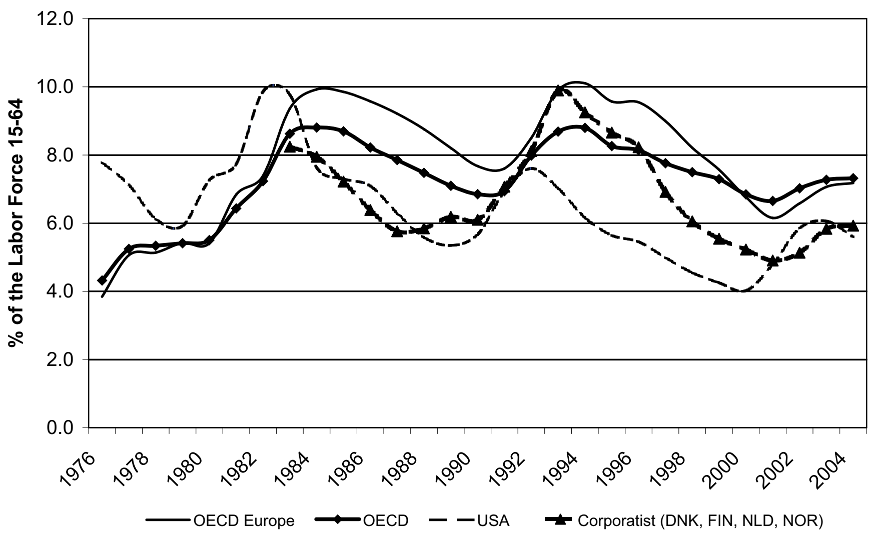
The plan of the rest of the chapter

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

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

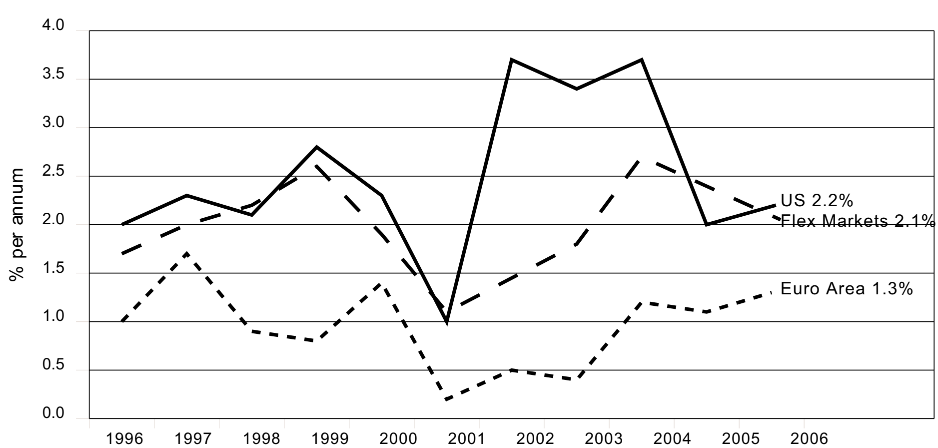
First consider the labour market. An OECD Jobs Report, released in 2006, shows that some of the reforms suggested in the 1994 Jobs Report (OECD 1994) have been implemented. It claims that those reforms partially account for the improved state of European labour markets. European unemployment rates post-1994 are lower but they are still very high. See Figure 1, which plots the 'open' (official) unemployment rates over time. Starting in the early 1980s, the overall Western European OECD unemployment rate rose. It has not fallen to its previous level. However, unemployment appears to be much lower in corporatist Europe. This has led to calls by some to adopt the corporatist model as a way to conduct economic policy.

Fig 1 Open Unemployment rates in the OECD.
Source: Author's calculations from OECD (2006a)



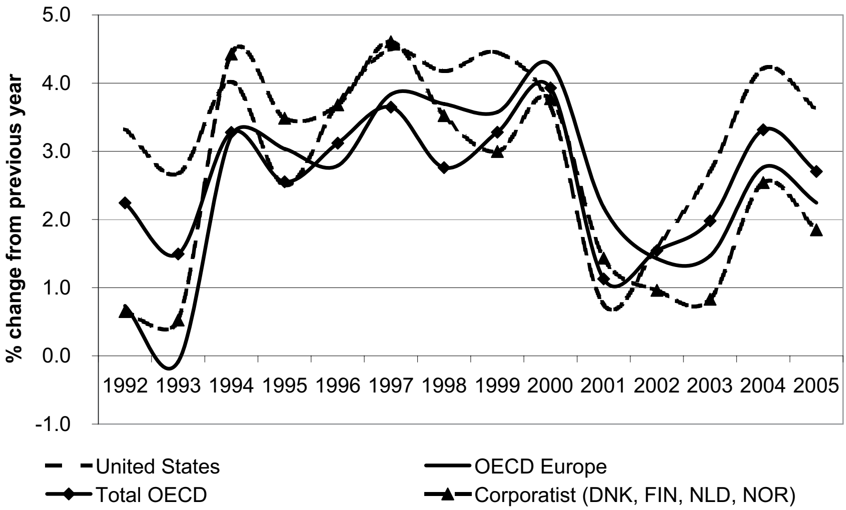
Average productivity growth is lower in the EU than in the US. However, it is high in the 'flex market' Nordic countries (see Figure 2).

Fig 2 Labour productivity growth in the business sector.
Source: Author's calculations from Organisation for Economic Co-operation and Development (2006a)



However, GDP growth is lower in the past five years in the EU than in the US. This is true even for corporatist Europe (see Figure 3).

Fig 3 Real GDP growth.
Source: Author's calculations from OECD (2006a)



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

Fig 4 PPP-adjusted GDP per capita in Sweden as per cent of OECD average.
Source: Davis and Henrekson (2006)

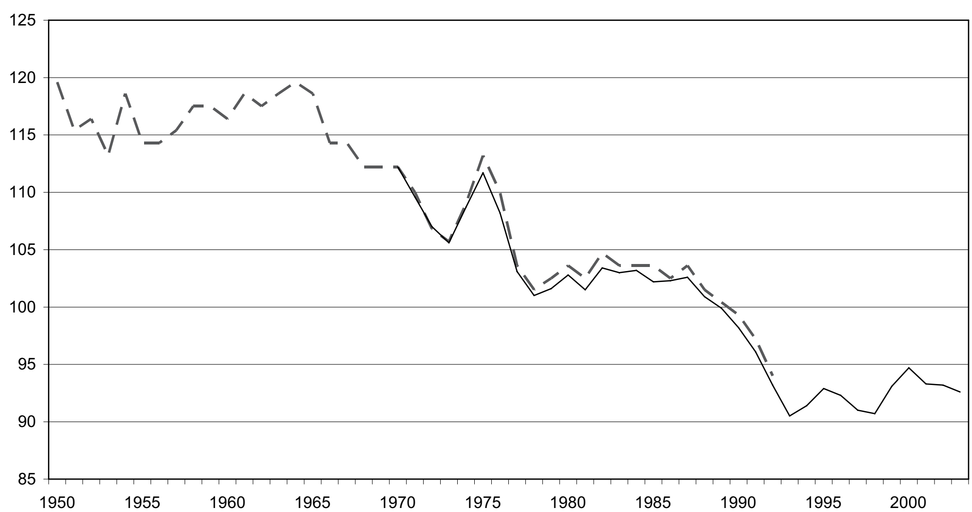


Fig 5 Cumulative employment and population change in Sweden, 1950-2004.
Source: Davis and Henrekson (2008)

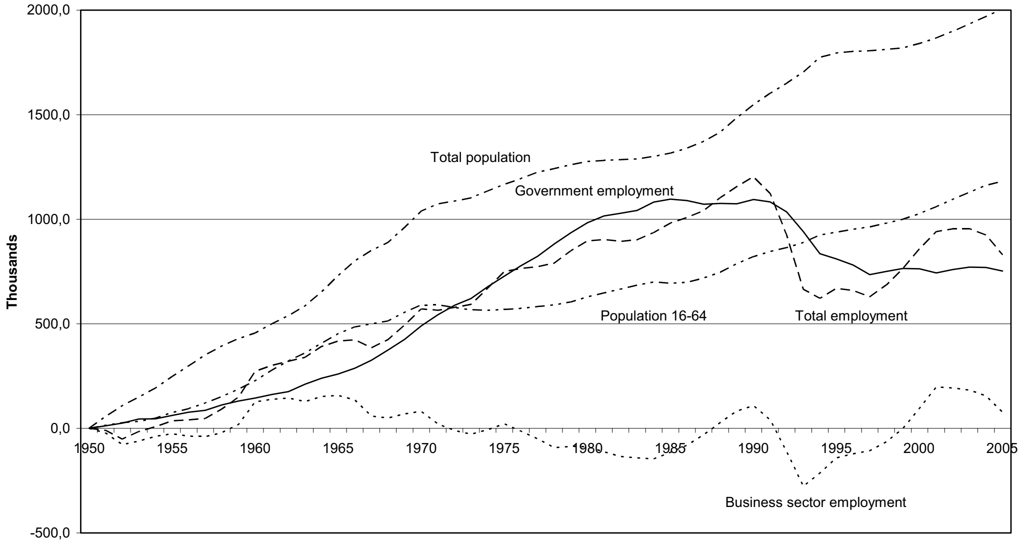
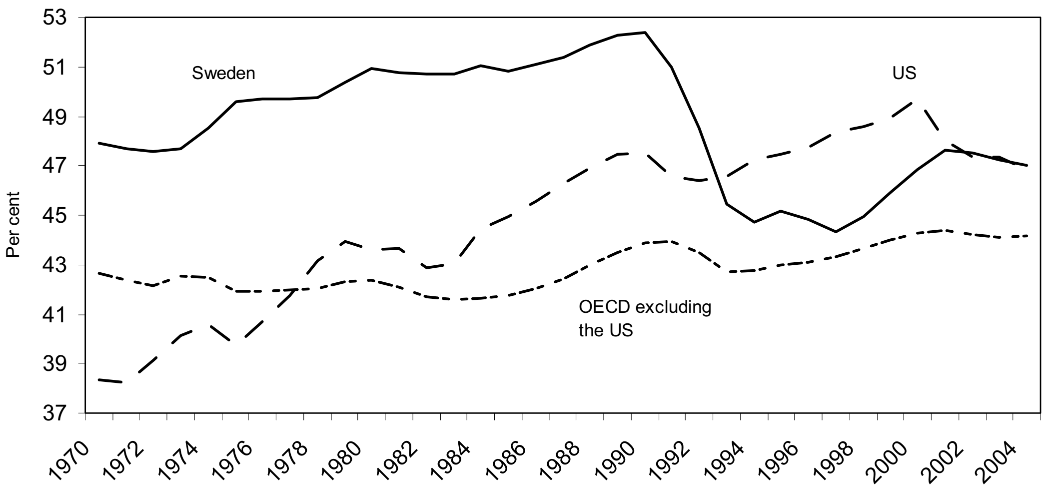


Fig 6 Employment as a share of total population in Sweden, the US, and the OECD, 1970–2004 (%).
Source: Davis and Henrekson (2006)



Sweden is far from being a basket case. Capital taxation there is relatively low and was cut substantially in the reform of the early 1990s. Levels of education are high. The international trade sector is competing effectively in world trade, especially in the Information and Computer Technology (ICT) sector, though it is dominated by a few big successful companies. Sweden's world leadership in information technology comes largely from the success of a few established firms.

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

Sweden has moved towards a more incentivised state. The introduction of incentives is an important ingredient of recent Swedish performance. However, a recent study concludes that there is still a lot of scope for reform and improvement in Sweden (Freeman et al 2006).

Focusing on Sweden or the Nordic countries neglects the most vibrant European economy: Ireland. Compared to Ireland, a country not often mentioned as a model for Europe by policy pundits, but much admired by many smaller Eastern European countries, the growth in employment in Sweden has been very limited. See Figure 7, which contrasts the GDP per capita growth of Ireland with that of the Nordics, and Figure 8, which contrasts Irish and Nordic civil employment growth, and Figure 5.9, which compares Irish and Nordic productivity growth rates.

Fig 7 Prosperity levels 1970-2003 (OECD = 100) – GDP per capita using current prices and current Purchase Price Parities. Source: Author's calculations from OECD (2006a)

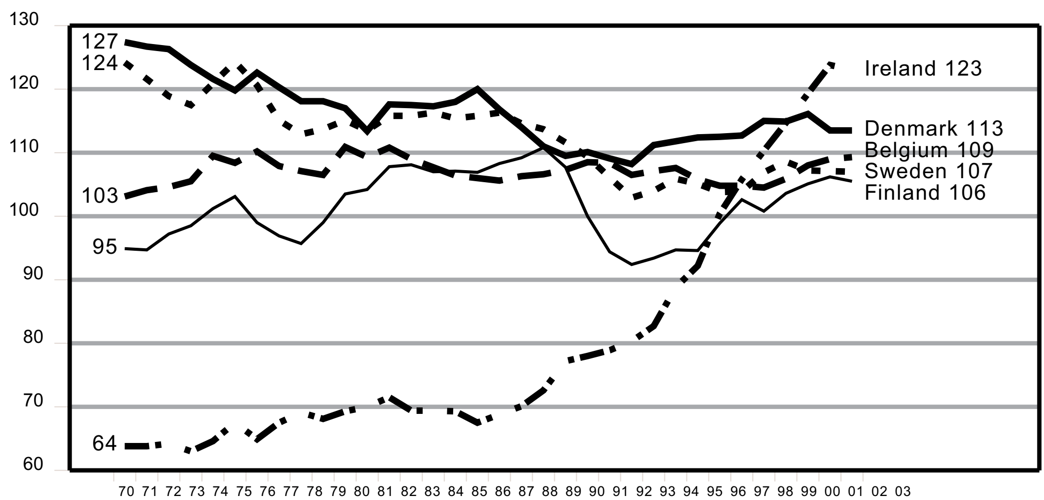


Fig 8 Job creation – total civil employment (1981 = 100). Source: Author's calculations from Organisation for Economic Co-operation and Development (2006a)

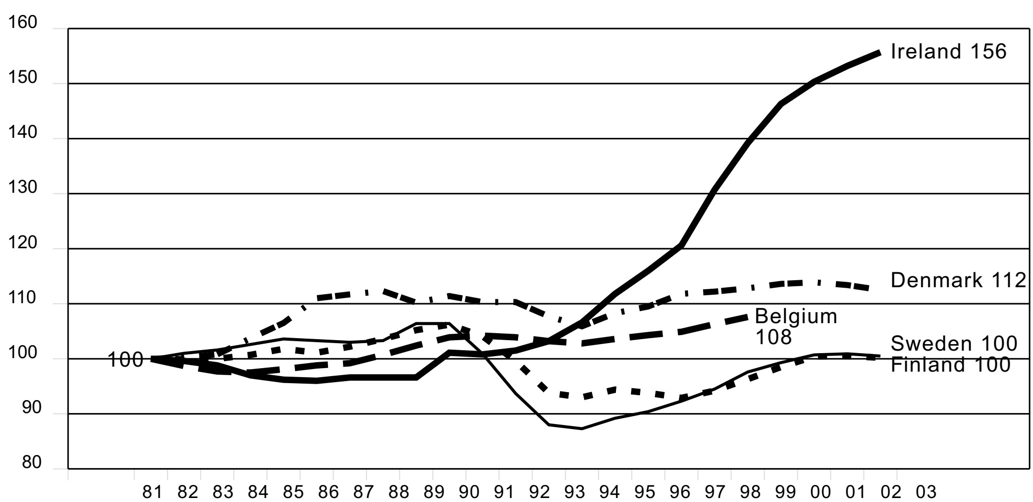
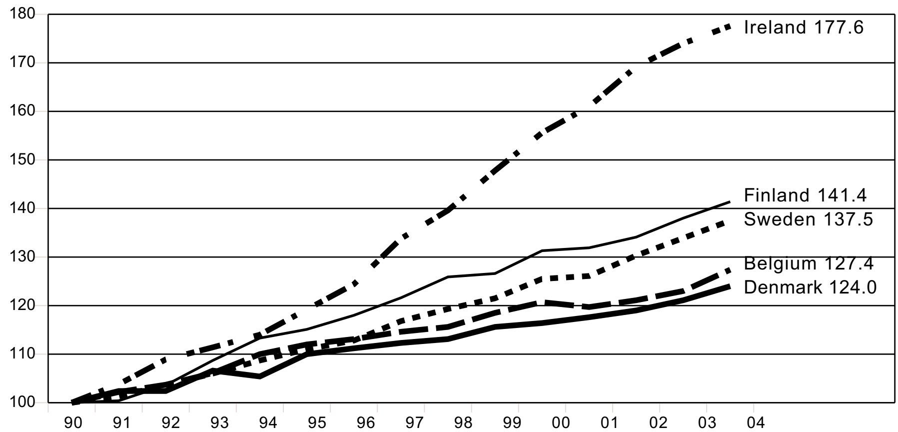


Fig 9 Productivity per working hour (1990 = 100).
Source: Author's calculations from OECD (2006a)



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

Understanding what the statistics reveal and conceal

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

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

ALMP accounting boosts reported Swedish GDP in a spurious way. Persons in training programmes are counted as government employees and their wages are counted in Swedish GDP. This artificially inflates employment figures. Adjusting 'open' unemployment by disguised unemployment produces a very different image of the performance of corporatist Europe compared to the performance of the US than is given in the official account of the success of the Nordic model. Figure 5.11 shows that adjusting the padded statistics boosts corporatist unemployment rates by a full four percentage points. Adjusting European unemployment rates for ALMP substantially increases true European unemployment rates (Figure 5.12).

Fig 10 Total expenditure on training and passive labour market programmes (% GDP).
Source: Author's calculations from OECD (2005a, 2005b, 2006a, 2007a, and 2007b)

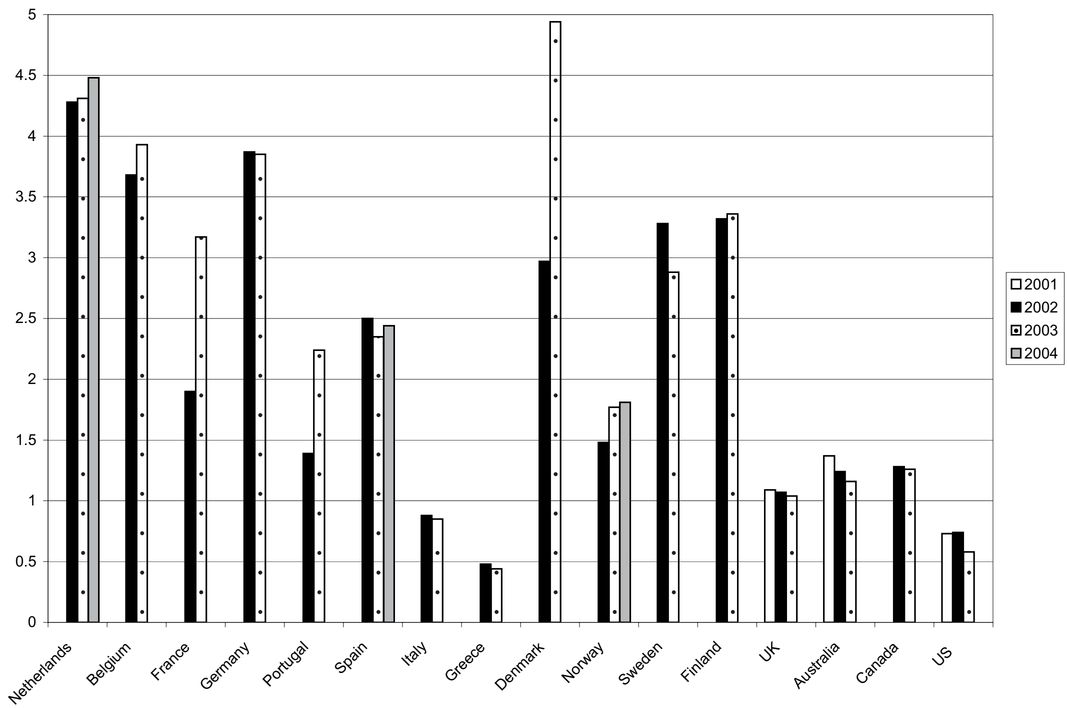


Fig 11 Open and full employment.
Source: Heckman, Ljunge, and Ragan (2006)

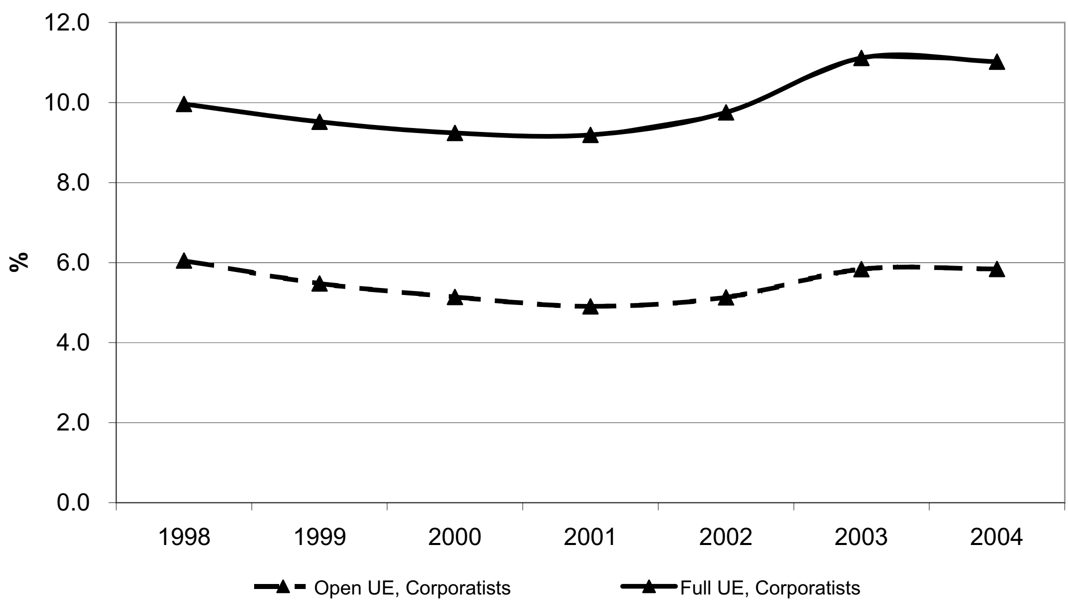
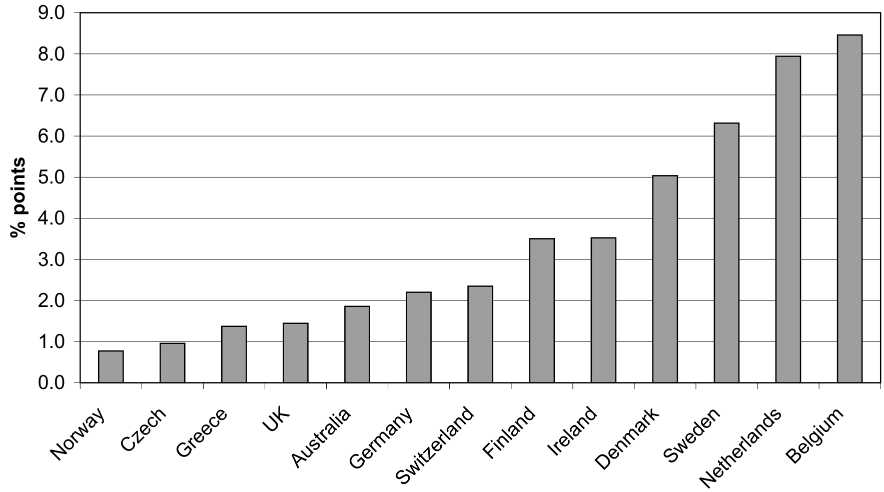


Fig 12 Differences between open and full unemployment, 1998-2004 averages.
Source: Heckman, Ljunge, and Ragan (2006)



ALMPs that conceal unemployment are only part of the reason for lower 'open' Nordic unemployment rates. Europe, and Nordic Europe in particular, has many more persons dependent on government programmes than the US. Consider just one programme. Expenditure on disability is much higher in the EU than in the US. In Holland, at its peak, some 14 per cent of all potential workers were collecting disability insurance. On top of the high expenditure on ALMPs, expenditure on disability commands a substantial chunk of OECD expenditure (see Figure 13). The data for 2004 shows that disability take-up rates among potential able-bodied workers reach levels as high as ten per cent in many countries (see Figure 14).

Fig 13 Disability-related expenditures (% GDP) in 1990, 1999.
Source: Author's calculations from OECD (2005a, 2005b, 2006a, 2007a, and 2007b)

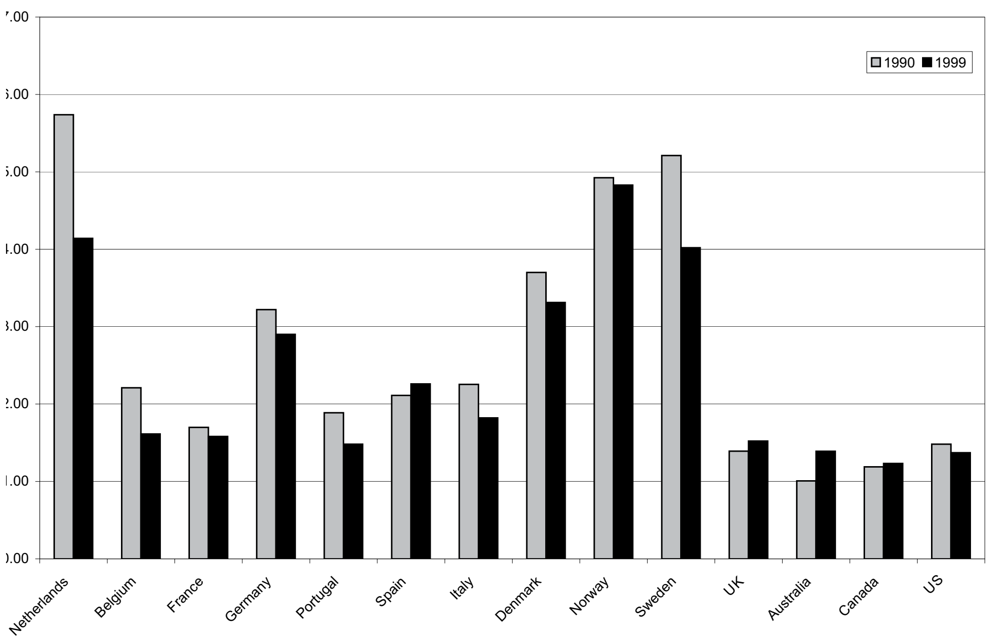
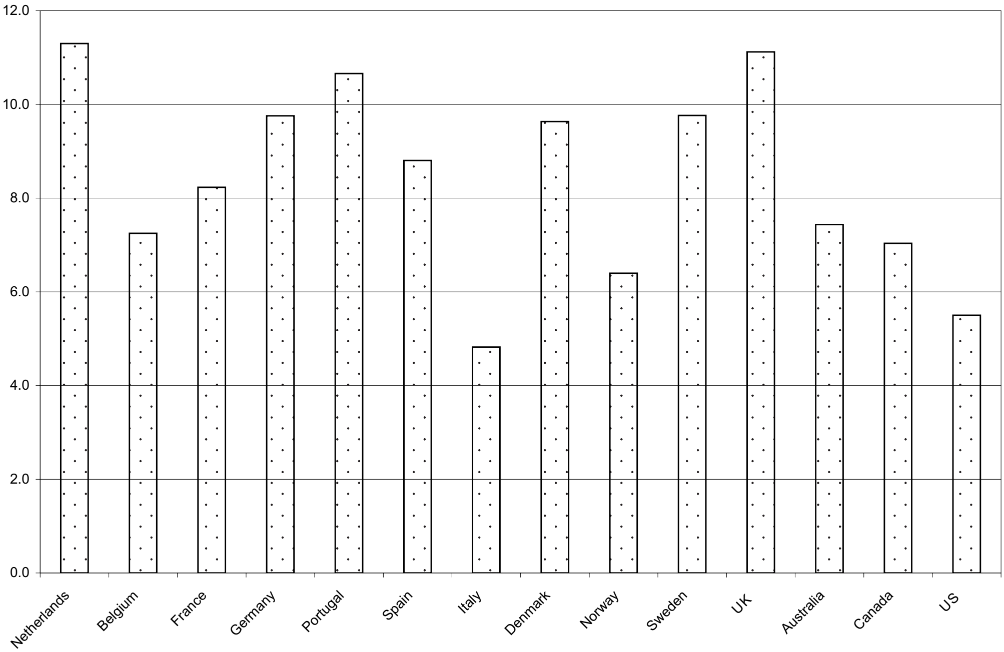


Fig 14 Non-employed disabled workers (% of labour force).
Source: Author's calculations from OECD (2005a, 2005b, 2006a, 2007a, and 2007b)



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

Fig 15 Open and adjusted employment rates in a subset of European countries.
Source: Heckman, Ljunge, and Ragan (2006)

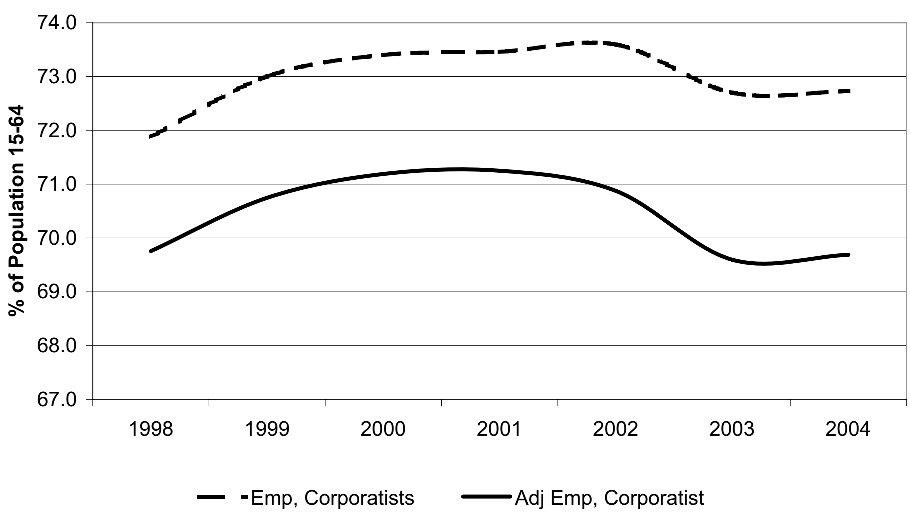
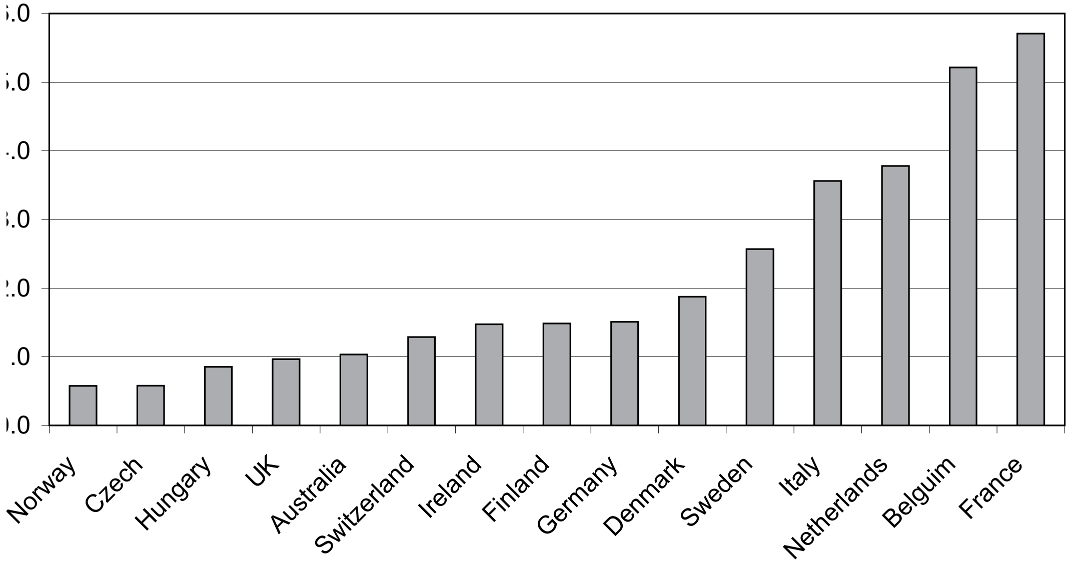
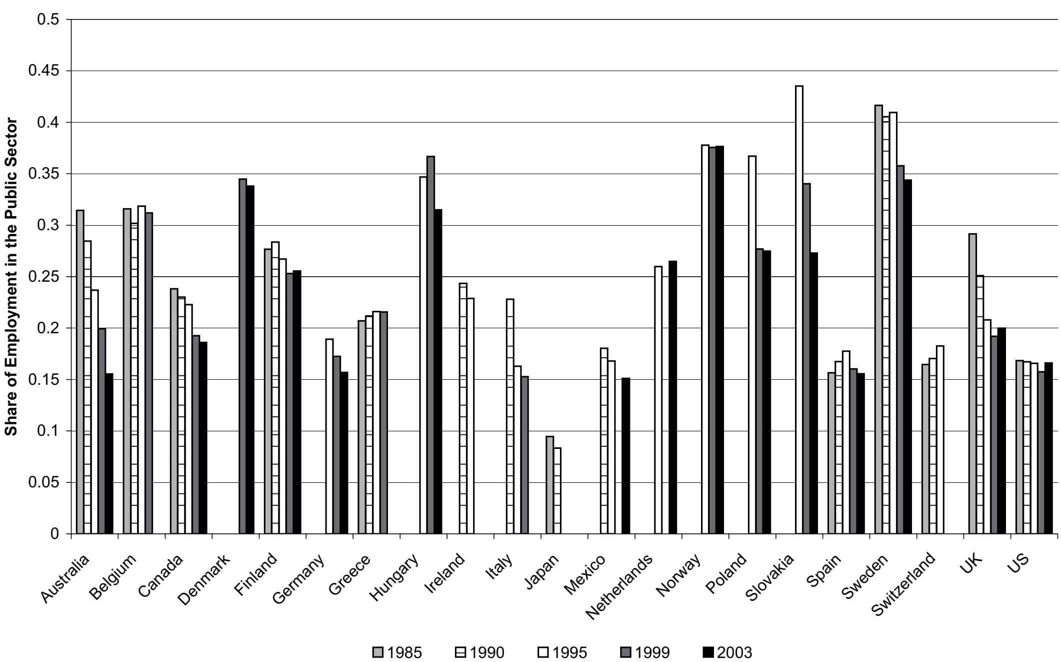


Fig 16 Differences between open and full employment rates, 1998-2004 averages.
Source: Heckman, Ljunge, and Ragan (2006)



A larger fraction of employment in the EU – especially corporatist EU – is in the government sector (see Figure 17). Government employment is an index of regulatory activity and in most sectors, government employment is not productive, although measurement of productivity in governments' activity is a tricky issue.

Fig 17 Public sector employment share.
Source: Heckman, Ljunge, and Ragan (2006)



The growth in dependency on government creates a serious problem of political economy in democratic welfare states. If one adds current dependents to government workers, one sees that there is considerable inertia to protect the status quo. Moreover, to finance the high level of benefits and the ALMPs, tax rates are high (see Figure 5.18). The total share of spending on government is substantial, although it has begun to decline (see Figure 5.19). The disincentives for work and the timing of work over the life cycle and investment in human capital are substantial. Retirement benefits are perverse at a time when the population is ageing. It has been estimated that in Denmark, for the median person, 75 per cent of the taxes are repaid in benefits but both taxes and benefits distort margins throughout the life cycle at many margins (see Bovenberg et al 2008). Incentive schedules often create poverty traps.

Fig 18 Total marginal tax wedge on personal income, including consumption taxes (% of income) for a single worker earning the average production wage without children (US: no cons. taxes available).
Source: Author's calculations from OECD (2005a, 2005b, 2006a, 2007a and 2007b)

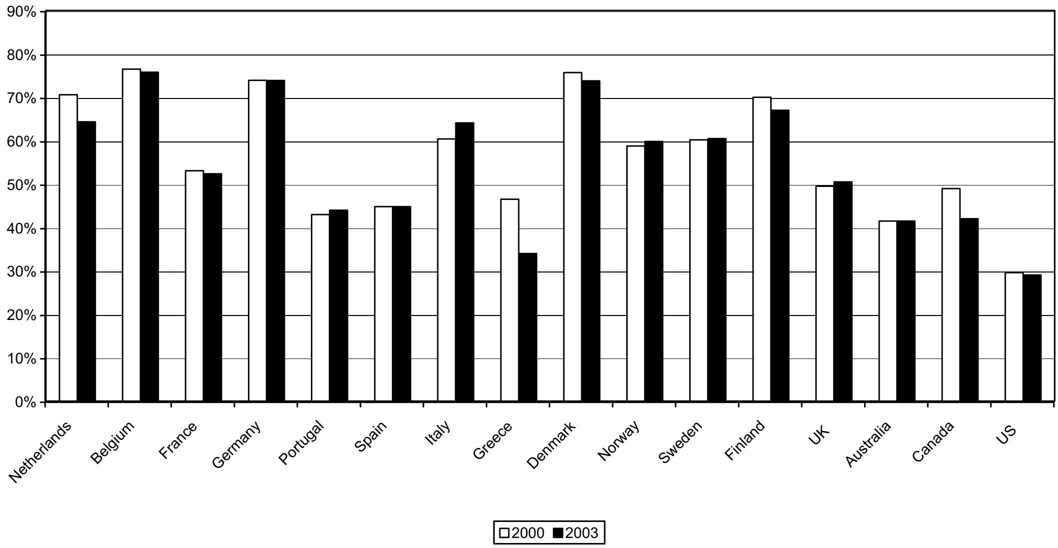
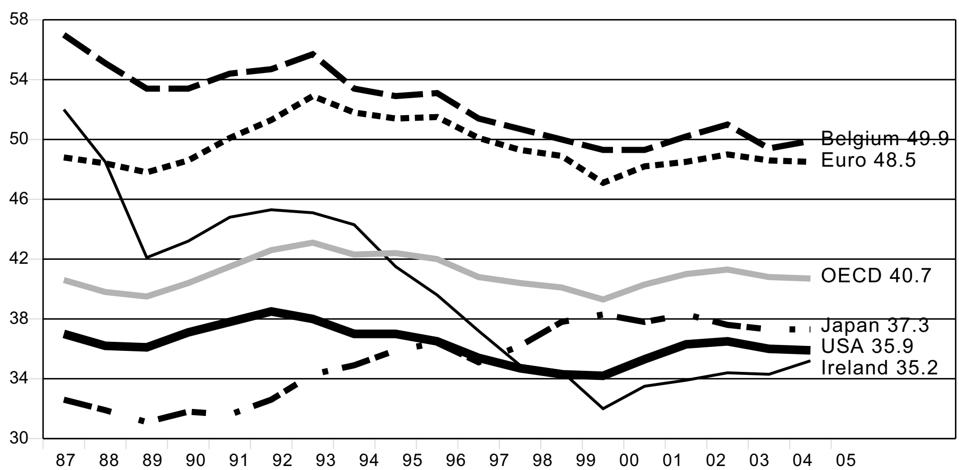
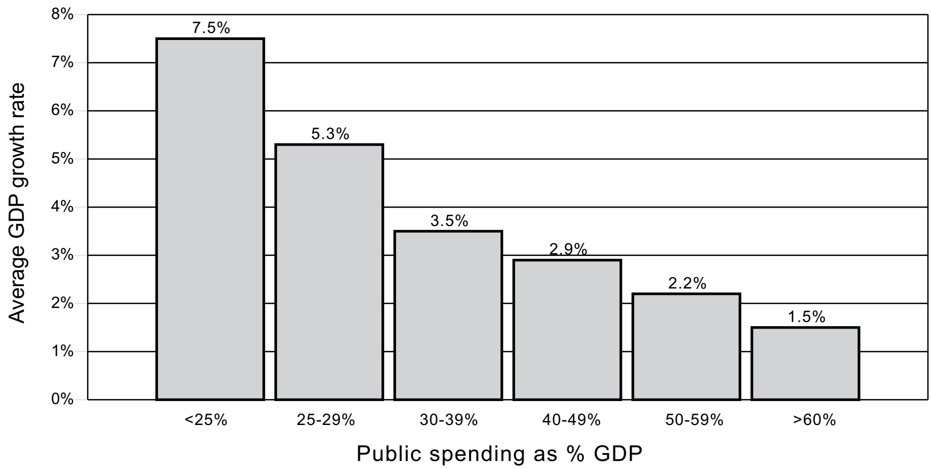


Fig 19 Public spending as a percentage of GDP.
Source: Author's calculations from OECD (2006a)



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

Fig 20 Correlation of growth and public spending – 30 OECD contries, 1960-2005.
Source: Author's calculations from OECD (2006a)



Education is a major determinant of long-term employment and unemployment. More educated workers are more adaptable, innovative and easily employed. Educational expenditure per student in tertiary education (college) is much lower in the EU than in the US. The relatively low rate of educational attainment in the OECD countries is due to high progressive taxation of income with reduced incentives to acquire skills. In addition, there is exclusive dependence on public sector resources to support education in a period when government resources are limited. Fees are not charged and there is little reliance on the private sector as an engine of revenue, unlike the case in the US. Student fees are a source of revenue and screen into schooling students with high demand for it. Joint ventures with business are limited. Sweden partially offsets this disincentive through generous subsidies to education. However, this policy runs the risk of training people for UK, US and Canadian jobs (see Figure 21, Figure 22).

Fig 21 Proportion of 25-34 age group with university education.
Source: Author's calculations from OECD (2005a, 2005b,2006a, 2007a, and 2007b)

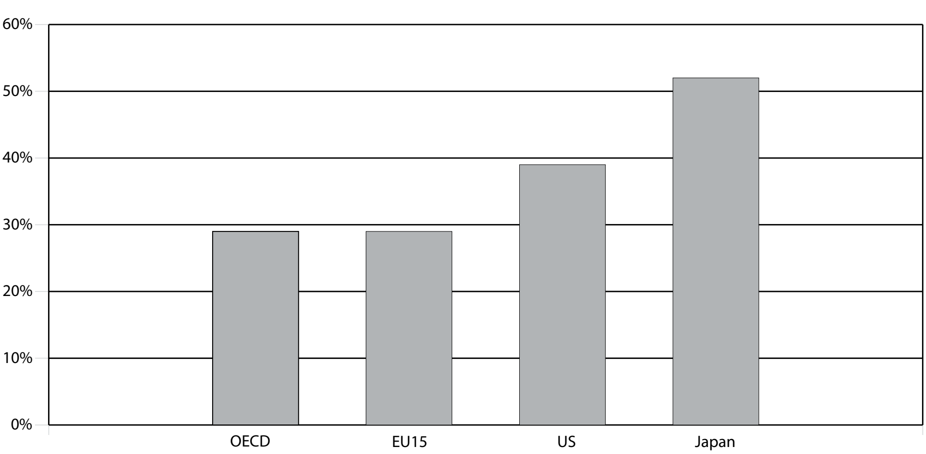
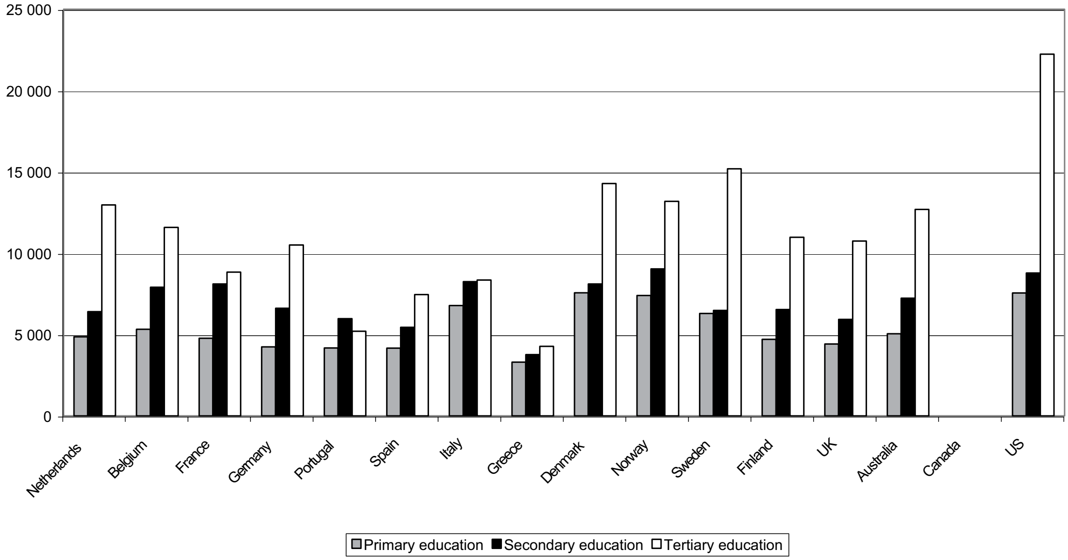
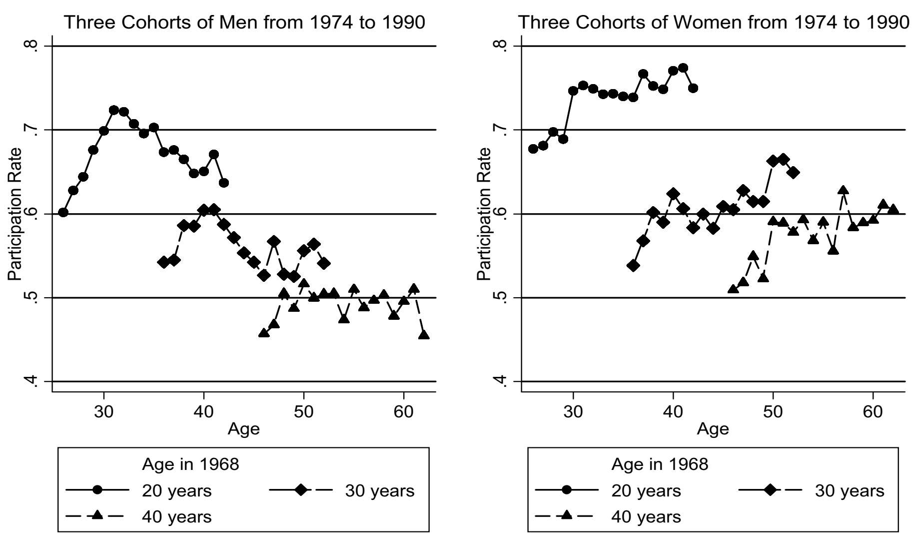


Fig 22 Real expenditure per student in US$.
Source: Author's calculations from OECD (2006a)



Participation in generous welfare states leads to erosion of the work ethic and withdrawal from participation in the social compact. There is evidence of cohort drift in welfare participation. Those cohorts who have lived a greater fraction of their lives under the generosity of the welfare state come to accept its benefits and game the system at higher rates. Martin Ljunge (2006) studied the use of sick leave for three cohorts of Swedes. The incentives to use the system have been the same for 40 years. Yet, as Figure 23 reveals, the take-up rate at the same age has increased for recent cohorts. This is a serious long-term problem for the European welfare state. Problems of an eroding work ethic are compounded by the lack of assimilation of many immigrant populations. In truth, the welfare state creates inequality and has self-perpetuating features.

Fig 23 Sick leave participation for men and women.
Source: Ljunge (2006)



Sample: Labour force participants, ages 26-62.

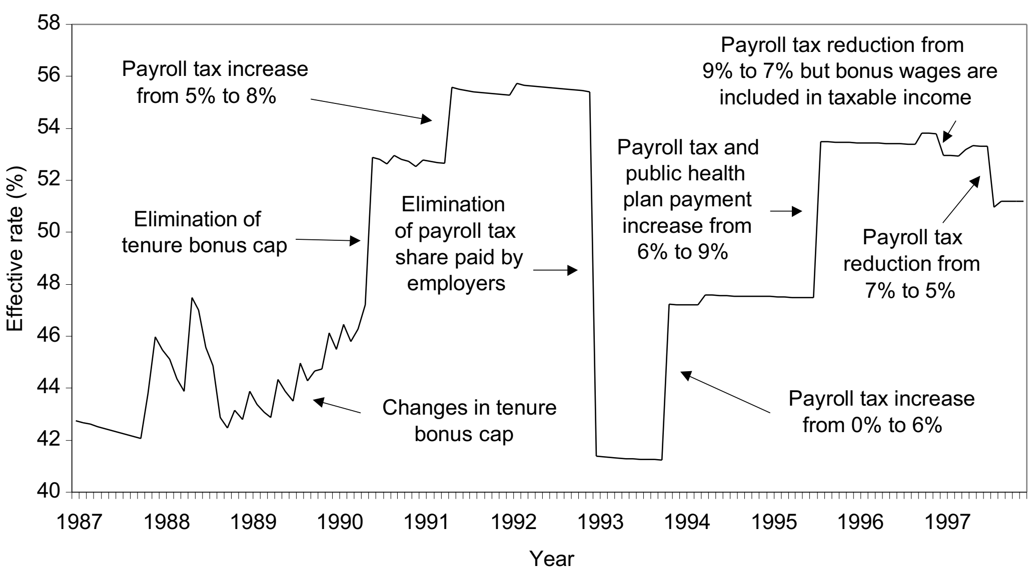
Bad measures lead to weak conclusions; good measures lead to strong conclusions

The OECD and many students of European economic performance analyse the effectiveness of alternative economic systems by relating performance to various ad hoc measures of the incentives created by institutions. There is a large literature on cross-country panels that uses these measures to explain variation in European unemployment and other issues (see, for example, Blanchard and Wolfers 2000; Layard et al 1991). The countries studied are very heterogenous and the time series analysed are typically very short. Many measurements of institutions are indices formed for entire countries. These studies do not analyse incentive effects on firms and workers at the levels at which the incentives operate. The analysis is conducted at aggregate levels using a 'representative agent' framework that ignores basic heterogeneity in society. Such evidence is fragile and unreliable.

It would be fruitful for students of OECD labour markets to follow the lead of students of the Latin American labour market and quantify the costs and incentives of institutions governing labour markets.[3] Such studies would reveal the quantitative insignificance of the reforms made in Europe in the past decade. Scholars of Latin America have collected micro data on costs, employment, wages and turnover in their countries. Policy instability in the region produces some radical economic experiments with much greater variability than any natural experiments or policy experiments that have been observed in Europe. Many of these natural experiments are plausibly exogenous. From these experiments we can learn about the basic economics of incentives that applies universally even if the details of the policy environment vary from episode to episode.

Consider the substantial variation in labour costs in Peru in the last decade associated with various Fujimori governments. Figure 24 shows the range of variation in non-wage costs due to policy shifts in Peru from the first quarter of 1987 to the first quarter of 1997.

Fig 24 Evolution of nonwage costs paid by employeyers – Peru.
Note: Non-wage costs paid by the employer include payroll tax, tenure bonus, public retirement plan payments, and public health plan payments. Vacations and holiday bonuses are included in the effective rate, although they were not modified during the period and stand for 25 per cent of non-wage costs paid by the employer (two bonus wages and one month of paid vacation per year).
Source: Saavedra and Torero (2004)



Using these and other data, the costs of institutions (unions, labour market regulations, severance payment schemes, minimum wages) can be quantified and estimated on microeconomic models of firms. Translating regulations into costs allows analysts to summarise a variety of features of labour

3 See the papers in Heckman and Pagés 2004.

market institutions using an interpretable cost schedule. The cost data can be used to estimate the impact of regulation on the labour market. In the best studies, the analysis is highly disaggregated and applied to the firm or industry level.

Studies that measure labour cost precisely establish that labour demand curves are downward sloping, that is, higher labour costs mean fewer workers demanded. This relationship has been found for economies around the world. The elasticity of demand for labour with respect to wage is 0.7 (Hamermesh 2004). Regulations and unions raise labour costs and reduce employment. A ten per cent increase in labour costs leads to a seven per cent reduction in employment. Contrary to a folklore that many embrace because it is politically convenient to do so, binding minimum wages reduce employment as do payroll taxes that are imposed in countries without wage flexibility. The current practice of using ad hoc measures of the costs of institutions on highly aggregated statistics from very heterogenous countries is guaranteed to produce the finding that 'institutions don't matter' when in truth they do.

Payroll taxes

Payroll taxes are a substantial fraction of total labour cost in most modern welfare states. The disemployment effects of payroll taxes depend on what economists call 'pass-through'. The proportion of the cost of the payroll tax that is borne by firms and, therefore, the extent of disemployment, depends on how flexible wages are and on how wisely funds are spent (do workers value the benefits?). One cost of corruption and bad governance is that firms bear a greater share of their payroll tax. This reduces employment.

Studies of union reforms corroborate the value of disaggregated studies

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

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

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

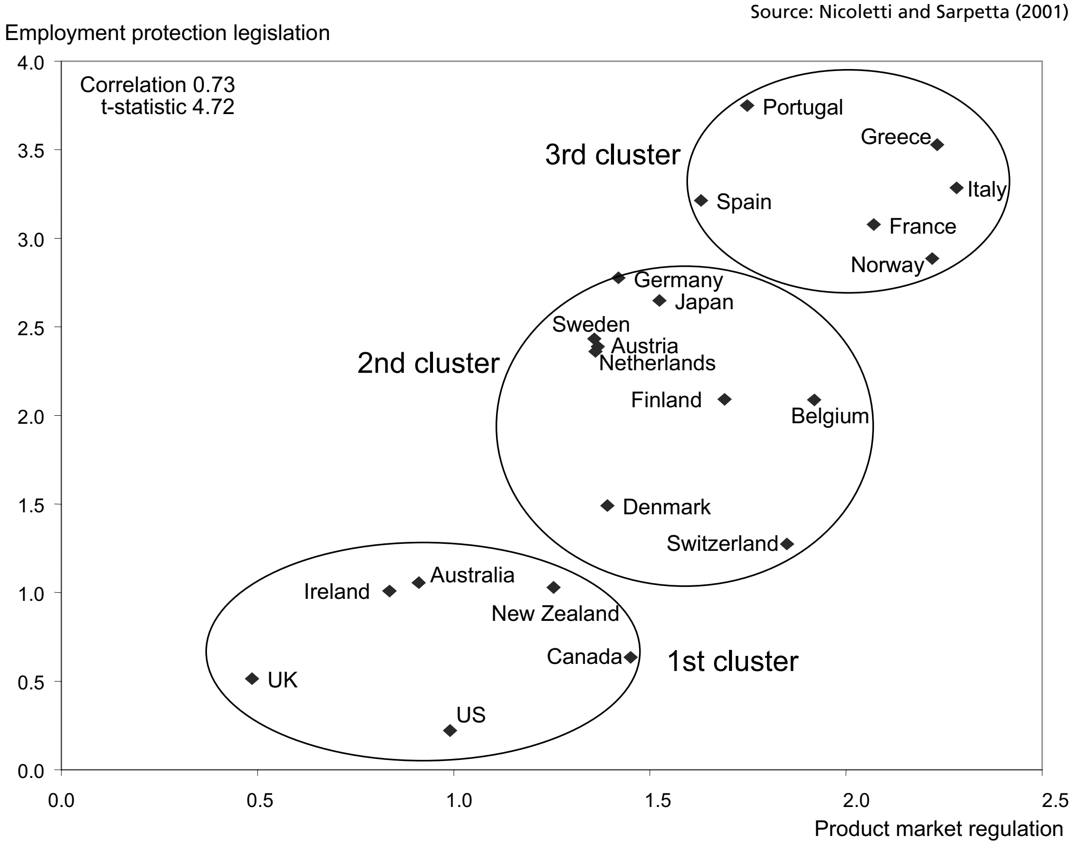
The burden of regulation

Many economies around the world operate under a heavy burden of regulation. These regulations raise adjustment costs of labour and promote inflexibility. Regulation leads to sluggish employment responses. Employment protection laws that are popular in least developed countries (LDCs) and in the Mediterranean welfare states reduce labour mobility. Deregulation raises mobility and flexibility.

Regulation reduces employment overall, but raises employment for protected workers. It produces a protected enclave of insiders (see Lindbeck and Snower 1989).

Moreover, as noted by Nicoletti and Scarpetta (2001), product market and labour market regulation are highly correlated (see Figure 25). This array of regulations reduces innovation and impairs adoption of technology (see Figure 26). Regulation reduces entry of firms (see Djankov et al 2002; Freeman 2002) (see Figure 27). These barriers have substantial long-term, perverse effects on growth in productivity.

Fig 25 Product-market regulation and employement-protection legislation.
Source: Nicoletti and Sarpetta (2001)



The inequality argument for the welfare state re-examined

A principle argument in support of welfare states is that they reduce inequality and promote social inclusion. In practice, the welfare state often excludes people, creates inequality, and reduces competitiveness (see Heckman and Pagés 2004). Incentives in place often slow immigrant assimilation and reduce inclusion.

Incentives that protect the status quo reduce mobility over the life cycle.The rigidities of the welfare state raise lifetime inequality. Cross-sectional inequality (over people at a point in time) is much larger in the US than it is in Italy. However, in Italy, jobs are protected for life. Mobility out of a bad starting job is much lower than in the more flexible US labour market. The gap in lifetime inequality between the US and Italy is much less than the cross-section gap (see Flinn 2002).

Fig 26 Internet usage and employement protection.
Source: Samaniego (2006)

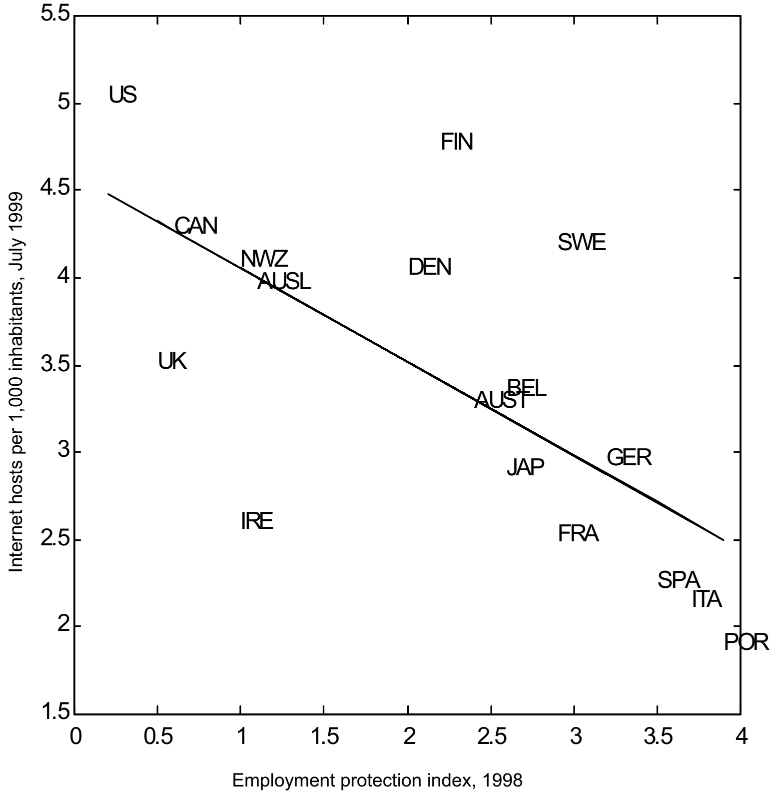
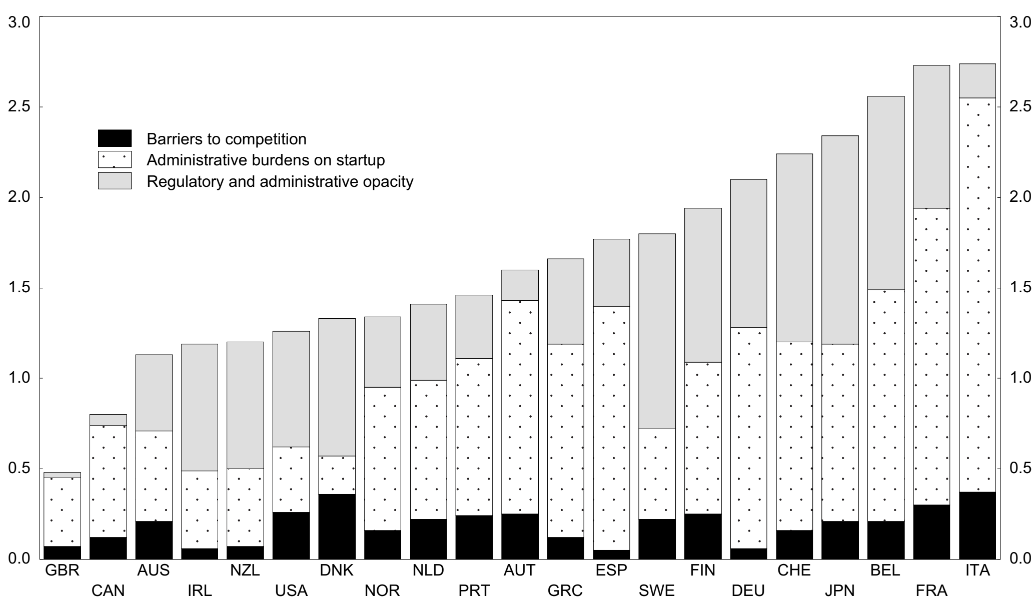


Fig 27 Barriers to entrepreneurship: cross-country comparison based on 1998 data.
Source: Nicoletti and Scarpetta (2001)



Crisis is the mother of all welfare state reforms

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

Summary

Provisions of the welfare state, such as the right to economic security, are often interpreted as basic human rights that implement the rule of law. Rights that improve the lot of all or most in society should be distinguished from rights that benefit some at the expense of many. Many provisions of modern welfare states favour some while harming others. Programmes that pay workers to withdraw from economic activity while others work to support them are examples of such provisions.

This chapter elevates the discussion of the welfare state beyond the level of endorsing one system over another. I have presented the essential features that underlie the success of aspects of many different systems. Systems that respect the basic incentives of economic life are the most successful. These incentives provide restraints on the freedoms possible under a welfare state.

Incentives include:

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

Long-run trends in Western welfare states are not favourable even in the Nordic countries. This is especially clear once the distorted nature of the published statistics is exposed. High levels of taxation, protection and generosity of benefits erode the dynamism of any society. They build a culture of dependency that erodes innovation. They create a level of complacency that erodes the work ethic and mutes incentives to invest in skills and in the larger society. They create a system that protects the status quo and is very difficult to change except when a crisis emerges. Most reforms of welfare states (eg, Ireland, Finland, the Netherlands and Sweden) came in moments of crisis.

There is much room for creative policy innovation. One can create incentives for mobility, but at the same time give workers some security as in the Danish 'flexicurity' system. One can create incentives to work (working tax credits in the UK, earned income tax credits in the US) and not participate in welfare. Such incentives boost productivity and raise levels of well-being and social integration. One can use social insurance accounts that insure, but at the same time introduce flexibility into the system.

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