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Institutions for Social Well-Being

Alternatives for Europe

Edited by

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Preface

The imperatives of economics and the reasons of equity are sometimes presented as incompatible in the current debate on the future of Europe's social dimension. The strong side of the economic argument, in the eyes of some observers, is its promotion of efficiency. By contrast, according to this point of view, the objectives of social equity are, at most, a political constraint on policy making, their rational foundation relying, at most, on subjective arguments with no standing in economic science. Compromise, rather than integration, is sometimes seen as the cipher of possible political mediation, the alternative being that social objectives give way to economic forces.

But is this an acceptable account of the relationship between economic and social objectives? And is it a reliable guide for policy makers and citizens? This book explores questions concerning the efficiency and effectiveness of economic policies and their implications for social equity. The economic arguments presented support the adoption of an integrated approach to both economic and social objectives, and show how welfare states and other institutions can contribute to both equity and efficiency goals. The contributing economists, while well aware of the complex relations between efficiency and equity, do not share a common viewpoint on matters of policy. But none of them subscribes to the above-mentioned interpretation that gives priority to efficiency over social justice.

Lilia Costabile

Notes on Contributors

Roberto Artoni is Professor of Public Economics at Bocconi University, Milan. He has written extensively on the economics of the welfare state and on the history of Italian public finances. He is the author of a textbook on Public Economics that is used widely in Italian universities.

Sir Tony Atkinson is Professor of Economics at the University of Oxford and Fellow of Nuffield College, of which he was Warden from 1994 to 2005. He has been President of the Royal Economic Society, the Econometric Society, the European Economic Association, and the International Economic Association. His research interests are in economic inequality and public policy.

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Arjun Jayadev is Assistant Professor of Economics at the University of Massachusetts, Boston. He has published articles in the *Journal of Development Economics*, *Economics Letters*, and the *Cambridge Journal of Economics* among others, as well as several contributions to edited volumes. His research interests include the economics of distribution, economic development, political economy, macroeconomic dynamics and the economics of power.

Teresa Munzi is a researcher at the LIS (Luxembourg Income Study). She has considerable experience of microdata harmonisation and documentation, and carries out comparative research on the economic and social status of populations using data from the LIS dataset. Her interests include the comparative study of the welfare systems of industrialized and transition countries, the comparative dimensions of poverty and inequality and their link with public policies, and the comparison of labour market outcomes across countries.

Ugo Pagano is Director of the Doctoral School in Economics and President of the Graduate School S. Chiara at the University of Siena, and Visiting Professor at CEU (Budapest), where he was also Head of the Department of Economics. He obtained his PhD at the University of Cambridge, where he was later University Lecturer and a Fellow of Pembroke College. One of the founding editors of the *Journal of Institutional Economics*, his current research interests also include corporate governance, economic integration, the economic analysis of legal orderings and bioeconomics.

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Roberto Scazzieri is Professor of Economic Analysis at the University of Bologna, Italy, and a Senior Member of Gonville and Caius College and Clare Hall in the University of Cambridge, UK. His recent publications include *Production and Economic Dynamics* (in collaboration with M. Landesmann, 1996); *Knowledge, Social Institutions and the Division of Labour* (in collaboration with P.L. Porta and A. Skinner, 2001); *Markets, Money and Capital. Hicksian Economics for the 21st Century* (in collaboration with A. K. Sen and S. Zamagni, 2008).

Timothy M. Smeeding is Distinguished Professor of Economics and Public Administration at the Maxwell School of Syracuse University, where he is also the founding director of the Center for Policy Research. He is the Founder and Director Emeritus of the Luxembourg Income Study Project, which he began in 1983 . Smeeding's primary research focuses on national and cross-national comparisons of income and wealth inequality, social mobility, and poverty among vulnerable groups, including low-wage workers, children, the aged, and the disabled. Smeeding is principal editor of the *Handbook of Economic Inequality* (forthcoming) and has written entries on poverty and inequality for the *International Encyclopedia of Social and Behavioral Science*, the new *Palgrave Dictionary of Economics*, along with 15 books and over 200 research articles on these topics over the past 30 years.

Introduction

Lilia Costabile

1 The European Social Model is characterised by a highly developed social protection system devised to remedy certain economic and social failures (such as missing markets, incomplete and/or asymmetric information, inequality, poverty, lack of social cohesion) which may occur even in otherwise successful economies. This system of social protection is regarded by many as 'one of the most successful social innovations of recent centuries' (Atkinson, in this book, pp. 22–3).

However, the European Social Model is currently challenged by a number of forces, as well as by theoretical and empirical arguments focused on the perverse incentive effects of social protection, the sustainability of social expenditure in terms of the fiscal burden, the impact of demographic factors, the increasing competition raised by emerging countries and, more generally, the effects of 'globalisation'. Moreover, there has been widespread concern that Europe's growth performance has been lagging behind those of both some advanced economies, such as the US, and of emerging countries. This lag, some argue, may be due to the impact of the European social protection system on Europe's economic performance.

These challenges require a rethinking of social policy. The current economic debate concentrates on how Europe should adjust its social model to the new conditions in order to promote prosperity. Some authors argue that modernising the European Model entails a scaling back of the welfare state as global markets and the other factors mentioned above tilt its relative costs and benefits in this direction. Others argue that a renewed system of social protection has a major role to play in the European Union (EU), both on equity and efficiency grounds, and can be useful in improving economic performance. This debate is important because alternative economic models and their respective policy prescriptions influence, and interact with, political decisions and events concerning core issues in the European construction process.

As one example of this interaction, consider the referendums on the European Constitution held in France and in the Netherlands in 2005. The results were probably influenced by the unresolved tension between two contrasting interpretations of what the European proposal is: as testified, for instance, by the opposition between a 'maximalist' and a 'minimalist' project, or by the contrast between the 'pure market' approach and the vision of an economically and socially integrated Europe. French and Dutch voters were probably influenced by the concomitant, vigorous debate surrounding the so-called 'Bolkestein Directive', namely the EU Services Directive proposing liberalisation in the service sector. The European Constitution may have been paying the toll for its widespread identification (or confusion) with this Directive, in its original version.

The European Council later approved the Services Directive in December 2006, in a version dispensing with the 'country of origin' principle,[1] which had aroused wide opposition in some quarters, and strong support in others. These contrasting views are rooted in alternative analytical and normative models concerning the desirability of integrating social and economic objectives in the ongoing process of European integration.

As another example, consider that, although the concept of a 'European Social Model' may be a useful approximation for some purposes, in reality the welfare states and social policies of European countries still differ widely. These differences result in a wide geographical dispersion of social indicators. The social nature of the EU will depend crucially on whether the present social inclusion process is able to promote convergence towards common standards. Consequently, it is essential to analyse, both theoretically and empirically, the conditions necessary for the common European objectives to be realised, and the factors which may constrain their achievement. It is also important to recognise that different theoretical and interpretative frameworks influence the definition itself of these common objectives.

This book contributes to the debate on whether, and in which direction, the European Social Model(s) should be reformed. It does so by furnishing a novel analysis of: (i) the nature of the EU social dimension and the related institutional structure of EU policy making; and (ii) the range of alternatives to, and varieties within, the European Social Model. The overall question addressed by the book is whether it is true that the European systems of social protection hinder Europe's economic performance, also in comparison to what is often presented as their main alternative, namely the social and economic model of the United States. As stated above, the purpose is to understand, and clarify, the implications for EU social policy.

Our main focus is on the economic arguments relevant to this debate. This is because most current arguments in favour of reducing Europe's social ambitions are advanced on economic grounds. Indeed, one does not hear of proposals aimed at dismantling social protection as an end in itself. Rather, the proposals are generally clothed in economic arguments, such as those which rest on the propositions that the welfare state imposes a burden on economic growth, or that countries may pay for their preferences for equality and other social objectives with diminished economic efficiency.

We felt that these arguments should be discussed on their own grounds, and that, consequently, an *economic* investigation into the nature of these trade-offs was a logical priority before any conclusions on the future of the European Social Model(s) can be drawn. This objective explains why all the contributors to this book are economists. Although such a single-disciplinary composition imposes obvious limitations on the scope and comprehensiveness of this project, we feel that, by developing an economic approach to some of the major issues involved, this book may help reopen a debate sometimes presented as definitively settled by the 'iron' logic of economic arguments.

Do economic arguments unambiguously counsel in favour of reducing social protection and cutting back the welfare state? In our view, this is the core issue in the current debate. The main contribution of this book consists in its conclusion that alternative routes are possible, and that choices are not preordained, as shown by our investigation of the relative costs and benefits of the alternative options.

The results will be analytically presented in individual chapters and summarised in the Conclusion at the end of the book. Here, it is appropriate to clarify our research strategy, and the main features of our approach.

Although we have not tried to cover all of the issues involved, we have attempted to get at least some of the basic questions right by making the issue of a potential trade-off between equality (or equity) and efficiency the central focus of our inquiry. On attempting to shed new light on this trade-off, two questions naturally emerge as basic for research and policy purposes. First, would 'lighter' welfare states be more conducive to economic efficiency and growth in the face of the new challenges? Secondly, is there scope, within Europe, for the less well-performing Member States to improve their social *and* economic performances through better social expenditure?

To answer these questions, our research strategy is articulated into three parts.

The first part (chapters 1 and 2) sets the stage by presenting an overview of the economic challenge, as well as by setting out the theoretical framework and the empirical information base. Because any analysis of potential reform of EU social policy must start from an interpretation of what this policy is, this part of our research begins, in chapter 1, by investigating the EU social dimension and setting the theoretical debate on the future of the welfare state within the context of EU social policy and the institutional frame of policy making. The first part of the book also presents, in chapter 2, a wide-ranging analysis of alternative welfare systems, both within Europe and in comparison to the USA. Hence this part of the book introduces the twofold comparative investigation that is subsequently developed.

The second part (chapters 3 to 5) adopts a 'transatlantic' comparative perspective and investigates the differences between Europe and the US. The purpose is to determine whether differences in economic performance may stem from the relative strengths and weaknesses of the alternative European and US Social Models, and/or from their ability to adapt to (or to drive) global macroeconomic forces. The third part (chapters 6 to 8) adopts an intra-European comparative perspective in order to assess the differences among care and welfare regimes in Europe, with chapter 7 focusing specifically on Sweden's welfare system. Finally, the book addresses an issue crucial for the new Europe, namely the economic rationale for social solidarity in the face of increasing cultural diversity within the EU.

There are particular reasons for adopting a framework of analysis based on these two comparative perspectives – the transatlantic and the intra-European. First, for our purposes here it is appropriate to take account of the versions of possible equality/efficiency trade-offs considered in the current economic literature. For a variety of reasons, which fall outside the scope of our analysis, some contributions to this literature treat the issue of welfare reform in European countries by conducting a 'systemic' comparison, or sometimes a confrontation, between Europe and the USA. The latter country, with its system of social protection, is juxtaposed to the social model of Europe as able to promote static as well as dynamic efficiency and, ultimately, better living standards for all.[2] This 'comparative' version of the equality/efficiency trade-off is multifaceted, and some of its versions are considered in this book. The new investigations developed here may help re-focus some current perceptions of comparative (in)efficiencies. Secondly, because social systems within Europe exhibit marked differences, an assessment of alternative models of social protection is a necessary preliminary step towards planning a future for the EU social dimension.

Our approach combines analytical tools and insights drawn from the theory of the welfare state, the economic theory of institutions, and the macroeconomics of open economies. New cross-national evidence from various sources (including the Luxembourg Income Study database and the OECD *Social Expenditure Database*) is integrated into this analytical apparatus via empirical investigations based on social and economic indicators. A valuable (or so we hope) characteristic of the book is that it integrates these different theoretical, institutional and empirical lines of analysis into the common objective of investigating the features of alternative economic and social models.

The rest of this introduction illustrates the logic of our argument and shows how the individual chapters fit together.

2 We start by interpreting what the European Union social dimension actually is, how it originated, and what its 'philosophy' and the instruments of its implementation are. The first chapter ('European Union Social Policy in a Globalising Context'), by Tony Atkinson, presents such an interpretation by framing the theoretical debate on the future of the welfare state within the context of EU social policy. Besides introducing the two comparative perspectives developed in the book, this chapter clarifies the nature of the global challenge, and considers both the 'tax cost' and the 'incentive' arguments for downsizing social protection. The author argues that there is no evidence that scaling back on social institutions would be a solution. Rather, institutional fine-tuning is proposed in order to remove possible perverse incentives and mechanisms.

This first chapter also illustrates the economic philosophy underlying the European project, and its related institutional architecture. It shows how the European Union has adopted an integrated approach to both social and economic objectives (although with some discontinuities in the development of its social agenda). It also shows how the European Union has gradually forged the relative institutional instruments. The proposed allocation of functions between different levels of government combines centrally set distributional objectives (also supported by a common set of 'social indicators', as developed among others by Atkinson *et al.*, 2002) and decentralised implementation. This approach differs from some of the public finance literature on decentralisation by developing the reasoning proposed by the 'founding fathers' of the European Union, this being the approach also adopted in chapter 8, where alternative models of federalism are discussed.

This interpretation of EU social policy can be better understood as an application of the theoretical approach to the welfare state that Atkinson himself has helped to develop (Atkinson, 1970). In light of this theory, EU social policy can be viewed as the result of a European social welfare function including an *inequality aversion* parameter that is sufficiently high to justify redistributive intervention. This is confirmed by the use, in this first chapter, of the 'distributionally adjusted' measure of national income proposed by Sen (1976) for the purpose of assessing the relative economic performances of countries. At the same time, this chapter also considers the *efficiency* grounds for social protection, such as when risk insurance devices are provided by the institutions of the welfare state.

Taking this formulation as the starting point, the next question asked by the book is whether Europe is paying an excessively high price for its preference for equality. What costs and benefits would be implied if Europe decided to switch policy towards lower inequality aversion?

One way of answering this question is to compare Europe against countries whose 'revealed preferences' show lower inequality aversion in their distributional outcomes. This comparison may help us to identify the advantages, and/or disadvantages, of such a switch. This research strategy requires us first to identify the countries most suitable for the comparison. Moreover, because, as already stated, a variety of social models coexist within Europe, we also need to know how individual European countries score in terms of anti-inequality and anti-poverty intervention. Hence, what we need as a first step in our inquiry is a classification of countries by their distributive outcomes.

This information base is provided in chapter 2 ('Conditions of Social Vulnerability, Work and Low Income: Evidence for Europe in Comparative Perspective') by Teresa Munzi and Timothy Smeeding. The authors present a study of levels and trends in poverty and inequality in a sample of 15 countries, chosen to typify the 'social models' relevant for the analysis in this book, namely the English-speaking countries, Continental Europe, the Mediterranean countries, and the Nordic model. Data are drawn from the Luxembourg Income Study database. The level of analysis in this chapter is considerably detailed because, in addition to those relating to the overall population, data on children and the elderly population also receive close scrutiny. Because this study measures poverty and inequality both at MI (Market Income) and DPI (Disposable Personal

Income) levels, an interesting classification emerges whereby countries are grouped by their distributive outcomes, both pre- and post-welfare state intervention. Moreover, the use of 'anchored poverty rates' helps the authors distinguish the impact of growth from that of changes in income distribution in intertemporal comparisons. The authors document numerous trends and differences among countries, and use them to interpret alternative social models. One of their conclusions is that the USA undertakes the least anti-poverty and anti-inequality effort via the welfare state. As for intra-European comparisons, a wide dispersion in social indicators among European countries emerges (and is confirmed by other chapters from different perspectives). Mediterranean countries do not perform well, and are close to the English-speaking countries in terms of poverty and inequality, and very weak welfare state intervention. By contrast, countries of Continental Europe and, above all, the Nordic nations achieve far better performances.

To sum up, the two chapters making up the first part of this book introduce the array of questions to be considered in the other two parts and provide the basic information on the social policies of countries.

The second part of the book conducts a transatlantic comparison between the social models of Europe and the United States. The purpose is to determine whether more inequality is associated with more efficiency – and vice versa – on the two sides of the Atlantic.

Sam Bowles and Arjun Jayadev base their analysis in chapter 3 ('The Enforcement–Equality Trade-off') on a simple model of growth. They develop the insight that the welfare state is one of two alternative mechanisms fulfilling the function of institutional reproduction, namely the reproduction of the rules of behaviour with which individual agents in any society must comply if production is to be continued under existing property rights. Such compliance is obtained either by redistributing income to promote social cohesion or by enforcing it via 'guard labour' (that is, activities performed by workers employed in defence, surveillance, contractual monitoring, plus the unemployed workers who 'discipline' the ambitions of the others). Both alternatives are resource-consuming. The authors measure the efficiency losses incurred by unequal societies through their allocation of resources to guard labour. They also study how inequality and the incidence of guard labour in the total labour force are related across countries: Continental and Nordic European welfare states rely on progressive transfers of resources among their citizens to a greater extent than does the USA, and they devote fewer resources to guard labour. The authors conclude that the equality/efficiency trade-off may be a less relevant and effective criterion than the 'equality/enforcement trade-off' for evaluating comparative performances, since all countries, both the more egalitarian ones and those exhibiting lower inequality aversion, devote resources to the not strictly productive, but nevertheless necessary, function of order maintenance.

The economic theory of institutions, in the version proposed by Bowles (for instance, Bowles, 1985; for a discussion see Costabile, 1995), combines insights drawn from the classical economists and Marx with the modern economics of information. The latter also underlies the economic analysis of the welfare state as an insurance device conducted by the next chapter, which uses it for another investigation into the features and the relative advantages of alternative social protection systems.

Roberto Artoni and Alessandra Casarico in chapter 4 ('Insurance, Redistribution and the Welfare State. Economic Theory and International Comparisons') use the theoretical distinction between the insurance and the distributive functions of the welfare state as a guide both for their critical analysis of some recent theoretical contributions and for their institutional and empirical comparative analysis. This chapter shows that welfare expenditures (percentage of GDP) show greater than expected convergence between Europe and the US when public/private (but supported by tax allowances) variables and pre-/post-tax figures are duly distinguished and summed. The public/private mix makes the real difference. Focusing on pension and health expenditures, the authors show that: (i) the insurance element prevails in the European system, while the institutional design of welfare expenditures privileges distributional effects in the USA; (ii) the US social protection system is less neutral than its European counterpart in its effects on income distribution, and some of its components have a regressive distributional impact (from a different perspective, this confirms the findings of Feldstein, 2005). The chapter concludes with the remark that, in assessing the relative performance of Europe and the USA, certain important macroeconomic factors (such as the role of macroeconomic policies and external constraints) should be taken into account, because 'constructing models that ignore these elements by assumption may lead to a wrong diagnosis and inappropriate remedies' (Artoni and Casarico, in this book, p. 121).

This remark opens the way for the next study, where the macroeconomic approach proposed at the end of the previous chapter is developed in an investigation of possible determinants of cross-country growth differentials. Some authors have proposed a trade-off between growth performance and social protection, possibly operating via incentives on savings, as a possible causal factor, but evidence from cross-country studies raises increasing doubts as to whether such a trade-off exists.

Moreover, this interpretation seems not to sit well with the coexistence of large saving inflows and low saving rates in the US economy; nor does it take account of the international roles and positions of countries. These roles, by contrast, are central to much of the current macroeconomic debate regarding, for instance, global imbalances. This book seeks to bridge the gap between these two bodies of literature, given that comparative analysis, in our view, cannot be satisfactorily conducted on purely microeconomic grounds.

In chapter 5 ('Social Models, Growth and Key Currencies'), Lilia Costabile and Roberto Scazzieri trace one possible source of growth differentials between Europe and the USA in certain *asymmetric* characters of the international monetary system which influence growth models and growth performances among nations. By virtue of the international status of its national currency, the costs of expansionary policies are relatively low for the country issuing the international money, and 'valuation effects' of depreciations positively influence its net external position. This country is thus induced to adopt a growth model driven by the expansion of domestic demand, trade deficits, and saving inflows to finance these expenditures. *Euro* countries have been (thus far) unable to exploit these asymmetries, for reasons explored in the chapter. Moreover, their macroeconomic policies were restrained in the 1990s and thereafter by the objective of achieving and sustaining the process of European Monetary Unification, considered here as a policy response to the above-mentioned asymmetries. This change in the international monetary regime feeds back on welfare issues. With a common currency, and appropriate fiscal policies, a mercantilist model (export-led growth, current account surpluses, and compressed consumption) should not be taken for granted. In the new circumstances, policies of *well-being promotion* aimed at the enhancement of *consumer* welfare could go hand in hand with policies of *capacity promotion* aimed at the development of *producer* capacities. In this framework, the European Social Model can be used as a factor promoting both growth and convergence among European countries.

To sum up: the theoretical, institutional and empirical investigations conducted in the first two parts of this book do not confirm that greater inequality is necessarily associated with higher efficiency, either theoretically or in actual economic outcomes. Comparatively, the US social system is indeed characterised by more inequality than European countries, but the possible positive effects of inequality on efficiency and economic performance are much less well-established, because of the efficiency costs of inequality and the asymmetries of the international economy illustrated above, which may to some extent explain cross-national growth differentials.

The concluding part of our research shifts the analysis from a 'transatlantic' to a European comparative perspective, and looks into the 'black box' of the European welfare states, the purpose being to investigate whether there is scope, within Europe, for the less well-performing Member States to improve their performances through better social expenditure. Far from being an entity representing the best of all possible worlds, the 'European Social Model' is in fact a mosaic of different models, and even the best-performing European countries, such as the Nordic ones, have had to adapt to the challenges raised by globalisation. Once again, the problem underlying 'convergence' is whether social protection needs to be 'bought' at the cost of economic inefficiency.

Chapters 6, 7 and 8 seek to answer these questions in three different stages: (i) by decomposing 'Europe', in a comparative perspective, into its different constitutive social systems and classifying them in terms of their functioning and relative performance; (ii) by inquiring into the main characteristics of, and the recent transformations in, the welfare model found by our research to be the best-performing one, namely the Nordic model; and (iii) by studying how cultural diversity in Europe affects the impact of social solidarity on economic efficiency.

In their comparative analysis, Francesca Bettio and Janneke Plantenga look at national systems from a particular perspective, that is, by focusing on 'Care Regimes and the European Employment Rate' (chapter 6). Care regimes are defined as institutional arrangements and policy instruments for producing and financing the services of 'care' for children and elderly people. A wide range of indicators (such as indexes of 'informal' care for children based on the amount of work devoted to this task by family members, generally by women; monetary transfers and tax allowances; real services offered by public authorities, etc.) are discussed in order to assess national policies. The resulting taxonomy shows that European countries can be grouped into (at least) four different welfare and care regimes. The chapter explores their features and their impact on the labour market from a gender perspective. In the 'Mediterranean' model a major role is played by the family, with scarce public transfers to support it as a producer of care services. At the other extreme lies the Nordic model, where care work is 'exported' from the family to the state. The other European countries fall into intermediate categories, with different weights assigned to formal and informal care, public transfers, and the diffusion of part-time employment. Bettio and Plantenga argue that the Mediterranean regime may be responsible for the very low activity rates for women recorded in these southern countries, while the Nordic system scores particularly well for female labour market participation.

Because the Nordic countries emerge from the inquiries conducted in several chapters of this book as the best performers in terms of social indicators, we felt it appropriate to subject these countries to closer scrutiny, particularly because they underwent crisis and reform during the 1990s. The negative trend of those years has now been reversed, and the Scandinavian countries top international rankings for growth rates, competitiveness, and similar economic indicators.[3] Paradoxically (given the current emphasis in part of the economic literature on reduced tax revenues and the consequent need for smaller welfare states), these achievements by the Nordic countries may even suggest a new approach stressing the positive impact of high taxation and large welfare states on economic performance.[4]

The features of the Nordic model as it emerged from reform in the 1990s are attracting considerable attention in the literature (Kangas and Palme, 2005; see also the analysis in Freeman, Swedenborg and Topel, 1997). Here, they are explored by Bjorn Gustafsson in chapter 7 ('The Swedish Model in the Era of Integration and Globalisation'), which focuses on the Swedish economy, the largest among the Nordic countries. This chapter first clarifies the historical origins and the main features of the Swedish welfare state in its mature form in the 1970s and 1980s, and explains how it developed historically. It then documents the tensions that have arisen within the system in recent years, and the main lines along which the Swedish Model has been reformed (pension reform, changes in the provision of public consumption, new forms of management in the public sector, changes in the systems of public health and child care, and so on). The author asks whether these reforms mark change or continuity in the welfare system. His answer is carefully modulated, and shows that there have been significant changes, but also that, in spite of these changes, there are enduring features such as universalism, gender equity, incentives to work both for men and women, and labour market policies which encourage technical change.

Hence the contention that societies need to renounce economic efficiency in order to buy equity and equality through their welfare and care regimes is not borne out by the investigations conducted in chapters 6 and 7. These contributions illustrate the wide gaps among the social performances of European countries and yield useful insights into how countries may improve their results by designing policies that provide the right incentives, for instance in the labour market.

Cultural diversity is a central issue in the enlarged Europe, and should be taken into account in our attempt to assess the future of the European Social Model. The last step in our research therefore consists in asking whether marked and increasing cultural diversity within the EU impairs the case for a European Model of social protection. Massimo D'Antoni and Ugo Pagano in chapter 8 ('Cultural Diversity and Economic Solidarity') make a theoretical argument in favour of a European system of social protection in a culturally diverse society. They argue that modern welfare systems, on the one hand, and a homogeneous culture and a common language on the other, are alternative insurance devices against the risks related to the illiquidity of investments in specific human capital. Because of substitutability between these two devices, the optimal level of social protection is a decreasing function of cultural homogeneity. The authors derive policy implications for the EU: because European countries exhibit marked cultural and linguistic heterogeneity, it is difficult to substitute cross-country labour mobility (which is discouraged by language barriers, for example) for economic solidarity. Consequently, within a culturally diverse area like Europe high benefits can be reaped from economic solidarity because social protection encourages investment in human capital and hence raises labour productivity. With its institutional implications for EU social policies, this concluding chapter closes the circle and establishes a link with the opening chapter by Tony Atkinson.

By way of summary: advanced economic systems are characterised by a variety of social models, and we can learn from their distinguishing features how different societies seek to solve common problems and perform basic functions, such as those of risk insurance, redistribution, order maintenance, and the provision of care services. Learning from other experiences can be particularly helpful when a country, or a group of countries, sets about devising new methods to promote social objectives, as the EU is doing at present. There is a range of social systems to consider, and the aim of this book is to improve the understanding of how these alternative systems work. By comparing the European and US social models, we have reached the conclusion that incomplete analysis of comparative costs, incentives, and macroeconomic constraints may have led to overestimation in some parts of the current literature of the USA's efficiency advantages. The US Social Model is also characterised by less equality than its European counterparts, at least in the Continental and Nordic countries. Consequently, also in view of the social preferences expressed by European citizens in many opinion polls, we have shifted the focus of our analysis to Europe, investigating whether European countries can learn from each other on how to improve their social, and economic, performances. As the studies in this book find by using several indicators, different models coexist in Europe. We have accordingly sought to establish which of these countries can function as 'models' in view of their more desirable outcomes. Because we are aware that social models do not easily transmigrate between countries, we have concentrated mainly on the distributional outcomes and the systems of incentives provided by different social protection systems to see whether equality and efficiency can be promoted jointly through an appropriate institutional design. For the same reason, we have also proposed that setting homogeneous distributional objectives at the EU level may encourage convergence towards more ambitious social standards.

Notes

The idea of this book originally arose from my interest in both the theory of institutions and macroeconomic analysis, which I thought could be used jointly to assess current problems in social policy and the European welfare states. I have been fortunate because a conspicuous number of colleagues believed in this project and decided to cooperate in the research effort from which this book originates. Some of the contributing authors participated at a session of the 46th Annual Meeting of the Italian Economists' Society, held in Naples on 21 and 22 October 2005, which I organised in my capacity as the Society's Vice-President. Others joined the project at a later stage. All contributed with competence and enthusiasm to the final outcome presented here, and I wish to thank them for their contributions and for their collaborative attitude. I also wish to thank Umberto Carabelli for helpful advice. Finally, support from Taiba Batool, Alec Dubber and Nick Brock of Palgrave Macmillan is gratefully acknowledged.

1. With reference to labour law, this principle implies that workers would be subject to the norms of their country of origin rather than to those of the destination country.
2. Some of this literature (for instance, Reichlin and Rustichini, 2004) has attributed 'anti-American prejudice' to authors proposing different interpretations. We shall refrain from speculating on the possible prejudices of other authors and do our best to provide sound and unprejudiced analysis.
3. Between 1999 and 2006 the average annual GDP growth rates for the Nordic countries were 3.37 for Finland, 3.12 for Sweden, 2.41 for Norway. This compares with average growth rates for the US and the euro area of 2.75 and 2.06 respectively (IMF, 2007). According to the World Economic Forum's 'Global Competitiveness Report' for 2005, 2006 and 2007, the Nordic countries top international classifications for competitiveness.
4. See *Time* Magazine, *The Nordic Model Rules: The World Economic Forum's Latest Survey of Competitiveness Says Scandinavia is Leading the World,* by

Peter Gumbel, Sunday, 2 October 2005: 'They have among the highest tax rates and most generous welfare systems in the developed world, but when it comes to international competitiveness, there's no beating Scandinavian countries. That's the conclusion of this year's annual global competitiveness survey by the World Economic Forum, which ranks countries according to economic dynamism, the quality of public institutions and technological prowess…'There is no evidence that [high tax rates] are undermining the level of competitiveness' said Augusto Lopez-Claros, the Forum's chief economist, who notes that Scandinavian countries put tax receipts efficiently back into the economy by investing in education and infrastructure'. Lindert (2003, 2004) explains how large welfare systems and efficiency can go together.

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1
European Union Social Policy in a Globalising Context

Anthony B. Atkinson

1.1 Introduction

This chapter first describes the development of the EU social dimension and the origins of the present Social Inclusion process, and then considers the nature of the challenge to the European system of social protection, both national and EU-wide, and the argument that the pressures of globalisation threaten its continuation. In this section, I treat the EU as an entity, contrasting European policy with that of the United States, but it is important to recognise the diversity within the European Union. There is much discussion of 'the European Social Model', but I do not find such a description helpful. I believe that we need to look at the fine structure of institutions, and this is the subject of the forth part of the chapter, where I consider both the design of institutions within Member States and the possible role of the EU, not in making policy, but in shaping the policy debate, taking as an illustration the recent calls for children mainstreaming.

1.2 Development of the EU social dimension

In the early days of the European Communities, the Community organisations were provided with very limited powers in the social field.[1] It is nonetheless useful to begin with the 1950s since this was a period of rapid economic adjustment in Europe, not least the movement of labour out of agriculture into manufacturing and services. One of the central policy concerns was the restructuring of the coal and steel industries, through the European Coal and Steel Community. This involved social measures in aid of training and to finance adjustment. It is worthy of note, in relation to contemporary debates, that social policy was seen as complementing policies for structural reform. The restructuring required today, in response to changes in the world division of labour, and as the EU is enlarged, is not that different in principle from the major restructurings that have taken place in the past.

In the 1970s, the Communities began to adopt social objectives in their own right, not simply as means to an end. In terms of concrete action, the Regional Development Fund was put in place and the Social Fund was increased in size. Policy to combat poverty led in 1975 to the first of a series of Action Programmes. In December 1981, the Commission made an evaluation report of the First Poverty Programme, containing an estimate of 37 million poor people in the Community (of 12 countries) in 1975. This was based on a poverty line drawn at half the average income of the Member State, which was the concrete implementation of the definition adopted by the Council of Ministers of the poor as 'individuals or families whose resources are so small as to exclude them from the minimal acceptable way of life of the Member State in which they live' (Council Decision, 22 July 1975).

Under Jacques Delors, the social dimension was developed further. In 1989 the Commission put forward a draft of the 'Community Charter of Fundamental Social Rights' and this was adopted in modified form by 11 of the 12 then Member States. The opposition of the United Kingdom led to the Social Chapter as such being excluded from the final Treaty on European Union, although there was an attached Social Protocol. Opposition from the UK and Germany also blocked the 1993 *Poverty 4* proposal for a fourth medium-term Action Programme to combat exclusion and promote solidarity. Yet two themes were beginning to develop: (i) the linking of social policies and economic policies, and (ii) a role for the EU as well as the Member States in the social sphere. The Commission in the 1990s made the case that social protection systems, far from being an economic burden, can act as a *productive factor* contributing to improved economic performance. This argument undoubtedly contributed to the acceptance of the new legal base for the fight against social exclusion incorporated in the Treaty of Amsterdam signed in October 1997.

A major reason why Member States started cooperating at EU level in the field of social policy was the growing acknowledgement that national social protection systems face common challenges demanding reforms and modernisation – for instance, concerning the need to fight poverty and social exclusion, and to ensure financially sustainable and socially adequate pensions for an ageing population. Equally important is the fact that one could not completely separate market issues, within the competence of the Union, from the social issues that are the prerogative of Member States. There is a tension that has to be resolved.

From this brief historical account, we can see that there has been a degree of continuity in the basic ideas underlying the development of EU social policy. At the same time, progress has been uneven, as we have seen from the rejection of the Poverty 4 Programme proposal and the failure to include the Charter of Fundamental Social Rights in the Amsterdam Treaty.

1.2.1 After Lisbon: the Social Inclusion Process

At the Lisbon Summit of March 2000, Heads of State and Government decided that the Union should adopt the strategic goal for the next decade of becoming the world's most competitive and dynamic knowledge-based economy, with more and better jobs and a greater degree of social cohesion. It is noteworthy that 'social cohesion' appeared in the same sentence as 'competitive economy'. The incorporation of the promotion of social inclusion within the overall strategy of the EU was taken up enthusiastically by successive Presidencies: Portugal, France, Sweden and Belgium.

At the Nice Summit in December 2000, it was agreed to advance social policy on the basis of an open method of coordination, modelled on that already adopted for employment in the 'Luxembourg process'. The process of open co-ordination involves fixing guidelines for the Union, establishing quantitative and qualitative indicators to be applied in each Member State, and periodic monitoring in a process of peer review. The open method of coordination is controversial, but my own view is that it is a rather clever invention, blending EU-wide action with the principle of subsidiarity, under which social policy is the responsibility of Member States. The tension described earlier can in this way be resolved. It was agreed that each Member State should implement two-year national action plans for combating poverty and social exclusion, setting specific targets, taking into account national, regional and local differences. These National Action Plans on Social Inclusion are like the National Action Plans on employment, and their purpose is to set out national strategies and detailed policies.

After peer review by other Member States, the Commission produces a report, comparing the successes and failures and, in particular, identifying the opportunities for policy learning.

The Lisbon process was reviewed by the EU in the light of the work of a committee chaired by the former Dutch Prime Minister Wim Kok. This committee expressed concern about the lack of progress towards the

Lisbon objectives and recommended that overriding priority be given to economic and employment growth policies, arguing that fulfilment of the social objectives would result from progress in these two areas. As a result, the Member States agreed to give priority to employment and growth, reflected in the motto adopted for the Social Agenda 2006–10. At the same time, the March 2005 Presidency Conclusions re-affirmed the role of the EU in combating social exclusion and emphasised the multidimensional approach. It also highlighted the problem of child poverty, which is one reason that I shall later take the case study of children mainstreaming.

1.2.2 Structure of policy making

The current social inclusion process recognises that action is the responsibility of Member States, but within a framework of common objectives. The precise nature of this resolution of the tension between EU and Member States should be clarified, since it is a source of confusion.[2] In the public finance literature on decentralisation, there has been analysis of the allocation of functions to different levels of government, particularly between federal (the European Union in the present context) and local (in this case the Member States). Some economists have argued that functions such as income redistribution should be allocated to local governments where there are marked differences in preferences of voters between local areas. Subsidiarity would then mean that a Member State was free to determine the extent of redistribution on the basis of the expressed preferences of its electorate. Some countries would choose a highly redistributive policy, with associated higher taxes, and others would provide less social protection. This is not, however, what is envisaged in the Treaty on European Union, which refers to the best way of achieving agreed common objectives. In other words, it does not leave the lower-level government free to determine the *objectives* of redistributive policy.

It is in the establishment of common objectives that social indicators enter the stage. The key role of social indicators is to embody the common ambitions of the EU. At the Nice Council, the European Commission was requested to monitor the implementation of the social agenda and to prepare an annual scoreboard of progress. It was invited to identify good practice and to promote its common acceptance. In order to achieve this, the Social Protection Committee has established a Sub-Group on Social Indicators. At the same time, the Belgian Presidency commissioned a scientific report on *Social Indicators: the EU and Social Inclusion* (Atkinson *et al.*, 2002). Subsequently, Heads of State and

Government at the Laeken European Council in December 2001 agreed a set of European social indicators. The primary indicators encompass financial poverty, income inequality, regional variation in employment rates, long-term unemployment, joblessness, low educational qualifications, low life expectancy and poor health. In each case there are breakdowns, showing, for example, poverty among men and women, or breakdowns by age groups.

1.2.3 EU social performance

The indicators may be seen as growing out of the early estimates of poverty in the European Union by O'Higgins and Jenkins, and by the late Aldi Hagenaars and colleagues, but they are not limited to income-based measures. I stress the multidimensional nature of the approach, which was important to securing acceptance of the indicators. Here, however, in the limited space available, I shall focus on the income measures.

Figure 1.1 shows the proportion of people living in households with incomes below 60 per cent of the median, taken by the EU as an indicator of the risk of poverty (source: Eurostat website, downloaded 3 September 2007). Among the Member States belonging to the EU at the time of Lisbon (the EU15), there is a clear geographical pattern. The Nordic countries have relatively low poverty rates. The mainland Continental countries come next, with the UK, Ireland and Southern Europe coming at the top of the league. The differences between Member States are quite large: the poverty rates in the Nordic countries are around 10 per cent, whereas in countries that speak English or have capitals south of Vienna the rate is above the EU15 average of 15 per cent. Similar differences are found with regard to persistent poverty, which was defined as having a current income below the poverty threshold and having been below the level in at least two of the previous three years. Persistent poverty, measured with 2001 incomes as the most current (source: Eurostat website, downloaded 3 September 2007), was 6 per cent in Denmark, Germany, the Netherlands and Finland, whereas it was 13 per cent in Ireland and Italy, 14 per cent in Greece and 15 per cent in Portugal.

There is a tendency for the EU Member States with lower per capita incomes to have above-average poverty rates. This might lead us to expect that the Enlargement of May 2004, adding ten new Member States with incomes per head mostly well below the EU average, would have widened still further the diversity of performance. In fact, while it is true that Poland has the highest figure in Figure 1.1, the Czech figure is nearly at the other extreme. Six of the new ten Member States are close to the EU average. The same pattern emerges if we look at overall income

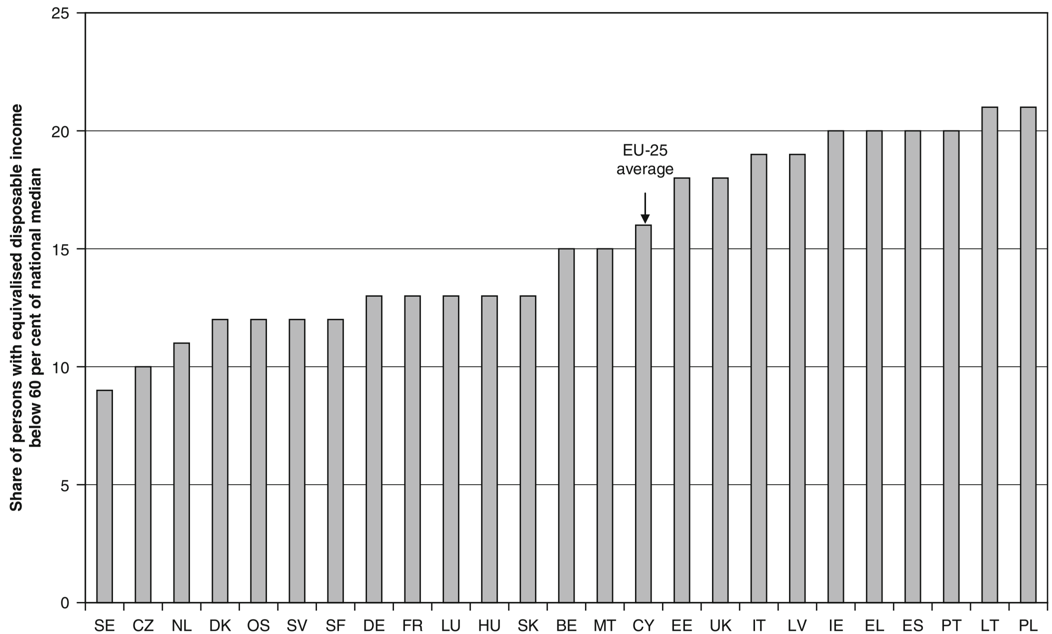

Figure 1.1 At risk of poverty rate after social transfers 2005

inequality (source: Eurostat website, downloaded 3 September 2007). Again, the Nordic countries tend to have relatively low income quintile share ratios (ratio of share of the top 20 per cent to that of the bottom 20 per cent), Benelux and the mainland Continental countries tend to come next, with the UK, Ireland and Southern Europe coming at the top of the league. The new Member States again appear at different points on the same range.

The considerable diversity across Member States should be stressed. At the same time, the EU Member States are considerably less unequal than the USA.[3] This makes a significant difference to how we view the relative economic and social performance of the US and Europe. If, for example, one takes the estimate of Maddison (2003) of PP adjusted per capita GDP for the US and 12 Western European countries, then in 2001 the US was ahead by some 40 per cent. Suppose, however, one takes the 'distributionally adjusted' measure of national income proposed by Sen (1976), which involves multiplying by (1 – Gini), the advantage of the US is reduced to 17 per cent. Put another way, there is much concern in Europe about the fact that the US appears to have pulled away over the course of the past two decades. It is true that, according to the Maddison estimates, the US advantage in 1980 was only 32 per cent, whereas in 2001 it was 40 per cent. But over the same period the Luxembourg Income Study website data show the US Gini as having risen from 30 per cent to 37 per cent, whereas in most European countries there was no major rise in income inequality – apart from the UK. The increases in the Gini, where they did happen, were only modest. If we assume that the Western European Gini went up by at most two percentage points, then in distributionally adjusted terms the US has not pulled ahead. The advantage in 1980 was in fact 20 per cent when calculated using the Sen real income measure – that is, more than in 2001.

1.2.4 Conclusions

I have looked at only one dimension of social performance, but in this case it appears that there are

- Significant differences from the US, of a magnitude that could affect our view of their relative performance.
- Within the EU there is considerable diversity.
- This means that there is considerable scope for the least well-performing Member States to improve their performance, and the Social Inclusion Process is designed to bring this about.

Will it, however, have scope to operate in a globalising world?

1.3 Globalisation and the economic challenge to social protection

In considering the impact of globalisation on social policy *today*, it is important to remember that the formative period for the modern welfare state was the latter half of the nineteenth century. This timing is of interest, since the period 1870–1914 was one of 'rapid globalisation' (Williamson, 1996, p. 227). Some writers (such as Tanzi, 2004) have suggested that the modern welfare state originated in the protectionist interwar period, but an important part of the welfare state was in place before 1918. Both Bismarck in Germany and Beveridge in the UK pre-date the First World War. It is true that family allowances largely post-dated the First World War, but social insurance against work injury, sickness and old age were well established by 1920.

The internationalisation of the economy was not the only reason for the emergence of the welfare state. The introduction of social insurance in the nineteenth century has to be seen in the light of the development of the modern employment relationship, with the associated risks and uncertainties (in the Knightian sense) of unemployment and retirement. Introduction of social insurance was a response to the perceived shortcomings of the industrialised market economy. Moreover, it served a political purpose. It was no accident that the move in the UK from the Poor Law to National Insurance was a move from local, parish jurisdiction to national administration. It was no accident that the pioneer countries in the field of social security were relatively recently unified (such as Bismarckian Germany) or relatively recent states (such as New Zealand). The new schemes were building solidarity not just between the employed and the unemployed, or between workers and the elderly, but also between the citizens of relatively new political units. There is an obvious parallel with today's EU.

One hundred years later, this positive view of the welfare state is being challenged. It is being seen as dysfunctional rather than functional. There are vocal demands for social protection to be scaled back. I turn now to these arguments. In my view, it is very important to be clear as to what exactly is being asserted. Economists are drawing strong policy conclusions, and we need to be sure how fully they are describing the menu of choice open to governments. This is essential, since their proposals threaten one of the most successful social innovations of recent centuries. We need therefore to have a clear view as to how far the conclusions are inevitable and how far we have a choice. The main theme of this section is – what choices are there?

1.3.1 Relegation of social objectives

Today's European debate is dominated by the economic challenges faced by the EU. The Lisbon aspiration that Europe will become a dynamic knowledge-based economy with more and better jobs does not seem closer to realisation than five years ago. If anything, the challenge posed by globalisation seems greater. Job creation has proved elusive, and Member States remain concerned about the slow rates of economic growth achieved.

Employment is the over-riding concern. It should be noted that it is *employment*, not *unemployment*, that is the explicit target. The EU at the Lisbon European Council agreed the target for 2010 of raising the overall employment rate in the EU to 70 per cent and that for women to 60 per cent. Now it is true that much of the difference in GDP per head between the US and mainland Europe is due to Europe having a lower employment rate. (I say mainland Europe, since the UK appears similar to the US in this respect.) Attention has therefore focused on raising employment, and reversing the trend to increased rates of inactivity. But it is important to remember that the activity rate for men aged between 30 and 50 has not fallen very much. It is at the two ends of the working life that activity rates have declined. Politicians have deplored particularly the trend towards earlier retirement. This led the EU to set a further target of raising the employment rate of older men and women (aged 55–64) to 50 per cent by 2010. But less attention has been given to the decline in activity rates among young people, not all of whom are in education.

Whether or not employment targets make sense is a good question. Within any country, it is certainly true that poverty among those in paid work is far lower than among those who are not – certainly if one considers only the non-elderly. However, across countries the link between employment and relative income poverty is much less strong. There are countries such as Greece and Spain that have low employment and high poverty, but there are also countries, such as Belgium, Luxembourg and Slovenia, that combine low employment with low poverty. Ireland, Portugal, the UK and Cyprus, on the other hand, combine above-average poverty with high employment. Similarly, across time, countries that have done well in terms of employment growth have not necessarily done well in terms of poverty alleviation (see Marlier *et al.*, 2006). Most striking are the examples of Finland and Ireland, where a pronounced rise in employment has gone hand in hand with a rise in relative poverty. The Netherlands and Spain show a marked rise in employment with no fall in their relative poverty rate.

The switch in policy to giving priority to employment has been presented as though Europe has no choice. The political rhetoric is that the EU has no alternative but to relegate social objectives to a subsidiary position. But there are also those who believe that Europe *has* a choice, and that it is possible to maintain an integrated approach to both economic and social objectives. As we have seen, this has been the long-standing EU approach. Economic change may involve the EU countries transforming their economic structure; it may be necessary to reform the social protection system, but one of the distinguishing features of European policy has been the ambition to achieve structural change without an unacceptable human cost. As noted earlier, it is no accident that the European Communities had their origins, at least in part, in the need to restructure the basic (coal and steel) industries of Europe.

1.3.2 The tax cost argument

The world has changed since the 1950s, however, and what was possible then may not be possible today. A clear statement of the argument that a downsizing of social protection is inevitable is that of Tanzi:

> high tax countries, and especially the so-called welfare states, will need to cope with their needs with progressively lower tax revenue. This scaling down of tax revenue would leave the countries with two options. First, to reduce the generosity of the benefits that individuals receive from the welfare states or to make these benefits less universal and thus better targeted. Second, to force citizens to buy at least parts of their insurances from the private sector. (Tanzi, 2004)

This is a valuable statement, because he is very clear about the nature of the cost. He is not talking about the excess burden of the welfare state, compared to private or other alternatives. He focuses on the total cost in terms of government financing. In the fanciful example that I have used elsewhere (Atkinson, 1999), in the unlikely event that a Martian offered to finance the welfare state, then Tanzi's concern would disappear.

It is a pure Laffer curve argument. Total revenue reaches a maximum at some tax rate less than 100 per cent. The effect of globalisation is, according to Tanzi and others, to shift the Laffer curve downwards and move its peak to the left. If we were not already at the maximum of revenue, then we will soon be overtaken by events. As put by Tanzi, 'tax competition among jurisdictions, ballooning electronic commerce, and increased mobility of the factors of production will likely cause significant falls in tax revenue in future years' (2002, p. 116). This is a real set of economic constraints, on which economists are well placed professionally to advise. We should, however, distinguish the argument from a second argument, which is that the tax rate is reaching the politically acceptable maximum. This argument lies outside the sphere of competence of economists. Electoral constraints are not the same as economic constraints. Voters should be given the opportunity to make choices; their choices should not be pre-judged.

So it is on the Laffer argument that we should focus. It is evidently an important argument. At the same time, as Tanzi recognises, it applies to all government spending. It is a threat not just to the welfare state but also to all activities financed by tax revenue. Of course, the welfare state is a large element, and its significance has been greatly increased by demographic and macroeconomic developments. In simple terms, the required tax rate is equal to

$$\begin{aligned}&\text{Replacement rate} \times \text{Dependency rate}\\&\quad + (\text{Other government spending} + \text{Cost of tax expenditures}\\&\quad + \text{Cost of debt interest})/\text{Total income}\end{aligned}$$

Reducing the replacement rate can evidently have a large effect. With a dependency ratio of a half (that is, one pensioner or unemployed for each two workers), a 5 per cent cut in the replacement rate reduces the required tax rate by two and a half percentage points. At the same time, it is clear that, while the welfare state may represent a particularly large item in the budget, the tax cost is the same $ for $ as if the spending were on roads or military defence. There is a choice as to where the cuts in spending should fall; and we can debate this choice. There is no inevitability that the welfare state has to bear the entire burden.

By the same token, *tax expenditures* have an identical impact to that of direct spending. Allowances against income taxation and tax credits play the same role as cash transfers, in that both increase the tax rate necessary. A higher tax exemption for the elderly reduces the overall tax receipts, as do child tax allowances. This is important since the option of private provision is often encouraged by tax concessions. The two – welfare state spending and tax expenditures – do not usually appear in the same equation, but they both raise the required tax rate.

1.3.3 The distortion argument

However, it may be argued that we should single out social protection expenditures because they are particularly damaging. This brings me to the disincentive argument. On this line of reasoning, social protection is different from other tax outlays because it not only costs money but also distorts key economic decisions. The welfare state is not only too expensive but also is the cause of Europe's economic malaise. To see that this argument is different, one has only to go back to my hypothetical Martian who offers to pay for the welfare state. On the distortion argument, we might well reject the offer on account of the economic damage caused.

This argument is sometimes made along the lines that any interference with the market economy distorts decisions; it imposes marginal tax rates different from zero; it causes us to depart from a level playing field. The trouble with this position is that it assumes a world of perfectly competitive and perfectly clearing markets, whereas in such a theoretical framework there are none of the contingencies for which the welfare state exists. There is no involuntary unemployment. There are assumed to be a full set of capital and insurance markets. I can buy today personal care in the event that I need it in 20 years' time. However, in order to examine the economics of social protection, we have to move away from an assumed world of perfectly competitive and perfectly clearing markets. We have to allow for at least some of the contingencies for which the welfare state was created.

To illustrate this point, I take the non-competitive model used in the influential article 'The Welfare State and Competitiveness' (Alesina and Perotti, 1997). They study a two-country world where in the home country wages are bargained by trade unions, generating unemployment in that country. In the other (foreign) country, there is a competitive labour market with full employment. Homogeneous workers have an alternative use for their time, worth R, which is assumed to be less than the full employment wage. If there is unemployment benefit B, then the resulting reservation wage is (R+B). In a right to manage model where firms determine employment, unions bargain over wages as a mark-up $(1 + m)$ over this reservation wage. The gross wage is increased by the payroll tax at rate t (assumed here to be the method by which social transfers are financed). The resulting total labour cost is $W \equiv (1 + t)(1 + m)(R + B)$. This means that, as shown, the welfare state affects employment via both the fiscal burden (t) and the behavioural effect (B).

In such a situation, it does indeed appear that, even if there were no tax cost, cutting the welfare state, reducing B, would indeed raise employment and improve economic performance. We should, however, note the relation between labour market policy and retrenchment of the welfare state, represented respectively by m and B. There is a view that these measures have to be used in conjunction. Coe and Snower, in *IMF Staff Papers*, argue that 'an important group of labour market policies are complementary in the sense that the effect of each policy is greater when implemented in conjunction with the other policies than in isolation. [What is required] is deeper labour market reforms across a broader range of complementary policies' (1997, p. 1). These authors are careful in their definition of complementarity, which concerns the reinforcing effects of policies, but the statements have been interpreted as saying that countries cannot choose to concentrate on one arm of the strategy.

However, it is not evident that governments have to *both* make labour markets more flexible *and* cut back on social protection. The advantage of a formal model, such as that just described, is that one can test such claims. In fact, in this model, a reduction in *either* m *or* B reduces unemployment. The policies are alternatives. Put differently, the more flexible the labour market, the less the cost in terms of distortion from the provision of social protection. In practical terms, we see this demonstrated by the Danish experience, where they have combined light regulation with generous benefits and active employment policies. As we saw earlier, they score well on overall poverty.

1.3.4 Conclusion

In this section, I have suggested that there is scope for choice. Simple relegation of social objectives is not preordained. There is no inevitability about scaling back social protection. If our concern is with the total tax cost, then there are other routes to tax reduction. If our concern is with disincentives, then increased labour market flexibility offers an alternative to cutting social protection.

1.4 Learning from the diversity of institutions

Much of the economic writing about the welfare state takes an aggregate approach, and my talk so far has been no exception. It has been aggregative both in the sense that it has tended to look at Europe as a whole, and in its treatment of the institutions of the welfare state. Much of the interest, however, lies in the diversity of experience and in the detail of the fine structure.

1.4.1 Institutional structure

The need to look more closely at the institutions of the welfare state is well illustrated by the analysis of the labour market just presented.

Alesina and Perotti (1997), like most macroeconomists, treat unemployment insurance as a 'wage when not working'. Anyone with experience of actual unemployment insurance (UI) systems knows that in reality it is not just a benefit paid unconditionally to the unemployed. There are a number of key conditions, such as contribution conditions, tests of job search activity, and tests of availability for work. To ignore these institutional features is to ignore the fact that the founders of the modern welfare state were well aware of the possible negative side effects on employment, and designed the scheme to take these into account. And these features, even if not perfectly enforced, affect the economic working of the scheme. Consider, for example, the much-used model of unemployment due to an efficiency wage being set so as to avoid shirking by employees. This formulation assumes that the worker has an outside option of receiving unemployment benefit. However, the provisions, found in most unemployment insurance schemes, which disqualify people who have been dismissed for industrial misconduct, mean that the benefit does not enter the non-shirking condition that determines wages.

Moreover, the contribution conditions mean that the worker gets some benefit from past contributions: it is not a pure tax. As Milton Friedman recognised many years ago, the existence of social security provides an incentive for people to enter the paid labour force. Today, when we are concerned about the growth of the informal economy, the existence of taxes is often cited as a disincentive, ignoring the offset provided by the benefits only available to those who have contributed. It is also very relevant when we consider migration.

1.4.2 Fine-tuning institutions

The lesson to be drawn is that the impact of social policy depends on its fine structure. While it may be true that existing benefit schemes contain disincentives to work or to save, this does not mean that we should give up on social protection. The challenge is to design reforms that provide positive incentives while maintaining, as far as possible, the redistributive function. A classic example is provided by risk. Where labour market outcomes are risky, unemployment benefits may be necessary to secure market efficiency. A person searching for a new job may otherwise settle too quickly rather than consider all the options. As Diamond (1981) pointed out years ago, the no-intervention equilibrium may not maximise expected net output: that is, even ignoring distributional concerns, we may wish to operate unemployment insurance to secure efficiency. Under certain conditions, such as equal bargaining power for employers and workers, the no-tax no-benefit equilibrium is indeed the output-maximising outcome. But if workers have less power, then the trade-off shifts, and a positive level of social protection is necessary to secure efficiency.

1.4.3 Role for EU: children mainstreaming

Social policy is the preserve of Member States, and the issues just discussed are ones for individual governments. But the EU can play a role, not least by shifting the agenda of Member States. The EU employment process is an example. Here I focus on a more recent example – the recent emphasis on children. This is a good example, both because most people agree that children are important, and because it illustrates the diffusion of policy thinking. Five years ago, very few countries were concerned about child poverty. The UK Prime Minister had set the objective for his government of abolishing child poverty, but most other EU countries had not identified this as an objective, and the first NAPs/inclusion did not emphasise this dimension. This has changed in recent years, with the 2004 Joint Report, and with countries such as France producing reports on the subject.

The EU common social indicators that I referred to earlier are broken down by a number of sub-groups. One of these sub-groups consists of children, defined as people aged 15 or under. As was observed in the 2004 Joint Report on Social Inclusion, 'in most countries children experience levels of income poverty that are higher than those for adults'. The rate of risk of financial poverty for children in the EU-25 as a whole was 19 per cent in 2005, compared with 16 per cent overall (source: Eurostat website, downloaded 3 September 2007). The situation for children is compared with that for all persons in Figure 1.2.

Figure 1.2 shows that some of the countries with low overall poverty rates also have low relative poverty rates for children, such as the Nordic countries, but it is also the case that Greece, with a high overall poverty rate, has a relatively good performance. The other Southern European countries, however, also score badly for children, as do the Netherlands and Luxembourg. It should also be noted that all except one of the new Member States (Cyprus) had child poverty rates in excess of the adult rate.

In identifying children, I am not suggesting that they are the most important group or that they should necessarily have priority over, say, the elderly. It is for this reason that I refer to 'children *mainstreaming*', not to children as a 'target group'. Rather, as with gender mainstreaming, we are suggesting a different perspective. It gives a different 'cut' through the problem. Indeed we can contrast the way we arrived at the figures – by starting with the common poverty indicator and then breaking it down,

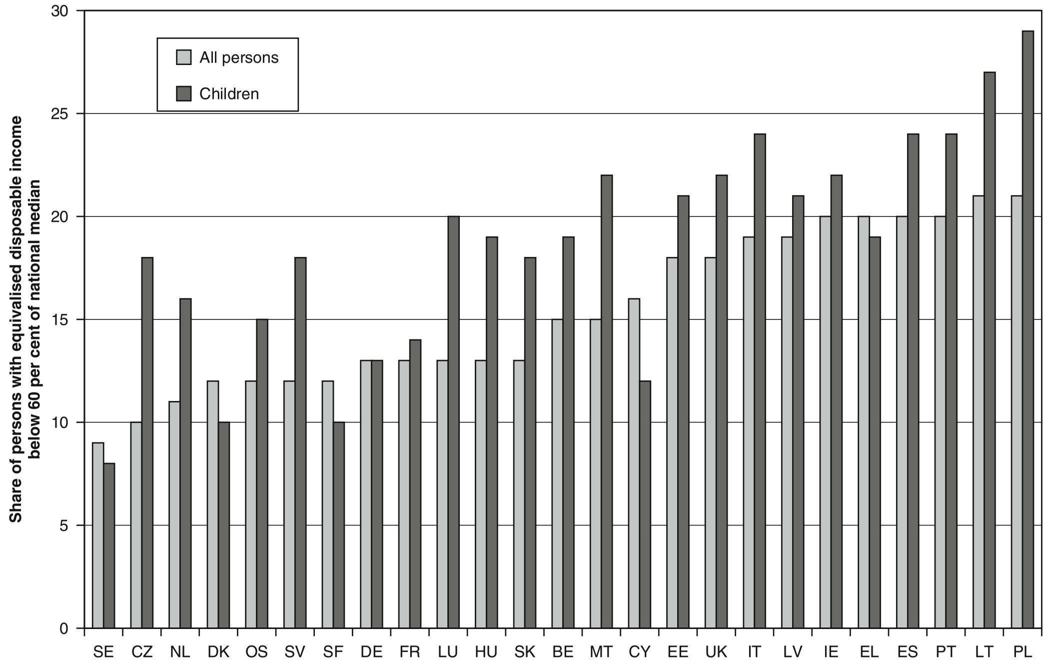

Figure 1.2 At risk of poverty rate after social transfers 2005 – children and all persons compared

with the alternative of starting from the group in question, and asking what indicators we would like to employ.

If we in fact ask the question 'What indicators would best serve the needs of children?', then one would conclude that the present set of indicators are not well-adapted. The coverage of dimensions other than income is very limited. The only indicators for children are the proportion living in jobless households and the proportion of 15-year-olds with low reading literacy. These are both evidently important, but there is a good case for considering educational measures at younger ages, covering attainment and attendance. We may want to consider measures of child health. In the same way, the policy analysis needs to be refined. The aggregate statistics on child poverty provide a clue where to start looking, but in order to go further we need to look at the micro-data. For this purpose, we need to know both the outcome for individual households, and the relation between this outcome and the choice of policy instruments.

1.5 Conclusions

In this chapter, I have suggested that

- A strong line of continuity runs through the development of EU social policy, but progress has been uneven.
- There is considerable diversity in social performance within the EU, and hence scope for the least well-performing countries to improve performance on social indicators.
- The European welfare state faces a challenge from globalisation, but simple relegation of social objectives is not the only option; nor can we rely on 'trickle down' – employment does not ensure escape from social exclusion. If our concern is with the total tax cost, then there are other routes to tax reduction; if our concern is with disincentives, then increased labour market flexibility offers an alternative to cutting social protection. The fine structure of institutions can be tailored to balance efficiency and redistribution; social protection can provide positive incentives. As the founders of the welfare state well understood, the welfare state can contribute to both efficiency and equity objectives.
- While the responsibility for social policy lies firmly with Member States, the EU can help shape the debate, as I have illustrated by the present-day emphasis on investment in children.

Notes

1. For further discussion of the historical development of the EU social dimension, see Marlier *et al.* (2006).
2. See also the discussion of federalism in chapter 8.
3. See also chapters 2, 3 and 4.

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2

Conditions of Social Vulnerability, Work and Low Income: Evidence for Europe in Comparative Perspective

Teresa Munzi and Timothy Smeeding

2.1 Introduction

Many nations have a long tradition of measuring income inequality and poverty and weighing the effectiveness, successes, and failures of government policies aimed at poverty reduction and at offsetting the instability effects of globalisation of labour markets.

One can find many types of 'social policy reforms' in rich nations: for instance, the 1996 United States Welfare Reform Act, which shrunk the AFDC/TANF (Aid to Families with Dependent Children/Temporary Assistance for Needy Families) rolls from over 5.0 million units and 11 million persons in 1994 to under 1.8 million cases (and less than 4.5 million persons) by June 2006. Or one could look at the series of child poverty-reducing reforms introduced by the Blair government in 1999 (see Hills and Waldfogel, 2004). These two cases, compared later in the chapter, help us understand the question of whether and to what extent dramatic changes in programme caseloads, work incentives and welfare state programme designs lead to better anti-poverty outcomes.

For the most part, examinations of domestic anti-poverty policy in any country are inherently parochial, for they are based on the experiences of only one nation in isolation from the others. The estimation of cross-nationally equivalent measures of poverty and inequality, and the comparison of programmes that help reduce them, provide a unique opportunity to compare the design and effectiveness of one nation's social policy and anti-poverty policy with the experiences of other nations. The Luxembourg Income Study (LIS) database, which undergirds this chapter, contains the information needed to construct comparable poverty and inequality measures for 33 nations. It allows comparisons of the level and trend of poverty and inequality across several nations, along with considerable detail on the sources of incomes and public polices that in large part shape these outcomes.

In this chapter, we use cross-national comparisons of poverty and inequality, adopting the two comparative (transatlantic and intra-European) dimensions on which the book is based. In so doing, our investigation into social policies and the effectiveness of anti-poverty and inequality policy programmes contributes to the assessment of social policy alternatives for the European Union. That is, we examine differential experiences in fighting poverty and inequality in the face of substantial and rising economic inequality, in a cross-national context. This chapter is the first to compare the recent situation of France, Germany and Northern Europe with that of Greece, Italy and Spain (the LIS Mediterranean nations) within Europe and with that in other richer nations, including the United States, Australia and Canada, using the LIS micro data.

Fifty years ago, at the onset of the EU, only a much-reduced set of current EU member countries were part of the initial union. Fifteen years later, when they joined the EU, Spain and Greece were countries of emigration, not immigration, and the welfare state was minor and insignificant compared to the already well-developed welfare states France, Germany and Northern Europe (Ferreira, 2005). While economic growth has benefited the EU enormously over the past 30 years, Spain and others are still at a relatively low standard of living (along with Greece) in real income terms compared to northern and central Europe. Spain continues to be an underdeveloped welfare state in the European sense, yet it also seeks to avoid some of the mistakes and poverty traps of the larger and more mature EU welfare states that we compare in this chapter.

Not only must all of these nations deal with the risks of old age, disability and unemployment but they must also deal with the 'new risks' to working families (divorce, child care, job flexibility) as well as low wages, job tenure and instability and globalisation. Indeed, the modern welfare state in Europe and elsewhere is about trying to find a 'better' way to support families and children while at the same time encouraging work and self-sufficiency (Matsaganis *et al.*, 2003).

To many observers, France, parts of which of course border on the Mediterranean, has found a 'better way' to deal with child and family poverty than have most other Central and Southern European nations. However, these changes have affected French economic growth and have brought much political and social unrest, as evident in recent national elections.

Still, we believe that there are lessons about anti-poverty policy that can be learned from cross-national comparisons. While every nation has its own idiosyncratic incentives and polices, reflecting its values, culture, institutions and history, wide differences in success and failure are evident from the comparisons that follow. And while there is evidence that such policies are becoming internationalised in their spread and evaluation (Banks *et al.*, 2005), they do in fact still differ substantially. Issues of globalisation, job instability, immigration and population aging are becoming more important throughout the rich and developing world, threatening safety nets and basic income supports. And there is growing evidence that the welfare states in Europe are also undergoing similar changes (Sapir, 2006; Wolf, 2005; Ferreira, 2005).

In section 2.2 we begin by reviewing international concepts and measures of poverty and inequality. In so doing, we identify a number of markers that we can use to examine the success and failure of anti-poverty policy in a cross-national context. In section 2.3 we mention the data and present some macroeconomic comparisons to motivate as we examine the effects of work, education, pay, family structure and social policy in achieving poverty and outcomes. We present these results in section 2.4 and suggest some common explanations in section 2.5, including a very recent US–UK comparison of policies and trends. In section 2.6 we conclude with a discussion of the relationship between policy differences and outcome differences among the several countries, and consider the implications of our analysis for research and for possible antipoverty policy strategies in Europe.

While all nations value low levels of poverty, high levels of economic self-reliance, and equality of opportunity for younger persons, they differ dramatically in the extent to which they reach these goals. Most nations have remarkable similarities in the sources of national social concern: births outside of wedlock and lone parent families (especially in Anglo-Saxon nations – less so at this time in many European countries); poverty in old age, especially among older women; unstable employment; low fertility rates; low wages; and the question of the sustainability of social expenditures in the face of rapid population ageing and rising medical care costs. These nations also exhibit differences in the extent to which working-age adults mix economic self-reliance (earned incomes), family support, and government support to avoid the poverty associated with low educational qualifications and, to a lesser extent, lack of employment. Clearly, the ‘right’ solution depends on the institutions, culture, politics, and feasibility constraints under which each nation finds itself.

2.2 Cross-national comparisons of poverty and inequality: methodology and measurement

There is considerable agreement on the appropriate measurement of poverty in a cross-national context. Most of the available studies and papers share many similarities that help guide our methodological strategy. Differing national experiences in social transfer and anti-poverty programmes provide a rich source of information for evaluating the effectiveness of alternative social policies in fighting poverty and inequality. While most rich nations share a concern over low incomes, poverty measurement began as an Anglo-American social indicator. In fact, 'official' measures of poverty (or measures of 'low-income' status) exist in very few nations. Only the United States (US Census Bureau, 2003b) and the United Kingdom (United Kingdom Department of Work and Pensions, 2007) have regular 'official' poverty series. In Northern Europe and Scandinavia, the debate centres instead on the level of income at which minimum benefits for social programmes should be set and on 'social exclusion' (Atkinson *et al.*, 2002). Most northern European nations recognise that their social programmes already ensure a low poverty rate under any reasonable set of measurement standards (Björklund and Freeman, 1997). Instead, they concentrate their efforts on social mobility and inequality reduction (Erikson and Goldthorpe, 2002). While rapid economic growth in many nations has lessened the incidence of poverty, it has not been eradicated in Europe.

While there is no international consensus on guidelines for measuring poverty, international bodies such as the United Nations Children's Fund (UNICEF), the United Nations Human Development Report (UNHDR), the Organisation for Economic Cooperation and Development (OECD), the European Statistical Office (Eurostat), the International Labour Office (ILO) and the Luxembourg Income Study (LIS) have published several cross-national studies of the incidence of poverty in recent years. A large subset of these studies is based on LIS data.[1]

For purposes of international comparisons, poverty is almost always a relative concept. A majority of cross-national studies define the poverty threshold as one-half of national median income. In this study, we use the 50 per cent of median income standard to establish our national poverty lines. We could have selected 40 per cent of national median income as our relative poverty threshold because it is closer to the ratio of the official United States poverty line to median United States household (pre-tax) cash income (35 per cent in 1997 and below 30 per cent of median since 2000),[2] but we have decided to stay with the conventional level in most of our analyses. Alternatively, the United Kingdom and the European Union have selected a poverty rate of 60 per cent of the median income (Eurostat, 1998b; Atkinson *et al.*, 2002; Bradshaw, 2003). The results we show at the 50 per cent poverty standard can be generalised to the lower poverty standard of 40 per cent (see Smeeding, Rainwater and Burtless, 2001). The differences between the United States and other nations are much larger at the 60 per cent of the median line, which is more than 50 per cent above the 'absolute' United States poverty line, in relative terms.

While some nations like to think of themselves as using an 'absolute' poverty measure, there is no one absolute poverty measure. All poverty measures are, in some sense, relative and are chosen to be appropriate for the context in which they are used. The World Bank and the United Nations Millennium Development movement define poverty in Africa and Latin America using an income threshold of \$1 or \$2 per person per day, and in Central and Eastern Europe a threshold of \$2 or \$3 per day (Ravallion, 1994, 1996). In contrast, the absolute United States poverty line is six to 12 times higher than these standards and the European poverty line is another 70 per cent higher than the United States line (Smeeding, 2006).

For this reason, no results based on absolute poverty rates are presented here; instead, because real incomes change not only across countries but also over time, we present comparisons of trends in poverty rates in a set of countries, where the poverty line is fixed or 'anchored' at the level of an initial year relative poverty standard, and then changed only by prices. Comparisons of poverty in later years using this 'fixed' line allow us to see the effects of economic growth on poverty rates, even if inequality is also changing.

As far as inequality is concerned, this study uses the most widely used summary indicator of income inequality, the Gini coefficient of income concentration. But because the Gini coefficient is just one measure of income concentration that only looks at the overall income distribution, other indices such as percentile points will also be analysed in order to have a more complete picture of different segments of the distribution.

2.2.1 Measurement issues

Comparisons of poverty and inequality across nations with LIS are based on many choices. A poverty line, a measure of resources such as (market and disposable) incomes, an equivalence scale to adjust for family size, and, in some cases, exchange rates for conversion to real terms are all important precursors to accurate cross-national measurement of poverty status. We assess both the poverty rate (per cent of persons who are poor) and overall levels of inequality using several measures in this chapter. We measure trends in poverty using a relative poverty and a second poverty line anchored at half of median income in the mid-1980s. Trends in relative poverty show how lower income persons do relative to the rest of the population, but they ignore any changes in real living standards for low income or higher income people over time. Using the 'anchored' poverty lines we fix the poverty line in real terms at the date of anchoring, and show how absolute income gains amongst the lower-income population affect poverty in a 'fixed' living standards sense. Indeed, in almost all nations, we show a reduction in poverty based on the anchored line. The results are very different for the purely relative poverty line trends. In measuring 'anchored' poverty, changes in prices within nations are measured by their own country change in the CPI (Consumer Price Index) as published by OECD (2007c).

Other key choices include:

- Poverty and inequality measurement is based on the broadest income definition that still preserves comparability across nations. The best current definition is disposable cash and near cash income (DPI) which includes all types of money income, minus direct income and payroll taxes and including all cash and near-cash transfers, such as food stamps and cash housing allowances, and refundable tax credits such as the earned income tax credit (EITC).[3,4] In determining the anti-poverty effects of social transfers and tax policy, we also use a measure of 'before-tax-and-transfer' market income (MI), which includes earnings, income from investments, private transfers, and occupational pensions.[5]
- In tracing the effects of income transfer policy from MI to DPI poverty and from MI to DPI inequality, we determine the effects of two bundles of government programmes: Social Insurance and Taxes (including all forms of universal and social insurance benefits, minus income and payroll taxes) and Social Assistance (which includes all forms of income-tested benefits targeted at poor people, including the EITC). Again, in making these poverty comparisons for all persons and for groups, we use poverty lines of half of median DPI anchored or relative, for all persons throughout.[6] We use the Gini coefficient,

decile ratio, and ratio of the 10th and 90th percentile to the median income to measure inequality.

- For international comparisons of poverty and inequality, the 'household' is the only comparable income-sharing unit available for almost all nations. While the household is the unit used for aggregating income, the person is the unit of analysis. Household income is assumed to be equally shared among individuals within a household. Poverty rates are calculated as the percentage of all persons of each type who are members of households of each type with incomes below the overall age poverty line. In some cases we also calculate the poverty rate for elders (65 and over) and children (17 and under) regardless of their living arrangements. Further, we use the available LIS data to separate annual hours worked (according to weekly hours last year and full-time–part-time status), marital status and standardised education level of the household head (reference person).
- A variety of equivalence scales that adjust household income for differences in needs related to household size and other factors have been used in cross-national comparisons of well-being between households with differing compositions. In the United States poverty literature, a set of equivalence scales is implicit in the official poverty lines, but these are neither consistent nor robust (Citro and Michael, 1995). For the cross-national analysis of *relative* poverty rates, however, we use a consistent scale, which is much more commonly used in international analyses. After adjusting household incomes to reflect differences in household size, we mostly compare the resulting adjusted incomes to the 50 per cent of median poverty line. The equivalence scale used for this purpose, as in many cross-national studies, which include both children and elders, is a single parameter scale with a square-root-of-household-size scale factor.[7]

We do not address mobility in or out of poverty across or within generations. Researchers have shown that both income and family structure affect children's life chances and, thus, the real income level of children and their parents is of serious social concern (Sigle-Rushton and McLanahan, 2004; Duncan *et al.*, 1993). The question of mobility in and out of poverty requires the use of longitudinal microdata. All of the comparisons in this chapter are based on cross-sectional data rather than longitudinal data. In fact, several recent cross-national poverty studies suggest that intragenerational mobility in and out of poverty is lower in the United States than in almost every other rich country (Bradbury, Jenkins and Micklewright, 2001; Goodin *et al.*, 1999; Duncan *et al.*, 1993) and that inter-generational mobility out of poverty is also slower in the United States compared to Europe (Jenkins and Seidler, 2007).

2.3 The data, countries and macroeconomic comparisons: data and countries

The data we use for this analysis are taken from the Luxembourg Income Study database, which now contains over 150 household income data files for 30 nations covering the period 1967 to 2004 (www.lisproject.org). We can analyse both the level and trend in poverty and low incomes, as well as inequality patterns, for a considerable period across a wide range of nations. A broad league table showing all LIS nations is first presented. But because we are computing the level and trend in relative poverty and inequality for several major policy relevant groups, we have decided to focus on just 15 nations for the remainder of this chapter, each with a recent 1999–2000 LIS database. These include five Anglo-Saxon nations (the United States, Australia, Canada, Ireland and the United Kingdom), five Continental European nations (Austria, Belgium, France, Germany and the Netherlands), three Southern European or 'Mediterranean' countries (Greece, Italy and Spain), and two Nordic nations (Finland and Sweden). These nations were chosen to typify the broad range of rich countries available within LIS and to simplify our analysis.[8] We include all of Germany, including the eastern states of the former German Democratic Republic (GDR), in most of our analyses.[9]

2.3.1 Macroeconomic comparisons

We begin to gain perspective by comparing living standards and labour market differences. First, in the top half of Table 2.1, three features of the economic and social institutions of each nation: standard of living (as measured by Gross Domestic Product (GDP) per capita in 2000 PPP adjusted dollars); unemployment (as measured by OECD standardised unemployment rates), and cash and near cash social expenditures for the non-elderly in the 15 nations (Table 2.1; Panel A). The United States is by far the richest nation that we observe among our set, with 2000 GDP per capita of $34,788.[10]

Excluding Spain and Greece, the other OECD nations lie within a tight 12-percentage point GDP per capita range, from 71 to 83 per cent of the United States level. Spain and Greece are more accurately classified as 'middle-income' countries, with GDP per capita that are 61 and 47 per cent of the United States level, respectively. With the exception of Austria

Table 2.1 Macroeconomic comparison
A. Average standard of living:

Nation (year)	**GDP/Capita (in 2000 US$)**[1]	**Index**	**OECD standardized unemployment rate**	**OECD social expenditures on non-elderly**[2]
United States (00)	34,788	100	4.0	2.3
Ireland (00)	28,840	83	4.3	5.5
Canada (00)	28,431	82	6.8	5.8
Austria (00)	28,380	82	3.6	7.4
Netherlands (99)	28,369	82	3.2	9.6
Sweden (00)	27,170	78	5.6	12.5
France (00)	26,688	77	9.1	9.2
Belgium (00)	26,609	76	6.9	9.3
Finland (00)	25,810	74	9.7	10.9
Italy (00)	25,778	74	10.1	4.3
Australia (01)	25,775	74	6.8	6.8
Germany (00)	25,555	73	7.2	7.3
United Kingdom (99)	24,869	71	5.9	7.1
Spain (00)	21,074	61	11.1	5.5
Greece (00)	16,272	47	11.3	5.6
Average	26,294	76	7.0	7.3

Source: OECD Economic Outlook (2007b); OECD Main Economic Indicators (2005); OECD Social Expenditure Database (2001).
Notes:
[1] 2000 constant PPP per capita GDP (volume), CPI adjusted in each nation to correct year.
[2] Total Non-elderly Social Expenditures (as percentage of GDP), including all cash plus near cash spending (e.g., food stamps) and public housing but excluding health care and education spending.

Table 2.1 *(Continued)*

B. Hours per person per week and employment ratios by country: 2002

Country	Hours per person and per week	Employment/ Population (E/P)	Weeks per year (Employed)	Usual weekly hours (Employed)	Labor force participation Ages 15–64	
					Men	Women
Australia	21.8	69.4	46.3	35.3	82.3	66.3
Austria	19.7	68.5	39.0	38.4	79.1	63.5
Belgium	16.7	59.7	40.0	36.3	72.6	55.4
Canada	21.8	71.4	47.2	33.6	82.7	72.1
Finland	19.4	67.7	38.5	38.8	76.2	72.8
France	19.6	62.2	40.5	40.5	74.5	62.1
Germany	18.6	65.3	40.6	36.5	78.7	64.2
Greece	20.1	57.7	44.6	40.7	77.6	51.0
Ireland	19.8	65.0	43.7	36.3	78.3	57.3
Italy	16.4	55.6	41.0	37.4	74.5	47.9
Netherlands	17.2	73.1	38.4	31.8	83.8	66.9
Spain	18.8	59.5	42.2	38.9	80.4	53.7
Sweden	19.4	74.9	35.4	38.1	80.9	77.1
United Kingdom	21.5	72.3	40.5	38.2	83.3	69.3
United States	25.5	71.9	47.0	39.2	83.0	70.1
Average	19.8	66.3	41.7	37.3	79.2	63.3

Notes: Update of Table 1 in Alesina, Glaeser, Sacerdote (2005). Hours per person per week is calculated as the product of E/P*weeks/52*usual hours. Data on weeks and usual hours for European countries are from OECD *Employment Outlook 2004*, while the others come from LIS. Employment to population ratios and Labor Force Participation rates are from *OECD Employment Outlook 2004*.
Sources: OECD Employment Outlook 2004 and 2006, LIS data.

and the Netherlands, the United States also enjoyed the lowest unemployment rate of all nations in 2000. All of the Mediterranean nations, Italy, Spain and Greece, had unemployment rates more than twice the United States rate, with the variance in unemployment far exceeding the differences in incomes across these select nations.[11] And Greece had the highest unemployment rate of all, at 11.3 per cent.

While the United States is unique in both its high standard of living and its low unemployment rate, it is also unique in the small amount of its resources devoted to cash and near-cash social transfer programmes. In 2000, the United States spent less than 3 per cent of GDP on cash and near-cash assistance for the non-elderly (families with children and the disabled). This is less than half the amount (measured as a percentage of GDP) spent by Australia, Canada, Ireland, Spain or Greece; less than a third of spending in Austria, Germany, or the United Kingdom; and less than a quarter of the amount spent in Belgium, France, the Netherlands, Finland or Sweden; only Italy spends less than twice as much as the United States. While there is a rough correlation between social spending and unemployment, the differences we see here are not cyclical, but are rather structural in nature (see also Garfinkel, Rainwater and Smeeding, 2006, for more on these differences counting health and education benefits in kind).

The second half of Table 2.1 compares several labour market variables based on an analysis by Alesina, Glaeser and Sacerdote (2005). One initial warning about this chapter is that these figures are not computed separately for men and women, and so differences in gender-specific participation rates have a considerable impact on differences in the estimates (see last two columns for these rates). On average, nations are remarkably similar in their usual weekly hours of work for those who are employed (fourth column, Table 2.1, Panel B). Nations differ much more, however, in terms of weeks per year worked and in employment to population ratios.

2.4 Results: level and trend in inequality and poverty

Much of the concern over social and economic vulnerability in modern nations and elsewhere is driven by the high and growing levels of economic inequality found in all the countries studied here. Thus, we begin with a broad view of cross-national inequality and later show the effect of government on reducing inequality by means of tax-transfer policy. Then we move on to comparisons of poverty. In addition to overall poverty rates, we examine many sub-groups. We separately estimated poverty among two vulnerable populations – children and the aged.[12] We examine the anti-poverty effect of government policy for each of these groups. We examine poverty status according to the amount of work and the education level of the parents of low-income children in each nation. We conclude with a brief summary of what we have learned about how government support affects poverty and inequality for the vulnerable in comparative perspective.

2.4.1 Inequality in comparative perspective

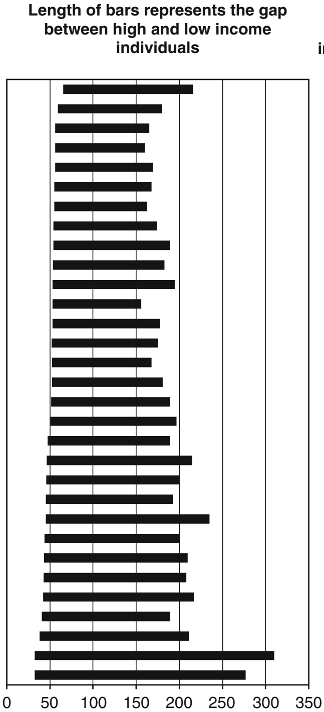
A wide range of inequality is apparent in the rich and middle-income countries contained in LIS. Figure 2.1 presents a 'bird's eye' view of these inequalities using four different measures of inequality in 31 nations, including the ones we analyse here which are marked with a (*). Countries are ranked by the adjusted income ratio of the 10th person to the 50th person in each nation (P_{10}). A different ranking can be observed by using the ratio of the 90th to the 50th person (P_{90}). In fact, concerns over inequality, vulnerability and social protection need to consider both the low-income (P_{10}) and the high-income (P_{90}) population. The difference between the two is summarised by the decile ratios (P_{90}/P_{10}) in the next column and the Gini coefficient in the final column.

While all four measures provide slightly different rankings, broad patterns are apparent. The least inequality is found in Continental European nations and Nordic/Scandinavian nations. Central and Southern Europe has more inequality, but not as much as the Anglo-Saxon nations, especially the United States. Eastern European nations show large differences (compare the Czech Republic and Estonia), but are all significantly more equal than are either Mexico or Russia. The 15 countries we have selected fairly well span the wide range in the table. Amongst the EU countries in this figure, Ireland has the highest levels of inequality.

2.4.2 Relative poverty levels

Relative poverty rates in the 15 nations we cover in this chapter are given in Figure 2.2. Using the 50 per cent poverty threshold, the overall poverty rate for all persons varies from 5.4 per cent in Finland to 17.0 per cent in the United States, with an average rate of 10.8 per cent across the 15 countries. Using a lower relative poverty rate (such as the 40 per cent of median rate) makes little difference in terms of overall poverty rate rankings.

Higher overall poverty rates are found in Anglo-Saxon nations with a relatively high level of overall inequality (United States, Ireland and the



	([1])	P10 (Low income)	P90 (High income)	P90/P10 (Decile ratio)	Gini Co-efficient[2]
Luxembourg 2000		66	215	3.24	0.260
Czech Republic 1996		60	179	3.01	0.259
Finland 2000	(*)	57	164	2.90	0.247
Norway 2000		57	159	2.80	0.251
Sweden 2000	(*)	57	168	2.96	0.252
Netherlands 1999	(*)	56	167	2.98	0.248
Slovak Republic 1996		56	162	2.88	0.241
Austria 2000	(*)	55	173	3.17	0.260
France 2000	(*)	55	188	3.45	0.278
Switzerland 2000		54	182	3.34	0.280
Hungary 1999		54	194	3.57	0.295
Denmark 1992		54	155	2.85	0.236
Germany 2000	(*)	54	177	3.29	0.264
Belgium 2000	(*)	53	174	3.31	0.277
Slovenia 1999		53	167	3.15	0.249
Romania 1997		53	180	3.38	0.277
Poland 1999		52	188	3.59	0.293
Taiwan 2000		51	196	3.81	0.296
Canada 2000	(*)	48	188	3.95	0.302
United Kingdom 1999	(*)	47	214	4.52	0.342
Australia 2001	(*)	47	199	4.25	0.317
Japan 1992[3]		46	192	4.17	0.315
Estonia 2000		46	234	5.08	0.361
Italy 2000	(*)	44	199	4.47	0.333
Spain 2000	(*)	44	209	4.78	0.340
Greece 2000	(*)	43	207	4.77	0.338
Israel 2001		43	216	5.01	0.346
Ireland 2000	(*)	41	189	4.56	0.323
United States 2000	(*)	39	210	5.45	0.368
Mexico 2002		33	309	9.36	0.471
Russia 2000		33	276	8.37	0.434
Average		**50**	**195**	**4.08**	**0.302**

Figure 2.1 Social distance and social exclusion (numbers given are per cent of median in each nation and Gini coefficient)

Source: Authors' calculations from the Luxembourg Income Study.

Notes:

[1]Asterisk denotes countries included in later analyses.

[2]Gini coefficients are based on incomes which are bottom coded at 1 per cent of disposable income and top coded at 10 times the median disposable income.

[3]Japanese Gini coefficient as calculated in Gottschalk and Smeeding (2000) from 1993 Japanese Survey of Income Redistribution.

United Kingdom), and in Mediterranean countries (Greece, Spain and Italy). Canadian and British poverty are both about 12 per cent and are, therefore, well below the United States levels. The lowest poverty rates are more common in smaller, well-developed, and high-spending welfare states (Sweden, Finland), where they are about 5 or 6 per cent. Middle-level rates are found in major Continental European countries where unemployment compensation is more generous, where social policies provide more generous support to single mothers and working women (through paid family leave, for example), and where social assistance

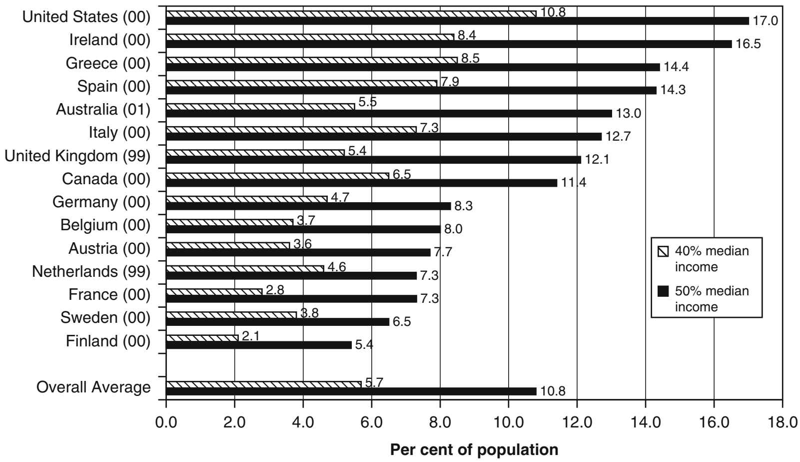


Figure 2.2 Relative poverty rates in fifteen rich nations at the turn of the century for all persons (Per cent of ALL persons with disposable income less than 40 per cent and 50 per cent of adjusted national disposable median income)
Source: Authors' calculations from Luxembourg Income Study.

minimums are high. For instance, the Netherlands, France, Belgium, Germany and Austria have poverty rates between 7 and 8 per cent.

There is a lot of detail on family type difference that is not included in this table. (See Table 2.3 and www.lisproject.com/keyfigures for child and elder poverty for all the LIS datasets.) On average, child poverty is less of a problem than elder poverty based on incomes alone. However, consumption poverty and wealth poverty might produce an entirely different picture among the elderly who do better than children (and their families) on both grounds (Johnson, Smeeding and Torrey, 2005). Single parents and their children and single elders generally have the highest poverty rates, while those in two-parent units, mixed units, and the childless experience the least poverty (not shown). In some nations elders live with their children, and in these cases living arrangements reflect the economies of scale gained by sharing living arrangements in multigenerational and cohabiting partner households. Privacy is sacrificed for a lower cost of housing.[13] A high rate of elder poverty could reflect living arrangements that are favourable to the formation of many low-income single elder households in the United States and the United Kingdom, but clearly not in the Mediterranean nations, where many more elders live with their children.

Another factor explaining this result might be the rapid pace of economic growth. This is particularly true for Ireland, where the elders are relatively poor because pensions are fixed in real terms, while the rest of the society enjoys an increasingly high standard of living as the result of rapid economic growth. Child poverty rates are highest in those countries with many single parents, low wages and low levels of transfer support.

The United States is among the three countries with the highest poverty rates in each category. In the richest nation, the United States, the poverty rates for children are almost 90 per cent above the average rate. In most cases, Ireland, a very rich nation but also a rapidly growing nation (Table 2.1), has the highest or second highest poverty rate (e.g., for elders and children). This observation brings up the issue of real income change and how these changes affect trends in poverty, to which we now turn.

2.4.3 Trends in poverty

The trend in poverty is shown in Tables 2.2a and 2.2b, reflecting between five and 17 years of history in each nation. The first year for which LIS has comparable data available for Spain or Greece is 1995; in these cases the figures reflect a very short trend. We present two types of trends. First, trend findings based on relative 50 per cent of annual median poverty, which are similar to those in recent LIS chapters (e.g., see Smeeding, Rainwater and Burtless, 2001) are presented. Next, trend measures are based on a poverty line that is 'anchored' or fixed in real terms at the mid-1980s (1995 for Spain and Greece) poverty measure, but then using poverty lines adjusted to the most recent year using each nation's CPI (Smeeding, 2006). We also list beginning and ending rates to give the reader some idea of starting points in each nation. In all nations, we show simple (percentage point) changes in poverty rates.

In general, relative poverty is higher in most nations at the end of the period than it is in the beginning, even at the end of the relatively prosperous 1990s. (This trend does not conflict with the observation that many nations' relative and absolute poverty rates, including those in the United States, rose in the early 1990s, fell in the later 1990s, and then rose again after 2000.) The major exception to this trend is France, where relative poverty fell 4.2 percentage points from 1984 to 1999. The decrease in relative poverty in Greece between 1995 and 2000 might be a 'short trend' example. The small drops in relative poverty over longer periods in the United States and Sweden are exceptions, but they start from vastly different levels of relative poverty. Four nations – Ireland,

Table 2.2a Trends in poverty in fifteen rich countries: Percentage point change from initial year

Nation	Years	Poverty rates			Percentage point change from initial year		Anchored change in percentage per year
		Initial year	End year				
			Relative	Anchored	Relative[1]	Anchored[2]	
United States	1986–2000	17.8	17.0	13.5	−0.8	−4.3	−0.3
Ireland	1987–2000	11.1	16.5	1.2	+5.4	−9.9	−0.8
Greece	1995–2000	15.4	14.4	9.9	−1.0	−5.5	−1.1
Spain[3]	1990–2000	10.1	14.3	3.0	+4.2	−7.1	−0.5
Spain	1995–2000	13.7	14.3	7.1	+0.6	−6.6	−1.3
Australia	1985–2001	11.8	13.0	10.9	+1.2	−0.9	−0.1
Italy	1987–2000	11.2	12.7	10.1	+1.5	−1.1	−0.1
United Kingdom	1986–1999	9.1	12.1	3.9	+3.0	−5.2	−0.4
Canada	1987–2000	11.4	11.4	11.0	0.0	−0.4	0.0
Germany[4]	1984–2000	7.9	8.7	5.6	+0.8	−2.3	−0.1
Belgium	1985–2000	4.5	8.0	2.0	+3.5	−2.5	−0.2
Austria	1987–2000	6.7	7.7	5.0	+1.0	−1.7	−0.1
Netherlands	1987–1999	4.7	7.3	3.5	+2.6	−1.2	−0.1
France	1984–2000	11.5	7.3	3.8	−4.2	−7.7	−0.5
Sweden	1987–2000	7.5	6.5	3.6	−1.0	−3.9	−0.3
Finland	1987–2000	5.4	5.4	3.5	0.0	−1.9	−0.1
Average		10.0	11.0	6.1	+1.1	−3.9	−0.3

Source: Authors' calculations from the Luxembourg Income Study.

Notes:

[1]Relative numbers show actual change in poverty rates at 50 per cent of median (in each year) calculated as the change from the initial year (see also http://www.lisproject.org/keyfigures/povertytable.htm).

[2]Anchored numbers show actual change in poverty rates calculated as the change from the initial year (50 per cent of median poverty line) to the final year (where the poverty line is the absolute poverty line in first year CPI-adjusted to final year).

[3]Based on two different datasets for 1990 and 2000.

[4]Only West Germany is included here.

Table 2.2b Percentage point change from initial year

Nation	Years	Overall		Children		Aged	
		Relative[1]	Anchored[2]	Relative[1]	Anchored[2]	Relative[1]	Anchored[2]
United States	1986–2000	−0.8	−4.3	−3.1	−7.3	+1.2	−4.5
Ireland	1987–2000	+5.4	−9.9	+3.4	−12.3	+27.6	−6.6
Greece	1995–2000	−1.0	−5.5	−0.5	−5.5	−0.3	−7.7
Spain[3]	1990–2000	+4.2	−7.1	+3.9	−7.9	+12.1	−10.1
Spain	1995–2000	+0.6	−6.6	−1.7	−8.6	+10.9	−4.6
Australia	1985–2001	+1.2	−0.9	+0.9	−1.5	−1.3	−5.5
Italy	1987–2000	+1.5	−1.1	+2.9	+0.5	+1.1	−3.2
United Kingdom	1986–1999	+3.0	−5.2	+3.1	−8.6	+10.3	−2.4
Canada	1987–2000	0.0	−0.4	+0.1	−0.6	−4.9	−5.5
Germany[4]	1984–2000	+0.8	−2.3	+0.3	−2.4	−1.7	−8.3
Belgium	1985–2000	+3.5	−2.5	+2.7	−1.5	+5.5	−8.9
Austria	1987–2000	+1.0	−1.7	+3.0	+0.2	−4.8	−10.4
Netherlands	1987–1999	+2.6	−1.2	+4.6	−0.7	+2.1	+0.7
France	1984–2000	−4.2	−7.7	−1.9	−6.0	−10.8	−15.0
Sweden	1987–2000	−1.0	−3.9	+0.7	−1.8	+0.5	−5.5
Finland	1987–2000	0.0	−1.9	0.0	−1.1	−3.4	−7.6
Average		+1.1	−3.9	+1.2	−4.1	+2.8	−6.6

Source: Authors' calculations from the Luxembourg Income Study.
Notes:
[1]Relative numbers show actual change in poverty rates at 50 per cent of median (in each year) calculated as the change from the initial year (see also http://www.lisproject.org/keyfigures/povertytable.htm).
[2]Anchored numbers show actual change in poverty rates calculated as the change from the initial year (50 per cent of median poverty line) to the final year (where the poverty line is the absolute poverty line in first year CPI-adjusted to final year).
[3]Based on two different datasets for 1990 and 2000.
[4]Only West Germany is included here.

Belgium, the United Kingdom and the Netherlands – experienced a rapid increase in relative poverty over this period (Table 2.2a).

The story of changes in anchored (absolute) poverty is very different, and perhaps more relevant for countries like Ireland, Greece, Spain and even France. In each nation, shown in Table 2.2, poverty falls in absolute terms, and in some rapidly growing nations such as Ireland, it fell by 9.9 points (or by over 80 per cent), albeit over a 13-year period. Spain and Greece also exhibited very large drops in anchored rates, but because the rates were high in the beginning, and even more so because the trend covers only a five-year period, they also exhibited high anchored rates by the end of the period. Still, in terms of reduction of per year-anchored poverty, both Greece and especially Spain have done remarkably well over the 1995–2000 period, with anchored poverty falling more than 1.0 points per year in both nations. If we go back to 1990 and use a different dataset to establish the trend, Spanish poverty falls by a lower annual rate. The United States, which experienced a large fall in anchored poverty, still had the highest anchored poverty rate (13.5 per cent) by a wide margin by 2000 – among the countries with longer trends, only Australia, Canada, Greece and Italy had anchored rates above 7.1 per cent by the end of the period.

In general, child and elder poverty also increased in relative terms over this period (Table 2.2b, bottom row) while both, especially elder poverty, fell in absolute terms in most countries. Among the nations for which the trend covers at least a decade, only two experienced a drop in relative child poverty, France and the United States – but the United States had the highest rate of child poverty at both the beginning and the end of this period. The rise in relative child poverty in many nations has also recently been reported by UNICEF Innocenti Research Centre (2005) and Chen and Corak (2005). Relative elder poverty rose in about half the nations; absolute elder poverty increased by less than one percentage point in the Netherlands.

We hasten to mention that the trends noted in poverty are different from the changes found in inequality (e.g., using the Gini index and the LIS key figures, available at www.lisproject.org) over this same period in these same nations. In many of the more equal nations, most of the rise in inequality noted over this period has taken the form of higher incomes at the top of the distribution rather than falling lower incomes at the bottom. Hence, relative poverty changed by much less than did overall inequality (Förster and Vleminckx, 2004; Brandolini and Smeeding, 2008).

2.4.4 The anti-inequality and anti-poverty effect of taxes and transfers

In every nation, benefits from governments, net of taxes, reduce inequality and relative income poverty (Figures 2.3 and 2.4, and Tables 2.3 and 2.4). Countries are more similar in their levels of pre-government or Market Income (MI) inequality than in their 'after tax and transfer' Disposable Personal Income (DPI) inequality. The United States has the highest level of DPI inequality and a high level of MI inequality as well, as taxes and transfers only reduced inequality by a further 22 per cent (owing to a relatively small welfare state). In 2000 French MI inequality levels are about the same as those in the United States, but the DPI level is much lower than the United States, with a 40 per cent reduction from MI to DPI inequality. The Spanish welfare state has roughly the same effectiveness in reducing inequalities as do those in Italy, Greece, Ireland and Canada. In the more equal nations of Scandinavia and Northern and Central Europe, taxes and transfers produce around 35–40 per cent drops in MI inequality (Figure 2.3).

As with inequality, poverty rates computed using household MI do not differ among countries as much as those calculated with after-taxes-and-transfers DPI (Figure 2.4). Furthermore, with an average 61 per cent decline in MI poverty for all countries considered, the drops in poverty due to taxes and benefits are much higher than those in inequality. This means that taxes and benefits tend to redistribute more income towards the low-income population rather than away from the high-income ones, so that poverty is decreased more than inequality; and this is true for all of the countries examined. The French have by far the greatest reduction in MI poverty from their social transfer system. This finding implies that different levels and mixes of government spending have sizable effects on national DPI poverty rates, but have much less impact on MI poverty rates, with the exception of France and Belgium (Smeeding, Rainwater and Burtless, 2001; Smeeding, 2006). The market income distribution seems to be more favourable to low-income families in the United States compared to most nations (with the relatively low unemployment rates in Table 2.1 obviously accounting for a large part of this difference). But because the welfare state in all nations is more efficient for poverty reduction than the American one, the final DPI poverty rates are much higher in the United States than elsewhere.

Detailed analysis shows that higher levels of government spending (as in Scandinavia and Northern Continental Europe) and more careful targeting of government transfers on the poor (as in Canada, Sweden,

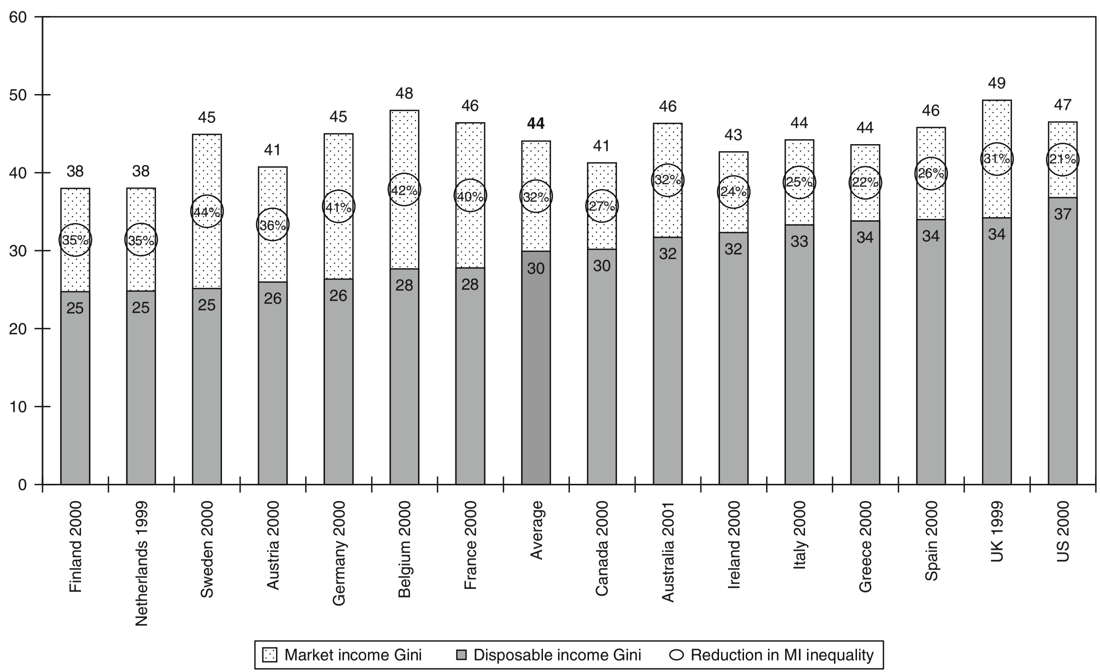


Figure 2.3 Inequality of market income and net disposable income in OECD Countries: Gini coefficients before and after taxes and benefits

Source: Authors' calculations from the Luxembourg Income Study.

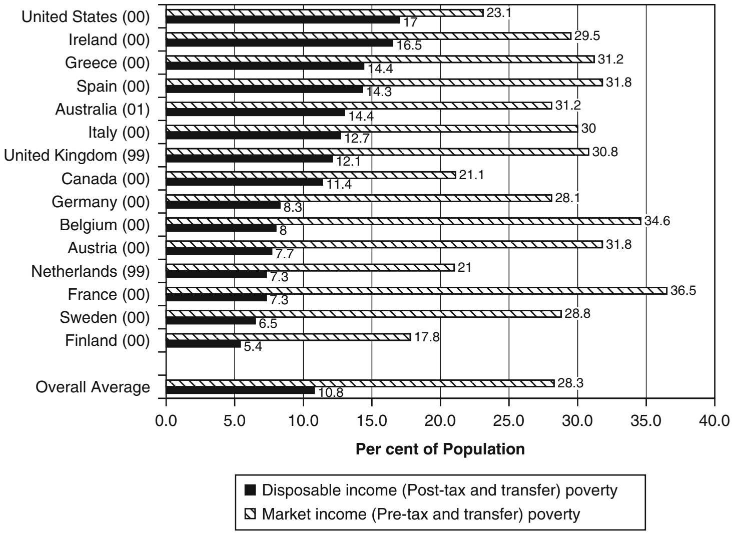


Figure 2.4 Relative poverty rates and antipoverty effects in fifteen rich nations at the turn of the century (Per cent of persons with market and disposable income less than half of adjusted national disposable median income)
Source: Authors' calculations from Luxembourg Income Study.

and Finland) produce lower poverty rates (see also Kenworthy, 1998; Kim, 2000). Unemployment is not well correlated with either market income poverty or disposable income poverty (Table 2.1); rather, earnings and wage disparities are important in determining both market income and disposable income poverty rates, especially among families with children (Jäntti and Danziger, 2000; Bradbury and Jäntti, 1999). Countries with an egalitarian wage structure tend to have lower child poverty rates – in part because the relative poverty rate among working-age adults is lower when wage disparities are small.

Greater detail as to the effects of different types of spending on poverty rates is shown in Table 2.3. Here we split the anti-poverty effect into two components: social insurance (including also universal benefits) and taxes, and social assistance. The former is not income or means tested and includes, in addition to the insurances against the risks of old age, disability, death or unemployment, also universal benefits such as child allowances and child tax credits; the latter is targeted to the otherwise poor using income tests.

One can see that most nations make effective use of both types of instruments. As one might expect, given that it started with below-average MI poverty rates and ended with the highest DPI-based poverty

Table 2.3 The anti-poverty effect of government spending: per cent of all persons poor[1] by income source

Nation (year)	Market income[2]	Social insurance (and taxes)[3]	Social assistance[4]	Per cent reduction	
				Social insurance[5]	Overall[6]
United States (00)	23.1	19.3	17.0	16.5	26.4
Ireland (00)	29.5	21.2	16.5	28.1	44.1
Canada (00)	21.1	12.9	11.4	38.9	46.0
Australia (01)	28.1	13.1	13.0	53.4	53.7
Greece (00)	31.2	14.5	14.4	53.5	53.8
Spain (00)	31.8	15.5	14.3	51.3	55.0
Italy (00)	30.0	13.7	12.7	54.3	57.7
United Kingdom (99)	30.8	23.0	12.1	25.3	60.7
Netherlands (99)	21.0	9.6	7.3	54.3	65.2
Finland (00)	17.8	11.4	5.4	36.0	69.7
Germany (00)	28.1	10.6	8.3	62.3	70.5
Austria (00)	31.8	9.1	7.7	71.4	75.8
Belgium (00)	34.6	8.8	8.0	74.6	76.9
Sweden (00)	28.8	11.7	6.5	59.4	77.4
France (00)	36.5	11.5	7.3	68.5	80.0
Average	28.3	13.7	10.8	49.8	60.9

Source: Authors' calculations from the Luxembourg Income Study.
Notes:
[1] Poverty rates are for persons living in households with adjusted incomes below 50 per cent of median adjusted disposable income.
[2] Gross market income, including earnings, income from investments, occupations (private and public sector) pensions, child support and other private transfers. In six countries (i.e. Austria, Belgium, Greece, Italy, Ireland and Spain) this is net of taxes and social contributions, and in France it is net of social contributions but gross of taxes.
[3] Includes effect of taxes and social contributions for countries where market income is gross.
[4] This is the same as poverty rate on disposable income. Refunds from the Earned Income Tax Credit (US) and the Family Tax Credit (UK) are treated as social assistance, as are near-cash food and housing benefits such as food stamps and housing allowances.
[5] Market income rate minus social insurance rate as a per cent of market income rate.
[6] Market income rate minus social assistance rate as a per cent of market income rate.

rates, the United States shows the least anti-poverty effort of any nation. The United States reduces poverty by 26 per cent compared to the average reduction of 60 per cent. The nations closest to the United States in terms of overall effect are Ireland and Canada. But even there, government programmes reduce market income-based poverty by 44 and 46 per cent, respectively. As far as the first component is concerned, we see that the United States social insurance and direct tax system is weakly

Table 2.4 Pre and post tax and transfer poverty rates for children[1], by education level of head/reference person

Nation (year)	All children			Lowest education level parents[2]				Other education levels parents[2]		
	Market income[3]	Disposable income	Per cent reduction overall[4]	Market income[3]	Disposable income	Per cent reduction overall[4]	Per cent parents in lowest level	Market income[3]	Disposable income	Per cent reduction overall[4]
United States (00)	23.3	21.9	6.0	53.3	50.8	4.7	15.8	17.5	16.3	6.9
Italy (00)	18.8	16.9	10.1	28.7	25.8	10.1	51.3	8.7	7.8	10.3
Greece (00)	15.4	13.0	15.6	25.5	22.0	13.7	46.8	7.1	5.6	21.1
Spain (00)	19.7	16.5	16.2	29.6	24.8	16.2	59.2	6.1	5.0	18.0
Canada(00)	20.0	15.2	24.0	36.0	28.5	20.8	15.2	17.1	12.7	25.7
Netherlands (99)	13.8	9.8	29.0	25.3	19.1	24.5	18.4	6.6	2.8	57.6
Ireland (00)	25.6	17.6	31.3	31.1	20.8	33.1	60.0	17.6	12.8	27.3
Germany (00)	16.1	9.1	43.5	35.1	24.5	30.2	11.5	13.1	6.5	50.4
Australia (01)	26.6	15.0	43.6	36.6	19.8	45.9	43.3	18.9	11.3	40.2
Belgium (00)	19.2	6.6	65.6	34.0	12.2	64.1	28.0	13.5	4.5	66.7
Austria (00)	24.3	7.6	68.7	46.6	13.4	71.2	12.1	21.1	6.8	67.8
France (00)	29.3	8.0	72.7	49.6	13.4	73.0	34.0	18.6	5.2	72.0
Sweden (00)	17.4	4.3	75.3	29.6	6.0	79.7	17.3	14.3	3.7	74.1
Finland (00)	16.2	2.9	82.1	30.2	6.2	79.5	20.2	12.7	2.0	84.3
Average	20.4	11.7	41.7	35.1	20.5	40.5	30.9	13.8	7.4	44.5

Source: Authors' calculations from the Luxembourg Income Study.

Notes:

[1]Poverty rates are for children living in non-elderly households with adjusted incomes below 50 per cent of median adjusted disposable income.

[2]Lowest level is less than a high school degree in the United States.

[3]Gross market income, including earnings, income from investments, occupations (private and public sector) pensions, child support and other private transfers. In six countries (i.e. Austria, Belgium, Greece, Italy, Ireland and Spain) this is net of taxes and social contributions, and in France it is net of social contributions but gross of taxes.

[4]Market income rate minus disposable income rate as a per cent of market income rate.

redistributive, as are the United Kingdom and Irish systems, while its safety net and social assistance system produces another ten percentage points of poverty reduction (including the effect of the EITC in the social assistance category). Most nations get at least a 50 per cent poverty reduction from social insurance, and in heavily insured countries like Austria, Belgium, France and Germany, social insurance reduces poverty by 62 to 75 per cent. In the case of social assistance, large effects of targeted programmes are evident in Finland (34 per cent) and the United Kingdom (33 per cent reductions), and lower ones (under 10 per cent) in the more socially insured nations where the heavy lifting has already been carried out (Austria, France, Germany, Belgium, the Netherlands and Canada). Among the heavily socially insured countries, the Mediterranean nations, especially Greece but also Spain and Italy, exhibit the lowest additional effect (if any) of social assistance on poverty reduction, suggesting either low spending on these programmes or low benefit levels or both.

It should be apparent that different nations use different instruments and different 'income packages' to achieve their anti-poverty effects. There is no one programme or one type of policy instrument that is universally generous and common across these 13 nations. The countries with the most and least effective anti-poverty systems are clearly evident from Table 2.3. The United States does not compare well. In comparison, European social welfare systems – especially the social insurance and tax systems – are definitely more redistributive, but this is in part because of higher MI poverty and inequality. As MI is primarily composed of earnings from labour, the causes of high MI poverty and inequality should be looked for in the labour market sphere, namely in terms of low employment rates. It seems that nations should aim at designing a tax-transfer system that keeps MI inequality low while improving the distribution of MI towards low-income units. One hopes for a system that will decrease MI poverty (by acting on employment rates and wage levels), but also strengthen the effect of the welfare state (taxes and transfers) in terms of both poverty and especially inequality reduction (Matsaganis *et al.*, 2003).

2.4.5 Anti-poverty effects for the children: education and work effort among parents

Already mentioned is the fact that children are at higher-than-average risk of poverty in modern populations. Therefore, we turn now to the effects of tax-transfer systems on families with children, and the factors that most influence them. None of us lives in a world where all parents are well-educated high earners – not in any of the countries studied here. And since none of our nations will soon be in this situation, it is important to ask how policy deals with the world in which we do live: with single parents, undereducated parents, and parents who work but who do not make enough to escape being poor. In the United States, where less than 2.0 million families with children are still on welfare, we still have 12 to 15 million families who work but are poor (Shapiro and Parrott, 2003). How do benefits for families with children vary according to the educational situation and work status of the parent?

In order to isolate a parental education effect, we have focused solely on those households with children. We now present poverty rates for children by the education level of the parents (Table 2.4). Due to education coding differences, our comparisons are reduced to 14 nations.[14] We separate those children whose parents have the least education (lowest level) into the second group. This group consists primarily of households in which one or both parents have not finished secondary school. These children are compared to children whose parents have had more education in the third group of Table 2.4.[15]

The results of this exercise show that, even more than in all other aspects of poverty, when it comes to child poverty the United States differs dramatically from all the other nations. As expected, in all nations, market and even disposable income poverty rates are much higher for the poorly educated than for the highly educated. But the poverty rate of the children of those American parents who did not finish high school (about 16 per cent of the population) is over 50 per cent, even after taking account of taxes and benefits (which again produce little effect on their incomes in the United States).[16] American children with more highly educated parents in the last group have much lower market and disposable income poverty rates, but their disposable income poverty rates are still the highest among the nations shown.

In the other nations, the after-government disposable income poverty rates for poorly educated parents are also different from those found among highly educated parents, but still the poverty situation of children is not so dependent on the education level of their parents. Indeed in most nations the percentage reduction in poverty rates is similar regardless of education level, but because the lower educated start at such high market income poverty levels in most nations, and especially in the United States, the disposable income poverty rates are higher among the lower educated, even after the effect of benefits is counted.

From Table 2.5, we can begin to understand whether it is wages or hours that lie at the heart of the MI poverty problem. Clearly, we want to

Table 2.5 Total annual hours worked[1] by head and spouse in non-elderly poor households[2]

Nation (year)	All non-elderly poor households		Non-elderly single-parent poor households[3]	
	Market income[4]	Disposable income[5]	Market income[4]	Disposable income[5]
United States (00)	1,150	1,283	1,060	1,044
Australia (01)	998	977	697	**363**
Canada (00)	947	963	671	524
Italy (00)	979	1,511	678	**774**
Spain (00)	968	1,175	1,150	**1,229**
Austria (00)	861	1,212	819	**551**
Ireland (00)	699	650	425	330
France (00)	611	381	591	317
Belgium (00)	463	737	279	**168**
Netherlands (99)	489	741	371	341
Germany (00)	371	526	475	561
Average	776	923	656	564

Source: Authors' calculations from the Luxembourg Income Study.
Notes:
[1]Annual hours of work in each nation for heads and spouses living in poor households, classified by type of household.
[2]Households composed by persons aged under 65.
[3]Households with children where the head is a non-elderly single person.
[4]Households whose market income is lower than half the median adjusted disposable income of all households.
[5]Households whose disposable income is lower than half the median adjusted disposable income of all households. Cells with less than 30 observations are left blank.

separate the problem of low wages but many work hours from high wages and few work hours. In so doing, we are limited to 11 nations where we have reasonable data on annual hours of work in the LIS database at this time.[17]

From Table 2.5, we find that in almost every case, poor non-aged Americans work much longer hours than do most any other nations' workers (see also Osberg, 2002; Alesina *et al.*, 2005). Spanish, Italian and Austrian heads also seem to work longer hours amongst the DPI poor, but not amongst the MI poor. The differences between American and other workers are the largest among low-income single parents. Market income poor American single parents average over 1,000 hours per year – almost twice as much as those in seven of the other eight countries shown here (Spain is the only country with higher single parent hours of work, perhaps because many Spanish single parents live with their extended families).

2.4.6 Summary

Comparative cross-national relative poverty rankings suggest that the 15 nations we selected form two distinct groups in terms of poverty and inequality. The Anglo-Saxon and Southern European countries belong to the worst half of the ranking, and the Northern and Continental European countries and the Scandinavian ones to the better half, for both the overall population and the groups at the highest risks of poverty, namely the children and elderly. Within the worst-performing group, Spain and Greece are near the top of the absolute poverty range (not shown), and above average on relative poverty grounds. The Mediterranean nations are all closely clustered in terms of inequality and poverty rankings, as well as anti-poverty effects. Still, when one looks at anchored poverty, it seems that great progress has been made in both Spain and Greece over the brief period that we can observe here. Poverty in France is lower for families with children than in any other Central European nation, and poverty and inequality also fall by more than in any other nation due to redistribution. These results are, of course, explained by France's generous and very redistributive welfare state, with extensive taxes and benefits for the population at large and for the poor in particular.

On the other hand, the United States' poverty rates are at or near the top of the range for all three groups of population (overall, elderly and children); its relative child poverty rates are particularly troublesome. What seems most distinctive about the American poor is that they work more hours than do the resident parents of most other nations where we can observe work hours, and they also receive less in transfer benefits than in other countries.

2.5 Towards explanations

In the following section, we will concentrate on finding explanations for the different levels of non-elderly poverty. A substantial fraction of the variance in non-elderly cross-national poverty rates appears to be accounted for not by variations in work or unemployment, but by cross-national variations in the incidence of low pay (Figure 2.5). Because the United States has the highest proportion of workers in relatively poorly paid jobs, it also has the highest poverty rate, even among parents who work half time or more (Smeeding, Rainwater and Burtless, 2001). On the other hand, other countries that have a significantly lower incidence

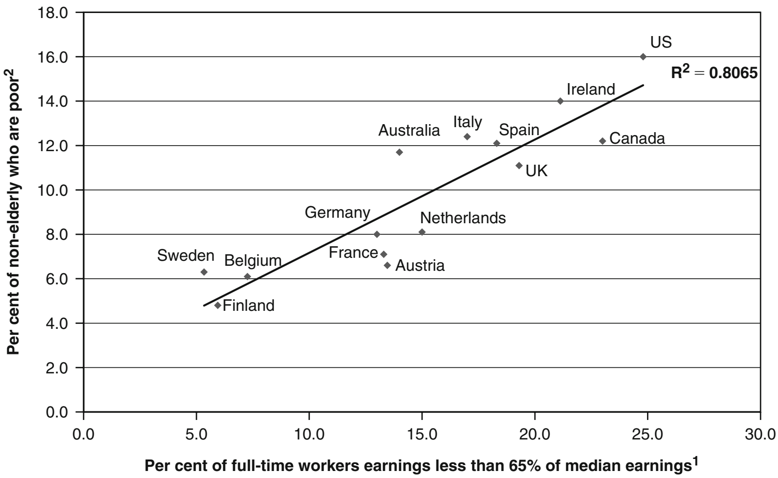


Figure 2.5 Relationship of low pay and non-elderly poverty rates in fourteen industrialized countries circa 2000

Source: OECD database on earnings (as reported in OECD Employment Outlook 2003 and authors' tabulations of the LIS data files).

Notes:

[1]Data refer to the most recent year for which data could be found (2000 for US, UK, Italy, Australia and Canada; 1998 for Germany, Sweden and the Netherlands; 1996 for Austria; 1995 for Belgium, France, Spain and Ireland). Data for Italy refer to net earnings. Data for Greece are not available.

[2]Percentage of persons below 65 in poor households.

of low-paid employment also have significantly lower poverty rates than the United States.[18]

While low pay is a good predictor of poverty rates, and while poorly-educated workers do not do well at keeping their families from poverty based on earnings alone, other factors, such as the anti-poverty efforts of the government, are also important predictors of the poverty rate (Figure 2.6). Social spending reduces poverty, as we have seen. And, as a result of its low level of spending on social transfers to the non-elderly, the United States again has a very high poverty rate.

Even though social spending in general has an inverse correlation with poverty rates, different patterns of social spending can produce different effects on national poverty rates. Anti-poverty and social insurance programmes are, in most respects, unique to each country. There is no one kind of programme or set of programmes that is conspicuously successful in all countries that use them. Social insurance, universal benefits

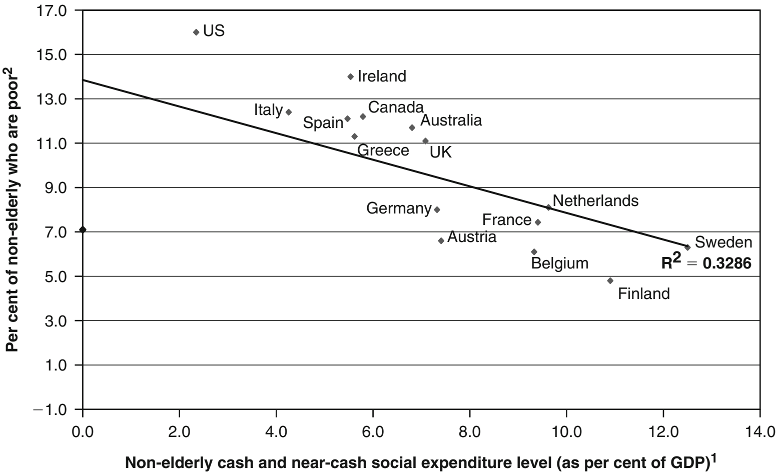


Figure 2.6 Relationship of cash social expenditures and non-elderly poverty rates in fifteen industrialized countries circa 2000

Source: Marical *et al.* (2006) and authors' tabulations of the LIS data files. Cash and non-cash social expenditures exclude health, education, and social services, but include all forms of cash benefits and near cash housing subsidies, active labour market program subsidies and other contingent cash and other near cash benefits. Non-elderly benefits include only those accruing to household head under age 65.

Notes:

[1]Cash and non-cash social expenditures exclude health, education, and social services, but include all forms of cash benefits and near cash housing subsidies, active labour market program subsidies and other contingent cash and other near cash benefits. Non-elderly benefits include only those accruing to household head under age 65.

[2]Percentage of persons below 65 in poor households.

(such as child allowances) and social assistance transfer programmes targeted on low-income populations are mixed in different ways in different countries. So, too, are minimum wages, worker preparation and training programmes, work-related benefits (such as child care and family leave), and other social benefits. The United States differs from most nations that achieve lower poverty rates because of its emphasis on work and self-reliance for working-age adults, regardless of the wages workers must accept or the family situation of those workers. For over a decade, United States unemployment has been well below the OECD average, and until recently American job growth has been much faster than the OECD average. The strong economy, coupled with a few specific anti-poverty devices (like the expanded EITC), has produced most of the United States child poverty reduction in recent years.

What lessons can Europe take from this exercise? The first is to note that high employment produces lower levels of MI inequality and poverty (as even the United States data suggest). But also we must note that a large number of workers with relatively low wages are not a good sign, especially if they are lowly educated workers whose wages and jobs are at risk due to globalisation and trade. While Europeans obviously need a set of policies that provide incentives for higher participation in the labour market, they must also be aware of those whose education – and thus wages – lag, especially because a large share of the population is still lowly educated. Next to work incentives or active labour market policies, perhaps an EITC-like programme for low-waged workers may help them avoid the 'working, but poor' syndrome evident in the United States (Arriba and Moreno, 2002; Sinn, 2007).

2.5.1 Discussion: a tale of two countries

While acknowledging that the United States has greater poverty than other industrialised nations, many defenders of American economic and political institutions have argued that inequality plays a crucial role in creating incentives for people to improve their situations through saving, hard work, and investment in education and training. Without the powerful signals provided by big disparities in pay and incomes, the economy would operate less efficiently and average incomes would grow less rapidly. In the long run, poor people might enjoy higher absolute incomes in a society where wide income disparities are tolerated than in one where law and social convention keep income differentials small (Welch, 1999). According to this line of argument, wide income disparities may be in the best long-term interest of the poor themselves.[19] But, of course, there is no evidence that this is true (Burtless and Jencks, 2003).

Moreover, recent studies suggest that Americans do NOT have exceptionally high rates of economic mobility that may make up for its higher poverty and inequality. Indeed a recent careful cross-national study (Jäntti *et al.*, 2006, p. 2) summarises the situation as follows: 'Comparative studies of socio-economic mobility have long challenged the notion of "American exceptionalism" and its belief in high rates of social mobility.' The sociological approaches (Erikson and Goldthorpe, 2002) suggest that the United States is fairly unexceptional. The economics literature (including Solon, 2002) suggests that the United States may indeed be exceptional not in having '*more* mobility' but in having '*less* mobility'.

In recent years, the economies of the United Kingdom and especially the United States have, in fact, performed better than other western economies where income disparities are smaller. Employment growth (even since 2001) has been relatively faster, joblessness lower, and economic growth higher than in many other OECD countries where public policy and social convention have kept income disparities low. However, evidence that lower social spending 'caused' higher rates of growth is not found in the literature (for instance, Arjona, Ladaique and Pearson, 2001; Lindert, 2004). United States lower-income citizens' real incomes are at or below the incomes that most poor people receive in other rich countries that have less inequality (Rainwater and Smeeding, 2003). The supposed efficiency advantages of high inequality have not accrued to low-income residents of the United States, at least to date. While the real incomes of families with children did rise in the latter 1990s (Blank and Schoeni, 2003), most of the gains since 2000 have been captured by Americans much further up the income scale, producing a conspicuously wide gap between the incomes of the nation's rich and poor children, elders, and adults.

Figure 2.7 compares child poverty in the United Kingdom and in the United States using almost the same 'absolute' poverty standards – the United States poverty line (about 35 per cent of United States median

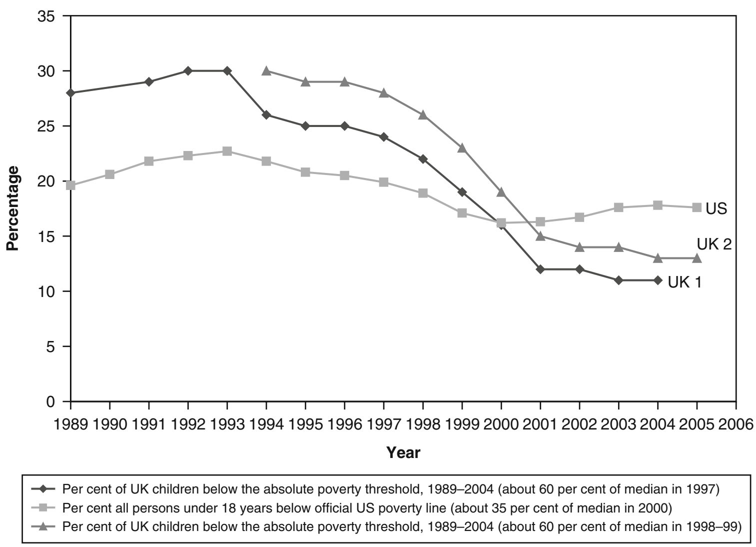


Figure 2.7 Trends in absolute child poverty: UK vs USA, 1989–2005
Source: US Census Bureau 2006; UK Department of Work and Pensions (2007); HBAI, P52.

income in 1998 or 1999) and the United Kingdom poverty line set at 60 per cent of United Kingdom median income in 1997–98 and then again in 1998–99. Both 'absolute' poverty lines are adjusted only for price changes across years. In the United States, we show 'official' Census Bureau poverty estimates. Because United Kingdom incomes are about 71 per cent of United States incomes in 2000 (see Table 2.1), this turns out to be a bit higher than a 'real' poverty standard for the UK (.71 times .60 per cent is 42.6 per cent of the median in the United Kingdom, compared with 35 per cent of the median in the United States).

We noted earlier that these nations were the top-ranked nations in terms of child poverty. We also note that child poverty in both nations began to fall, without the help of policy, from the mid to late 1990s, owing mainly to strong wage growth and tight labour markets in both countries (Figure 2.7). In 1997, British Prime Minister Tony Blair announced his policies against child poverty; and in 1999 they began to be implemented. By 2000–01, the level of child poverty in the United Kingdom (around 15–16 per cent) was just about the same as in the United States measured against this similar 'real' resource level. But as we entered the twenty-first century, and when both economies, especially that of the United States, became less vigorous, the United Kingdom continued to have policy-driven reductions in child poverty while poverty in the United States stopped declining and even reversed. The poverty rate for United Kingdom children had fallen to 11 per cent by 2003–2004 (or 13 per cent by 2004–2005, by the top UK line in Figure 2.7), while the official United States child poverty rate was 17.6 per cent in 2005 according to the most recent United States Census Bureau estimates (US Census Bureau, 2006).

Five or six years earlier, these low-income United Kingdom kids were worse off in real terms than were United States kids (Rainwater and Smeeding, 2003). The reason for the absolute and relative UK improvement is that they have a leader who set a national goal of improving living standards and eradicating child poverty in Britain over the next decade, and who matched his political rhetoric with some measure of real and continuing fiscal effort, which has already had an important impact (Bradshaw 2003; Walker and Wiseman, 2001; Micklewright and Stewart, 2001). In Britain, since 1999 Prime Minister Tony Blair has spent an *extra* 9 per cent of GDP for low-income families with children (Hills, 2003). Nine-tenths of one per cent of United States GDP is about $100 billion. This is more than we now spend on the EITC, food stamps, and TANF combined. The result of this spending in Britain is that child poverty rates in 2004 were 50 per cent below their 1996–97 level (or in

2005, 50 per cent below their 1988 level in the top UK line) and, as evident, real living standards for these children also rose (United Kingdom Department of Work and Pensions, 2005; Bradshaw, 2003).

2.6 Summary and conclusions

The experience of the United States can give many lessons to other nations' domestic anti-poverty and inequality policies. As long as the United States relies almost exclusively on the job market to generate incomes for working-age families, changes in the wage distribution that affect the earnings of lower-skilled workers will inevitably have a big effect on poverty among children and working-age adults. While Europe needs to set in place a number of policies aimed at increasing its employment rate, and thus go towards the direction of relying more on the job market to generate income for working-age families, it should also be aware of low wage incomes, especially among the unskilled. Welfare reform in the United States has pushed many low-income women into the labour market and they have stayed there as TANF rolls continue to fall. Even with the $25.4 billion spent on TANF today, only $11.2 billion, at most, is in the form of cash assistance; the rest is now in the form of child care transportation assistance, training and other services (Pear, 2003). While the switch from cash to services has undoubtedly helped to account for higher earnings among low-income parents, it has not helped to move many of them from poverty. In fact, serious gaps still exist, especially in the child care arena (Smolensky and Appleton Gootman, 2003) and in family leave policy (Gornick and Meyers, 2003). Still, labour markets alone cannot reduce poverty because not all of the poor can be expected to 'earn' their way out of poverty. Single parents with young children, disabled workers, and the lowly educated and unskilled will all face increasingly significant challenges earning an adequate income, no matter how much they work. The relationship between anti-poverty spending and poverty rates is, of course, complicated, so the arguments discussed above are, at best, suggestive. United States poverty rates among children and the aged are high when compared with those in other industrialised countries. Yet economic performance in the United States has also been outstanding compared with that in other rich countries. As the British have demonstrated, carefully crafted public policy can certainly reduce poverty for families with children. Implementing the policies that would achieve lower poverty rates would also have budgetary costs and, perhaps, some efficiency costs that are yet to be unearthed.

Of course, the direct and indirect costs of anti-poverty programmes are now widely recognised (and frequently overstated) in public debate.[20] The wisdom of expanding programmes targeted at children and poor families and older women depends on one's values and subjective views about the economic, political and moral tradeoffs of poverty alleviation. For many critics of public spending on the poor, it also depends on a calculation of the potential economic efficiency losses associated with a larger government budget and targeted social programmes. It is hard to argue that the United States cannot afford to do more to help the poor; particularly low-skilled, lowly-paid workers. If the nation is to be successful in reducing poverty, it will need to do a better job of combining work and benefits targeted to low-wage workers in low-income families (for instance, see Ellwood, 2000; Danziger *et al.*, 2000). There is already evidence that such programs produce better outcomes for kids (Clark-Kauffman, Duncan and Morris, 2003).

European countries can ill afford to adapt United States policies wholesale, and they may not all be able to afford an effort such as has been mounted in the United Kingdom. But they can and should begin to institute active labour market and education polices for the younger members of their populations while at the same time encouraging work for the unemployed and wage subsidies when pay alone is not enough to keep a family from poverty.

Notes

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1. See for UNICEF Innocenti Research Centre (2000); Bradbury and Jäntti (1999). See Chen and Corak 2005; for the United Nations (UNDP, 1998; 1999); for the OECD, see Förster and Pellizzari (2000); for the European Union, see Eurostat (1998a, 1998b); Dennis and Guio (2003); and Immervol *et al.* (2006); Hagenaars, deVos, and Zaidi (1994); and, for LIS, Jäntti and Danziger (2000), Smeeding (2005), Kenworthy (1998); Smeeding, O'Higgins, and Rainwater (1990); and Rainwater and Smeeding (2003).
2. In 1998, the ratio of the United States (four-person) poverty line to median *family* income was 38 per cent. Since then both ratios have fallen to the 30 per cent level (Smeeding 2005) while the ratio to median *household* income was 31 per cent. Median household income ($38,855) is far below median family income ($47,469) because single persons living alone (or with others

to whom they are not directly related) are both numerous and have lower incomes than do families (US Census Bureau 2003a, 2003b). Families include all units with two or more persons related by blood, marriage, or adoption; single persons (unrelated individuals) are excluded. In contrast, households include all persons sharing common living arrangements, whether related or not, including single persons living alone. Different adjustments for family or household size might also make a difference in making such comparisons.

3. See Atkinson, Rainwater, and Smeeding (1995) and Canberra Group (2001) for more on this income definition and its robustness across nations. Note that the use of this "LIS" disposable income concept is not unique to LIS alone. Eurostat and OECD have independently made comparisons of income poverty and inequality across nations using identical or very similar measures of net disposable income.
4. This income definition differs from the Census income definition used in most poverty studies. Still, the internationally comparable measure of income does not subtract work-related expenses or medical care spending. In particular, there is no account for provision of or costs of child care. The EITC and similar refundable tax credits and near-cash benefits such as food stamps and cash housing allowances are included in this income measure, however, as are direct taxes paid.
5. Market income includes earnings, income from investments, occupational (private and public sector) pensions, child support, and other private transfers. For the calculation of poverty rates, MI refers to gross income in all countries but Austria, Belgium, Greece, Ireland, Italy and Spain, where MI is net of taxes and social contributions.
6. Of course, our measures of the anti-poverty effects of benefits are partial equilibrium in nature. That is, poverty measured *before* government taxes and benefits (using MI) is not the same as poverty in the *absence* of government, if tax and transfer programmes affect one's level of MI. In the case of benefit programmes for the elderly, we expect and find larger effects as the size of benefits (percentage of GDP spending on cash benefits for the elderly) is correlated with MI poverty. However, in the case of the non-elderly, the correlation between MI-based poverty and non-elderly social spending is only 14. Thus, we conclude that for the non-elderly general equilibrium effects are modest. For an excellent discussion of behavioural effects and benefit incidence, see Reynolds and Smolensky 1977.
7. Formally, adjusted disposable income (ADPI) is equal to *un*adjusted household income (DPI) divided by household size (S) raised to an exponential value (*e*), $\mathrm{ADPI} = \mathrm{DPI}/\mathrm{S}^e$. We assume the value of *e* is 0.5. To determine whether a household is poor under the relative poverty measure, we compare its ADPI to 50 per cent of the national median ADPI. National median ADPI is calculated by converting all incomes into ADPI and then taking the median of this 'adjusted' income distribution. The equivalence scale that we employ is robust, especially when comparing families of different size and structure (for instance, elders and children). See Atkinson, Rainwater, and Smeeding (1995) for detailed and exhaustive documentation of these sensitivities.
8. Adding another Northern European or Scandinavian nation (Demark, Norway) would mimic Sweden and Finland. The Central and Eastern European

nations have much lower living standards than the others and are, therefore, excluded.

9. We present LIS data on the Unified Germany for 2000. However, trend data for Germany (Table 2.2) are still restricted to West Germany. The LIS West German poverty rates tend to be 0.9 to 1.2 percentage points below those for all of Germany.
10. Earlier comparisons of microdata-based real incomes per equivalent adult and GDP per capita (not shown) reveal a similar ranking and relationship of microdata based and macro data based income levels across these 15 nations. See Smeeding and Rainwater (2004).
11. Unemployment is, of course, cyclical and business cycles differ across nations. However, the 1999–2000 period was one of strong economic performance in every nation studied here. In previous research on this topic, Atkinson, Rainwater, and Smeeding (1995) found no consistent effect of unemployment on overall inequality measured at a point in time. Rather, they concluded that institutional factors were more likely to explain the cross-sectional relationship between unemployment and inequality (or poverty) than were cyclical conditions. Smeeding (2005) found the same result. Still, we must conclude that economic cyclicity probably affects MI-based poverty via its effects on wages and employment. However, we do not know how much difference economic conditions make in a cross-national study such as this.
12. Children are all persons under age 18; elderly are all persons age 65 or over.
13. Were there more time and space, it would be interesting to see how many single parents and elders live in such arrangements and if they would be poor if they lived independently on their own income.
14. The United Kingdom does not have education codes that are comparable to the other nations.
15. Education is coded into low (less than high school), median (high school degree), and high (some college or university) by LIS and OECD. The reader can find this code in LIS at http://www.lisproject.org/dataccess/educlevel.htm.
16. In fact, United States families for rich children whose MI is below the poverty level pay higher net taxes (even after the Earned Income Tax Credit) than do families in other nations. These taxes are mainly payroll taxes which mean more poverty today, but which may also contribute to reduced poverty in old age or in case of disability. The reader should note this treatment of payroll taxes in current income, not as payments toward future benefits.
17. Unfortunately, the United Kingdom and Sweden are not among the nations we examine due to lack of data relating to hours. In both cases, other research shows that British lone parents work few hours, while Swedish women work a substantial number of hours (Smeeding, 2002; McLanahan and Garfinkel, 1994).
18. Unfortunately, it was not possible to add a comparable figure for the incidence of low pay in Greece.
19. A lucid presentation and analysis of this viewpoint can be found in Okun (1975). See also Welch (1999).
20. The efficiency costs of public programmes are debatable. The recent increase in market work among single mothers who would otherwise be on public support after the 1996 welfare reform is taken by many to be strong

evidence that labour supply responded in part to changes in this programme. However, the literature cannot separate the importance of TANF vs the EITC and the strong labour market of the late 1990s as primary causes of greater market work among low-income mothers. See Grogger (2003) and Lindert (2004).

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3
The Enforcement–Equality Trade-off

Samuel Bowles and Arjun Jayadev

3.1 Introduction

In order to maintain order, all societies allocate resources to defence, policing, surveillance, contractual monitoring and other activities that sustain the property rights and other claims that characterise status quo institutions. Transfers of resources among members of a society also contribute to the maintenance of social order. We model the growth in a modern capitalist economy taking explicit account of the problem of social order, and borrowing themes from the classical economists (unproductive labour, profit-driven investment), Marx (the labour-disciplining effect of unemployment), and the contemporary theory of incomplete contracts (the role of monitoring and enforcement rents). We use this model to identify the resources devoted to the maintenance of order, which we term guard labour, as we measure these in labour units.

Data from the United States indicate a significant increase in its extent in the USA over the period 1890 to the present. Cross-national comparisons show a significant statistical association between income inequality and the fraction of the labour force that is constituted by guard labour, as well as with measures of political legitimacy (inversely) and political conflict. Continental European welfare states devote considerably less resources to the maintenance of order than do the English-speaking economies.

A possible explanation is that these economies divert fewer resources from directly productive uses to guard labour by undertaking larger transfers of claims on resources in the form of social expenditures and higher wages. Some observations on the welfare implications of guard labour conclude the chapter along with the suggestion that a severe constraint on productivity enhancing public policy may be a trade-off between equality and the use of resources devoted to the enforcement of social and economic discipline. Economies that implement high levels of economic inequality appear to face substantially higher costs of sustaining the property rights and other aspects of the society's institutional structure. Because more equal countries devote fewer resources to enforcement activities, we refer to this relationship as the enforcement–equality trade-offs.

3.2 Power and growth – a classical model

> [T]he efforts of men are utilized in two different ways: they are directed to the production or transformation of economic goods, or else to the appropriation of goods produced by others. (Vilfredo Pareto, *Manual of Political Economy* (1905) (Pareto (1971, p. 341))

To understand the dynamics of an economy we need to study not only the production of goods and services as conventionally defined but also two aspects of reproduction. The first is the process of procreation and development of new individuals to replace those retiring from active economic life. The second is the reproduction (or alteration) of the economic institutions governing the process of production. Like production, reproduction is resource-using, and, taken together, the two reproduction processes just mentioned – individual and institutional – account for something like half the work done in most societies. For these and other reasons, the way that reproduction is organised matters critically for the dynamics of the economy and the trajectory through time of the livelihoods of its members. Here we abstract from individual reproduction to focus on the process by which an economy's institutions are reproduced. Institutions (as we use the term) are the laws, informal rules, and conventions which give a durable structure to social interactions among the members of a population. Conformity to the behaviours prescribed by institutions may be secured by a combination of centrally deployed coercion (laws), social sanction (informal rules), internalised norms, and mutual expectations (conventions) which make conformity a best response for virtually all members of the relevant group.

The insight we wish to develop is that securing conformity to institutions can be quite costly, and the cost differs among institutions and across time and space. Conformity achieved through the coordination of expectations or the internalisation of norms, for example, may not be very costly, as in the case of driving on one side of the road or the other, or the voluntary compliance with tax laws in some countries.

However, where conformity to a society's institutions is secured primarily through governmental coercion or privately deployed sanctions, the resource costs may be substantial. Examples include some authoritarian political systems, colonial regimes, and, as we will see, highly unequal capitalist economies.

Consider a closed economy in which owners of firms, acting non-cooperatively, maximise the rate of growth of their wealth by hiring (identical) workers to produce a single output that is sold on competitive markets. Owners individually set wages and hire supervisors to monitor workers so as to minimise the cost of an effective labour unit, taking account of the fact that workers select the (non-contractible) level of work effort. Workers choose an effort level that maximises the present value of their lifetime expected utility, given both the likelihood of job loss (which is decreasing in the level of effort) and the expected duration of a spell of unemployment, should their employment be terminated.

The following summarises the employer–employee interaction modelled as a standard contingent renewal principal–agent problem (Bowles, 1985; Shapiro and Stiglitz, 1984). The principal (the employer) knows the agent's (worker's) best effort response, $e(w, m; z)$: given each wage rate (w) and level of monitoring (m), with an exogenously determined worker's fallback position (z). At the beginning of a period, the employer selects (so as to maximise profits) and announces: (i) a termination probability $t(e, m) \in [0,\ 1]$ with $t_e < 0$ and $t_m > 0$ over the economically relevant ranges; (ii) a wage rate, w; and (iii) a level of monitoring per hour of labour hired m. Both the wage and the monitoring inputs are measured in the same units as per period output. Following the employer's announcement of her effort incentive strategy, and hence knowing the above, the worker selects e so as to maximise v, his expected present value of utility, which depends on the wage, the level of effort, and the likelihood of job termination. Finally, at the end of the period, the worker is paid, experiences the utility he incurs as a result of his effort and pay, and his employment is renewed or terminated, the latter occurring with probability $t(e, m)$. If the worker's job is terminated, he obtains a present value of lifetime utility of z and is replaced by an identical worker from the unemployment pool. In order to maximise v, the worker selects e so as to set $v_e = 0$ which requires

$$u_e = t_e(v - z) \tag{3.1}$$

Thus the worker will choose the level of effort that equates the marginal cost of effort (that is, u_e the marginal disutility of effort) to the marginal benefit of effort, the latter being the product of the effect of greater effort on the likelihood of retaining the job (recall t_e is negative) times the employment rent associated with the job $(v - z)$.

Knowing the worker's best response function given by (3.1), the firm then maximises profits by setting the wage and monitoring intensity so that

$$e_w = e/(w + m) = e_m \tag{3.2}$$

so that the marginal effect on effort of variations in wages and monitoring expenditures is equal to the average level of effort per unit of expenditure on hiring and disciplining labour. We know that under quite general conditions, the competitive equilibrium of this economy is characterised by positive levels of monitoring, employment rents, and unemployment, and that the effective cost of labour effort is rising in the level of employment (Bowles, 2004, chapter 8).

The before-tax profit rate (π) will generally be inverted U-shaped in the level of employment (h) because the positive effects of enhanced capacity utilisation associated with higher levels of employment will eventually be more than offset by the profit squeeze associated with the rise in the cost of effort (see, for example, the empirical studies in Bowles, Gordon, and Weisskopf, 1989; and Bowles, Edwards, and Roosevelt, 2005). Thus we have $\pi(h)$ with $\pi_h > 0$ for low levels of h and $\pi_h < 0$ for h close to full employment.

The effect of unemployment clearly extends beyond the labour discipline environment. In many countries, property crime increases with the level of unemployment (for instance, Gould, Weinberg, and Mustard, 2002; Fougere, Kramarz, and Pouget, 2003; Raphael and Winter-Ember, 2001; Edmark, 2003). It is plausible to assume, further, that the owner's risk of loss of wealth by means other than crime (for example, confiscation, governmental imposed populist restrictions of wealth making) is also increasing in the level of unemployment. Property lost in this way is assumed to simply disappear. The government imposes a linear tax on profits at rate τ, the proceeds of which are devoted to protecting property, incarcerating those convicted of property crimes, and defending the national borders. We assume that all realised profits (after taxes and net of depreciation) are invested (and that wage and theft income is not invested), so that the rate of growth of wealth (k) is just the after-tax rate of profit minus the rate of losses (per period, as a fraction of the capital stock) through theft or confiscation, δ. Making explicit the relationships of the above variables to the level of employment (h)

and the tax rate (τ) we have

$$k(h, \tau) = (1 - \tau)\pi(h) - \delta(h, \tau) \tag{3.3}$$

where δ is decreasing in both of its arguments. The government determines both τ and h (the latter through monetary policy).

Suppose some entity (the owning class, for example, acting cooperatively, or the government acting on its behalf) sought to adopt policies to maximise k given the (known) best response functions of workers and the resulting profit-maximising labour-discipline strategies of owners. The entity would then have to vary τ and h to maximise (3.3). The resulting first order conditions for a maximum are:

$$\pi(h) = -\delta_\tau \tag{3.4}$$

$$\pi(h)(1 - \tau) = \delta_h \tag{3.5}$$

The first, (3.4), instructs the entity to raise taxes to the point where the deterrence-of-confiscation effect of the resulting governmental property rights enforcement activities (the marginal benefits) equals the profit rate (which is the marginal cost associated with increases in the tax rate). The second, (3.5), instructs the entity to set the employment at a level higher than that which maximises before-tax profits, trading off the (negative) effect of greater employment on the profit rate (marginal cost) against the (also negative) effect of higher employment on the probability of wealth loss (marginal benefit). We assume that there is at least one allocation meeting these conditions; if there is more than one, the entity should choose that yielding a higher level of k.

Abstracting from the owners (and from those engaged in raising the next generation), the adult population in this economy consists of employed workers, monitors, unemployed workers, prisoners, guards and military personnel. The first (employed workers) are productive in the sense that their effort is an argument of the firms' production functions. The efforts of the monitors, guards and military personnel, by contrast, are directed not towards production, but towards the enforcement of claims arising from exchanges and the pursuit or prevention of unilateral transfers of property ownership.

These workers might be called (in the classical sense) unproductive, a term that does not suggest that they are unnecessary, but only that their efforts are directed towards the second kind of activity to which Pareto refers in the quote at the start of this section, somewhat expanded to include not only the appropriation of goods produced by others, but also preventing such appropriation. Prisoners and the unemployed represent a distinct category. They are unproductive not in the classical but in the everyday sense; but they are not without a function. Their extent results from the entity's selection of the τ and h that maximises the rate of growth of the owner's wealth, and their presence is part of the incentive structures entailed by this solution to the entity's maximum problem.

To emphasise their common role in sustaining the status quo distribution of property rights and claims, we call all but the employed workers 'guard labour'. Supervisors, guards and military personnel exercise power in the sanction-based sense just defined, while prisoners and the unemployed are the necessary concomitants of the public and private sanctioning systems respectively.

3.3 Measures of guard labour

> An industrial army of workers under the command of a capitalist requires, like a real army, officers (managers), and NCOs (foremen, overseers) who command during the labour process in the name of capital. The work of supervision becomes their established and exclusive function. ... The leadership of industry is an attribute of capital, just as in feudal times the functions of general and judge were attributes of landed property. (Karl Marx, *Capital, I* (Marx 1976, pp. 450–1)

We have deliberately constructed a model in which productive and guard labour are readily distinguished, because, in the case of supervisors, as Marx put it, 'the work of supervision becomes their established and exclusive function'. This world is fictional, in that most types of work combine some of both aspects. Foremen monitor workers and also solve technical or coordination problems that are clearly productive in the sense just defined. Teachers instruct the next generation in essential productive skills; and they also socialise them to internalise the norms contributing to conformity to the society's institutions, and so on.

Nonetheless it may be of interest to count the fraction of the labour force occupying the roles of guard labour identified in the model: supervisory labour, private guards, police, judicial and prison employees, military and civilian employees of the Department of Defense (and those producing military equipment), the unemployed, and prisoners. Some supervisors work in segments of the economy in which all employees are counted as guard labour – a supervisor of guards in a prison – and to avoid double counting we have accounted for these as supervisors rather than as employees in a 'guard industry'. Ideally we would also include those producing guns for private use, locks, security systems and the like, but we are unable to do so because of the lack of data. To abstract from cyclical effects we have measured guard labour at the peak of the business cycle (and for the last year, 2002, used the unemployment rate of the previous peak, in 2000). We include an estimate of the number of full-time equivalent discouraged workers among the unemployed and exclude a measure of the frictionally unemployed. Jayadev (2006) gives the details of our calculations.

While most of the measurements are straightforward, estimating the number of supervisors in the relevant sense is not. Following Gordon (1990, 1994), we use the codes in the Dictionary of Occupational Titles (DOT), which provides detailed information on the nature of each of over a thousand jobs, distinguishing those in which the individual deals primarily with people (as opposed to things or data) and in which their relationship to people is 'supervisory'. We find that in 1979, for example, by this definition, supervisors constituted 11.7 per cent of the labour force. A partial check on this estimate is possible using Wright (1990, 1995), which present detailed information on the types and extent of supervisory tasks undertaken by large samples of US and other nations' labour forces. According to these data for the year 1980, 19.7 per cent of the US labour force reported that they exercise task supervision, meaning that they have more than one subordinate and they decide one or more of the following: the tasks, the tools or procedures to be used, and the pace of work of their subordinates. A slightly smaller fraction (15.4 per cent) reported having more than one subordinate whom they can sanction (or cause to be sanctioned) with respect to pay, promotions, or job termination.

The fraction exercising both the task supervision of the first group and the sanctioning supervision of the second were 10.6 per cent of the labour force. Supervisors with 'unrestrained' sanctioning power (meaning those who can take sanctioning action without approval by others) were 12.4 per cent of the labour force. The US census categories 'Managers and administrators' constitute 11.2 per cent of the labour force in the same year. These three numbers are very similar to our estimate of 11.7 per cent based on the Dictionary of Occupational Titles. (The Census managers and administrators category is very close to the DOT estimate in other years as well, and we use it to estimate the level of supervision in 2002, and for the pre-Second World War years.)

The fact that these various estimates are similar occurs despite the somewhat surprising fact that many who are not managers or administrators exercise supervisory functions, while many who are classified as managers and administrators do not. 93 per cent of foremen and 85 per cent of managers report that they have supervisory authority. But more than half of professionals and technicians and two-fifths of craft workers report the same. Table 3.1 gives our estimates for the total and subcategories of guard labour – supervisors, guards, military, prisoners and unemployment – expressed as a fraction of the labour force.

A substantial increase in the guard labour fraction of the labour force is evident, with supervisory labour and the military growing most rapidly over the period 1890–1948, and the growth of prisoners and guards (police, corrections officials and private security personnel) being more rapid during the latter period. The latter period witnessed a substantial decline in the military fraction, which peaked at 5.4 per cent in 1966 and fell to 1.5 per cent in 2002. About half of those classified as guards (47 per cent) were privately employed in 2002, up from 28 per cent in 1890.

Our measures of guard labour in the US are necessarily incomplete. While we do not think we have overestimated the number of supervisors, we have certainly missed some types of work that could be termed guard labour. Activities similar to the enforcement of property rights by the waterlords in Bangladesh, or the imposition of cotton on southern farmers by the merchant lenders, or the workers producing the trip recorders monitoring the movement of truckers all fall beyond our purview. Nonetheless differences across nations in the extent of guard labour (measured as this simple model recommends) suggests that the concept may illuminate an aspect of economic structure that is crucial for the process of growth and stagnation.

In order to assess the degree of supervisory labour in a cross-country context, we use the data on occupational classifications derived from

Table 3.1 Guard labour and its components as a percentage of the labour force in the United States, 1890–2002

Component of guard labour	**1890**	**1929**	**1948**	**1966**	**1979**	**1989**	**2002**
Supervisors (%)	0.8	1.4	9.8	9.9	11.7	13.2	15.7
Guards (%)	0.3	0.7	0.8	0.9	1.7	1.8	2.2
Military (%)	0.3	0.8	3.3	5.4	3.0	3.1	1.8
Prisoners (%)	0.4	0.2	0.2	0.3	0.3	0.5	1.5
Unemployed (%)	4.2	3.8	4.7	4.5	6.7	6.3	4.8
Total (%)	6.0	6.9	18.9	20.9	23.4	24.9	26.1

labour force surveys and available in the International Labour Organization's SEGREGAT database. These data are collected from the labour force surveys of the respective countries using definitions based on the International Standard Classification of Occupations 1988 (ISCO-88). Specifically, we use the category 'Major Group 1: Legislators, Senior Officials and Managers' as our measure of supervisory labour. The estimated ratio of supervisors to labour force using this source for the USA (14.9 per cent) is very close to that estimated by the methods above (15.7 per cent). Further details of the methods are described in Jayadev (2006).

Using these data, we were able to estimate the numbers of all types of guard labour except the category of guards (police and private security personnel) for 18 advanced economies (for details see Jayadev, 2006). The results appear in Table 3.2.

First, the differences in the extent of guard labour among countries are substantial, ranging from a tenth of the labour force in Switzerland to over a fifth in the UK and the US. Broadly, three groups are

Table 3.2 Guard labour and its components as a percentage of the labour force in 18 advanced economies

Country	**Supervisors** (%)	**Unemployed** (%)	**Military** (%)	**Supervisors** (%)	**Total** (%)
Switzerland	5.8	2.7	1.0	0.1	9.7
Iceland	7.9	2.6	0.1	0.1	10.6
Sweden	4.4	5.3	1.1	0.1	10.9
Denmark	6.9	3.6	0.9	0.1	11.5
Norway	7.3	3.6	1.4	0.1	12.4
Austria	6.8	4.3	1.3	0.2	12.6
Portugal	6.7	4.4	1.4	0.3	12.7
Italy	2.9	9.7	1.5	0.2	14.3
Netherlands	11.6	3.0	0.8	0.2	15.7
Ireland	10.6	4.1	0.9	0.2	15.8
Canada	8.5	7.2	0.4	0.2	16.3
Belgium	10.3	6.6	1.0	0.2	18.1
Australia	11.1	6.3	0.5	0.2	18.2
New Zealand	11.9	5.5	0.5	0.3	18.3
Spain	6.7	11.9	0.9	0.3	19.8
United Kingdom	13.4	5.5	0.7	0.2	19.9
United States	14.9	4.8	1.0	1.4	22.2
Greece	9.1	10.3	4.5	0.2	24.0

Notes: Unemployment figures are the average of 2001–2003, Military does not include civilian employees of the military. Prisoners data are from Walmsley (2003) and for the latest year available between 1998 and 2001.

evident: social democratic countries which display low levels of guard labour, English-speaking countries which display high levels of guard labour (with substantial supervision), and Southern European economies which exhibit high unemployment rates and thus, large amounts of guard labour.

Secondly, differences in the extent of supervisory labour are especially striking, ranging from lows of 2.9 per cent and 4.4 per cent in Italy and Sweden respectively to the UK and the USA both with at least three times the Swedish level. According to responses to identical questions in the Wright dataset referred to above, while 39.2 per cent of craft workers in the USA exercise supervisory authority, only 9.7 per cent of Swedish craft workers do; similarly, 26 per cent of clerks in the USA exercise supervisory authority, while only half that fraction do in Sweden.

Thirdly, the composition of guard labour differs substantially among the nations, especially in the proportions of the two largest components: supervision and unemployment. In the labour discipline model sketched in section 3.3, these two types of guard labour provide incentives for the workers' choice of an effort level. From the first order condition that determines the worker's choice of effort (Eq. (3.1) above), we can see that increased monitoring or increased unemployment will increase effort (the former by raising $t(e)$ and the latter by raising the rent associated with the job $(v - z)$. The top four in guard labour – Spain, the UK, the US and Greece – for example, devote about a fifth of their labour force to supervision and unemployment combined. But the US is distinctive, with less than half the level of unemployment of that observed in either Spain or Greece and 50 per cent more supervisory labour. A comparison between the English-speaking countries suggests a similar story. The US displays between 90 and 50 per cent more supervisory labour than Canada, Australia and New Zealand, but about 50 per cent less unemployment than these countries. The UK is intermediate between these countries. Comparing the two paradigmatic social democratic economies – Sweden and Norway – the same pattern emerges. Sweden exhibits two-fifths less supervisory labour than Norway, combined with an unemployment rate that is one and a half times that of Norway. In a descriptive sense, unemployment and supervision appear to be substitutes in the labour discipline process.

3.4 Correlates of guard labour

> It is true that certain living creatures, as bees and ants, live society one with another ... and therefore some ... may perhaps desire to

> know why mankind cannot do the same. (Thomas Hobbes, *Leviathan*, chapter XII)

How are we to explain the marked increase in guard labour in the US and the significant differences in its extent among countries? First, the large differences in the supervisory component of guard labour might be explained by differences in technologies or the composition of output across countries and over time. For example, as firms grow larger, additional layers of supervision must be added, increasing the ratio of supervisors to productive workers. However, this effect is likely to be very small: if each supervisor directs only five subordinates, then the firm supervisory ratio rises from 0.24 for a firm of 25 productive workers (five foremen and one CEO) to 0.25 for a firm with 15,625 productive workers. Sufficient data on aggregate cross-national measures of firm size are difficult to obtain because of differences in measurement across countries (Bartelsman *et al.*, 2005). Using data collected and harmonised by them, the correlation of supervision and firm size (defined as the share in employment of firms with less than 20 employees as a percentage of all employment) is −0.01 for 10 European economies and the USA. Thus, there is no good evidence for a positive firm size–supervisory intensity relationship. Differences in the extent of self-employment and the preponderance of very small firms might explain some of the variation across countries. The remarkably low supervisory ratio in Italy (Falchi, 1999), for example, may be the effect, in part, of the high level of self-employment and prevalence of very small firms there.

While the data are inadequate to provide a compelling test of the hypothesis, we thus find little evidence that the increase in guard labour in the US or the differences across the countries is due to differences in output composition and technology. A more likely explanation is what we term *enforcement specialisation*. Economic development proceeds through a process of specialisation and increasing division of labour; the work of perpetuating a society's institutions is no exception to this truism. Over history's long sweep, the tasks of punishing those who violate norms, defending a people's territory and one's own property, and inducing hard work towards common ends have become increasingly specialised. Gossip, ostracism, shunning, and (sometimes violent) group-level collective sanctioning played a larger part in maintaining earlier social orders (Boehm, 2000). Most, if not all engaged in these activities at least some of the time. The fact that these functions are increasingly specialised in occupations that we have termed guard labour allows us to measure their extent. But it should also caution against too literal an interpretation of these measures. Our data indicate that the United States devotes well over twice as large a fraction of its labour force to guard labour as does Switzerland. This may occur in part because peer monitoring and informal sanctioning play a larger role in Switzerland, as well as the fact that ordinary Swiss citizens have military defence capacities and duties and are not counted in our data as soldiers.

The increasingly explicit nature of norm enforcement that proceeds with modernisation may explain why per capita income and supervision intensity co-vary. Data limitations preclude the estimation of all of the components of guard labour for other countries. However, using the ILO SEGREGAT data again, we are able to compare supervision intensity across a large sample of developing and developed economies. Higher-income countries are characterised by higher levels of supervision relative to the level of unemployment in the year 2000. For economies in which the gross domestic product per capita (averaged over the years for which data are available) is less than $10,000 (exchange rate conversion), there are on average half as many supervisors as there are measured unemployed. Among these economies, the ratio of supervisors to the unemployed is unrelated to per capita income. However, for the 33 countries in the sample with per capita income greater than $10,000 there are 20 per cent more supervisors than unemployed. Moreover, the ratio of supervision to unemployment varies strongly with the level of income among these high-income countries; a standard deviation difference in income is associated with more than a half of a standard deviation (0.57) difference in the supervisor/unemployment ratio.

The fact that the labour discipline mechanisms in high-income countries are more supervision intensive and less unemployment intensive is something of a puzzle. One possible explanation is that supervisors are involved in training and problem solving on the job, and the greater skill intensity of the production processes in the higher-income countries explains the relationship. Another explanation consistent with the data is that nutritional effects of the wage are important in low-income countries, as in the initial version of the efficiency wage model due to Leibenstein (1957) and others. If this is the case, the firm's incentives to offer wages above the worker's next best alternative include not only the disciplinary value of the employment rent, but also the contribution of the wage to the nutritional and health status of the worker, and hence the level of effective work done for a given level of subjective effort by the worker. If this is the case firms will devote more resources to wage costs and fewer to monitoring costs than in an economy in which variations in the wage have less significant effects on worker strength and health.

A fourth possible explanation of the differences among nations and over time in the extent of guard labour is that societies do indeed differ in some underlying structural aspects that affect the marginal benefits and costs of guard labour and hence its amount. It is plausible that highly unequal or class-polarised economies, or societies in which ethnic, political or other divisions are marked, might deploy more guard labour. Similarly, high levels of political legitimacy might reduce the benefits and raise the costs of guard labour.

The two panels of Figure 3.1 show that the extent of guard labour varies with the degree of inequality and a measure of income polarisation in 1995 due to Duclos, Esteban and Ray (2004). Their measure of polarisation is intended to capture two aspects of an income distribution which Duclos, Esteban and Ray term identity and alienation. Identity is measured by how close one is to one's nearest neighbours. Alienation is measured by how far one and one's neighbours are from others more distant in the income distribution.

Countries in which conflicts between classes, ethnic or racial groups and political factions are greater may be expected to devote more resources to guard labour. We measured political conflict as the normalised sum of three indices for our 18 countries: Ethno-linguistic fragmentation in 1960, average annual general strikes, and average annual riots over the years 1960 to 1998. In all cases we have selected long time periods as we would like to capture underlying structural characteristics of the nations that are unlikely to be the consequence of the level of guard labour in the 1990s. The correlation of the resulting political conflict index with the guard labour ratio (shown in Figure 3.1 panel 2) is 0.61.

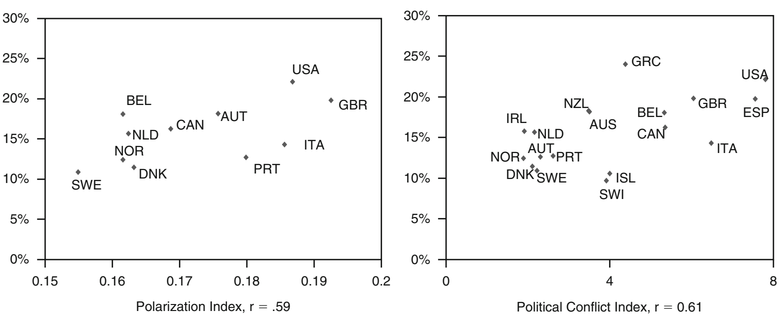

Figure 3.1 Inequality and guard labour across OECD countries

Where social conflicts are channelled into legitimate political and other legal channels, and where citizens are incorporated into these processes rather than alienated from them, it may be that we would observe less guard labour. We measure this in several ways. The first panel in Figure 3.2 shows a negative correlation between social and welfare spending and guard labour. Panel 2 shows the correlation between an index of political legitimacy index and the guard labour ratio ($r = -0.57$). Panels 3 and 4, drawn from responses from the 1996 International Social Survey Program on the role of the government, shows an inverse relationship between guard labour and political tolerance (measured as the willingness to allow protest) and trust in political process (measured as the perceived responsiveness of politicians to elections).

In addition, we explored several other theoretically plausible correlates of guard labour. Union density, constructed as net union membership

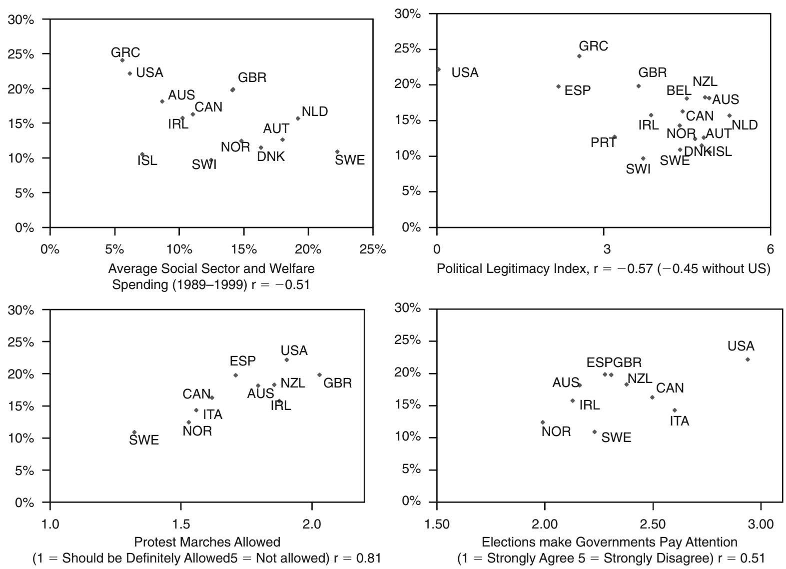

Figure 3.2 Political legitimacy, political conflict and guard labour across OECD countries.

Note: We included two (summed normalized) measures in our index of political legitimacy: average voter participation as a fraction of voting age population in all elections since 1945 and the number of consecutive years to the present in which universal male suffrage in competitive elections obtained. We chose male suffrage rather than male and female because guard labour as we have measured it is not involved in the mediation of male female conflicts to any important measure.

(total membership less self-employed and retired) divided by the total dependent labour force, yielded a correlation of −0.45 ($p = 0.13$). A more conceptually accurate measure of the Gini coefficient (post-tax and transfer Gini from Rehme, 2003) which was available for a smaller sample showed a correlation of 0.48 ($p = 0.15$). Countries in which more individuals saw conscience rather than obedience as the appropriate guide to action, as measured by the ISSP, have lower levels of guard labour ($r = -0.65$, $n = 10$), perhaps reflecting the perceived legitimacy of the institutional structures in place. Other correlations were less impressive. Technological differences, when measured by investment in knowledge as a percentage of GDP, displayed a low correlation (−0.29). Per capita GDP, trust (from Knack and Keefer, 1997), and a standard measure of corruption (the business international index) yielded low negative correlations (−0.22, −0.14 and −0.20 respectively).

None of the statistical associations we have presented are properly identified causal relationships, of course, because the determination of all of the correlates of guard labour (excepting, arguably, the English language) are endogenous, as the model in section 3.3 makes clear. The empirical patterns we have identified are sufficient to suggest questions, not answers. In particular, our suggestion that the extent of guard labour be a consequence of the degree of underlying economic inequality and social conflict is simply a plausible speculation that has not yet been tested adequately.

3.5 Some welfare implications

> Both productive and unproductive labourers, and those who do not labour at all, are all equally maintained by the annual produce of the land and the labour of the country ... [but] the whole annual produce, ... [is] the effect of productive labour. (Adam Smith, *The Wealth of Nations* (1937, p. 315))

John Hicks (1946) famously defined the income of an individual as the 'maximum value that he can consume during a week and still expect to be as well off at the end of the week as he was at the beginning' (p. 172). This concept is often extended to national income and given an explicit welfare interpretation, as in the definition of what William Nordhaus (2000) calls Fisherian income, namely the 'maximum amount that a nation can consume while ensuring that members of all current and future generations can have expected lifetime consumption or utility that is at least as great as current consumption or utility' (p. 259). Both the Fisherian and Hicksian definitions represent income as a maximum flow consistent with the maintenance of the current stock of productive capacities. Thus it must be measured net of any use of output required to maintain these stocks, the most obvious subtraction being the stock of productive resources used up during the period in question. Nordhaus and others have proposed the additional netting out of changes in the stock of economically relevant natural resources (Vellinga and Withagen, 1996). Martin Weitzman (1976), for example, writes that in taking account of depreciation, the measure of capital should be 'more general than the usual equipment, structures, and inventories .... pools of exhaustible natural resources ought to qualify as capital, and so should states of knowledge ...' (p. 158).

Given compelling arguments for institutions as a determinant of output and growth (North, 1990; Acemoglu, Johnson and Robinson, 2004), we follow Weitzman and represent the quality of a nation's economically relevant institutional environment as a stock, measuring its contribution to the production. The stock varies with the level of trust, work ethic, honesty, effective protection from confiscation and the like. It is maintained in part by the activities of those we call guard labour, for these make theft, shirking, foreign invasion and the like unattractive strategies to pursue and hence sustain the expectations, incentives and norms associated with what have come to be called 'good institutions'. Should this institutional stock be degraded for some exogenous reason, equilibrium output would fall. Following Weitzman, should the costs of maintaining this stock not be subtracted from gross output in calculating a welfare relevant concept of net national product?

Suppose, for example, that many members of a society convert to a religion that condones theft, and that in response to the ensuing spread of lawlessness, individuals purchase more private security services, thereby reallocating some workers from the production of consumption goods to guard labour. Because their activities would be counted as output whether they were producing consumer goods or safer streets, and assuming that the workers' incomes were unaffected by the reallocation, there would be no direct effect of the reallocation of labour effect on measured gross output. But welfare certainly would be lower as a result of the change. The amount that members of the society could consume without encroaching on their future consumption would have fallen, indicating a lower income in the welfare-relevant (Hicksian or Fisherian) sense. If, as Weitzman (1976) and many since have advocated, 'net national product is ... a proxy for the present discounted value of future consumption' (p. 157), it would be difficult to avoid the conclusion that in the example just given, net product properly measured has fallen, and that subtracting the value of the labour services shifted from producing consumption goods to protecting property would be a way of taking account of this.

The above argument and the example suggest that in a welfare sense the workers producing new machinery to repair that used up in the production process and the typically larger number who are engaged in the guard labour activities (excepting prisoners and the unemployed) that sustain the economically relevant institutional stock are performing analogous tasks. They are producing something that the market has demanded, and both are thereby sustaining the productive assets of the economy (material capital and institutions respectively). When defining a welfare-based measure of net output, the case for netting out the output produced by those maintaining the stock of capital goods is, of course, uncontroversial. We wonder if a similar case could be made for netting out the services produced by those who maintain the economically relevant institutional stock. The suggestion is more conceptual than practical, as the statistical difficulties associated with such a re-calibration of net income might be insurmountable for the reasons apparent in our efforts to measure guard labour in this chapter.

Were such an adjustment made, however, our estimates of guard labour suggest that the impact on growth rates and relative income levels across countries might be substantial. This would be especially true for the United States where roughly one in five workers (not counting prisoners and the unemployed) are performing guard labour, something like double the number of those producing the investment goods making up the depreciation of the capital stock.

3.6 Conclusions

> . . . it is lamentable to think how a great proportion of all efforts and talents in the world are employed in merely neutralizing one another. It is the proper end of government to reduce this wretched waste to the smallest possible amount, by taking such measures as shall cause the energies now spent by mankind in injuring one another, or in protecting themselves against injury, to be turned to the legitimate employment of the human faculties . . . (J.S. Mill, *Principles of Political Economy* (1848) (Mill 1965, p. 979))

Could the reallocation of guard labour to productive employment promote economic development and enhance the livelihoods of the least well off? We cannot answer this in any definitive way; but the following speculative conclusions may point towards partial answers.

First, the costs of reproducing an economy's institutions arise in large measure because of conflicts of interest over things that cannot specified in complete contracts that are enforceable at low cost. These conflicts provide incentives for the costly exercise of power by private economic actors. Policies that result in more fully and clearly defined property rights and attenuated conflicts of interest would reduce the cost of institutional reproduction.

Secondly, conflicts over non-contractible goods and services are exacerbated when many economic actors lack the assets necessary to become residual claimants on the results of their own non-contractible actions or to engage in other efficient contracts (Rosenzweig and Wolpin, 1993; Laffont and Matoussi, 1995; Bardhan, Bowles and Gintis, 2000). Thirdly, enforcement strategies adopted by wealthy principals facing wealth-poor agents typically confer a rent on the agent, who is then monitored by the principal. Both the rent and the resources devoted to monitoring are private costs, but only monitoring involves a social cost (the rent is a transfer, not an additional claim on resources that have alternative uses). As a result, private enforcement strategies are technically inefficient: if a larger rent were paid, the same output could be accomplished with less monitoring inputs and no more of any other input. Thus private enforcement exhibits an endemic 'too much stick, not enough carrot' technical inefficiency (Bowles, 1985). Private bargaining typically cannot eliminate the resulting inefficiency for the same reason that the labour contract is incomplete: efficient bargaining will be impeded by asymmetric information concerning the effort of the agent and commitment problems facing the principal.

Fourthly, illegitimate inequalities are costly to sustain. While cultures often justify vast differences in power and access to valued resources, the mind is not a blank slate on which such ideas as the divine right of kings or the superiority of the 'white race' can be etched at will. Two decades of behavioural experiments have provided convincing evidence that humans in dozens of cultures are inequality averse, and that violations of norms or reciprocity often lead to costly conflicts (Fehr and Gaechter, 2000; Falk, Fehr, and Fischbacher, 2003).

Arthur Okun expressed the consensus view among economists in 1975 when he wrote that 'the conflict between equality and economic efficiency is inescapable'. What he termed 'the big trade-off' remains a staple of undergraduate instruction. But new developments in economic theory referred to above as well as failed attempts to identify the trade-off empirically have cast doubt on the idea. Our growth model and data on guard labour suggest an alternative trade-off, that between equality on the one hand and enforcement of social and economic discipline on the other. Economies that have sustained high levels of economic inequality, as we have seen, appear to have shouldered an extra-ordinary guard labour burden. We do not know, of course, if measures to redistribute wealth and economic opportunity to the less well off would allow a reduction in guard labour, as we are not aware of the natural experiments or long time series that would allow one to confidently identify the relevant causal effects. But the available evidence suggests that for policy makers seeking to allocate more labour to productivity-enhancing rather than disciplinary functions, such measures would be a good place to start.

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4

Insurance, Redistribution and the Welfare State: Economic Theory and International Comparisons

Roberto Artoni and Alessandra Casarico

4.1 Introduction

In this chapter we reconsider the role of the welfare state in modern market economies. After defining the welfare state, and distinguishing between its insurance and redistributive functions (sections 4.2 and 4.3), we tackle the issue first by studying the relationship between the welfare state and economic theory, doing so by analysing how the economic literature has investigated the role and justifications for the welfare state. We address three specific themes: the economic environment in which the institutions of the welfare state are embedded; the impact that they have on savings; and the effects that they generally produce on incentives (section 4.4 and subsections).

Our first conclusion is that the literature, in particular the macroeconomic literature, places great emphasis on redistributive aspects, while marginalising theories and representations of the welfare state which envisage alternative functions or objectives. Is this appropriate?

To address this question we maintain that, owing to the fundamental function of the welfare state in the structure of society, its role should be studied both historically and institutionally. In section 4.5 we therefore conduct a brief historical investigation of the reasons that led to the introduction of certain welfare state institutions, and of the characteristics that distinguished them during their formation. On an institutional level, in section 4.6 and subsections we then compare how the welfare state functions in the United States and in Europe. The analysis highlights that these two geographical areas have alternative models with regard to the role of public and private welfare institutions, and that they exhibit different compositions of total spending, with health expenditure absorbing more resources in the US than in Europe. We offer an interpretation of the different institutional settings in the two areas and seek to determine whether they are inspired respectively by an insurance or a redistributive objective.

In section 4.7 we return to economic theory. If theoretical models and empirical analyses should take account of the facts which emerge from historical and institutional investigations, we argue that the latter indicate that study of the effects of the welfare state on incentives requires a broad viewpoint that transcends the individual dimension. Analysis of the impact on savings only makes sense when one acknowledges that the pension system is perceived as an insurance mechanism against individually uncontrollable risks. On a macroeconomic level, it is necessary to adopt assumptions that do not precondition the results of the investigation. Section 4.8 concludes, briefly summarising the main findings of the analysis.

4.2 The welfare state: a definition

The term 'welfare state' refers to the group of institutions that perform two main functions: redistributing resources, and providing insurance against specific risks. The actions undertaken to reduce the inequalities present in a particular society and to strengthen social cohesion enter into the redistribution function. The institutions that furnish coverage against the risks of illness, old age, disability and unemployment are included in the insurance function; and so are the mechanisms that allow income smoothing over the life-cycle.

On the one hand, the redistributive institutions act, or should act, on the basis of considerations of equity, as implied by a social welfare function with an egalitarian bias. On the other hand, the direct or indirect role of public authorities in the provision of insurance can be explained by failures of the hypotheses that guarantee Pareto optimality in a competitive market. As Arrow (1963) put it:

> By the absence of marketability . . . is meant here the failure of the existing market to provide a means whereby the services can be offered and demanded upon payment of price. The instance of non marketability with which we shall be most concerned is that of risk-bearing. I propose the view that when the market fails to achieve an optimal state, society will, to some extent at least, recognise the gap and non market social institutions will arise attempting to bridge the gap.

Barr (2001) argues that 'Risk, uncertainty, and imperfect information transform the intellectual landscape by undermining the automatic efficiency of unconstrained market outcomes'. The failure of the hypothesis of certainty gives rise to the necessity of insurance for individuals who are risk-averse. Market incompleteness and the presence of information asymmetries are such that an individual's need for insurance is not completely fulfilled by private institutions and therefore represents the main justification for public welfare in its insurance function.

Having separated the two functions of the welfare state, an unambiguous identification of the institutions performing them does not follow immediately. As Barr (2001) points out, there are many sources of welfare, just as there are many ways of supplying services, both for redistribution and for insurance. Not only the public sector, which can regulate, finance and offer on the market forms of support or cover, but also private parties, play an important role in this area. Private parties may be the family or formal organisations whose objective is pursuit of the above-mentioned goals. Relevant here is the distinction between public welfare and company and fiscal welfare originally drawn by Titmuss (1976). Although the current meaning of welfare state tends to identify it with public welfare, that is, with in-kind or monetary benefits distributed by public administrations, a large part of welfare in fact derives from transfers from employers to employees which replace or integrate public intervention, and from indirect support in the form of tax breaks or fiscal incentives. It follows that the boundaries of the welfare state are not easy to define, that its form and structure differ from country to country, and that comparisons between different models of organisation are not trivial.

4.3 The welfare state: redistribution or insurance?

While redistribution and insurance are not questioned as the fundamental objectives of the welfare state, economists have recently disagreed on which of these two functions takes priority in the real world. This question, and the answer to it, are important because they influence and define the criteria used to evaluate the effects generated by the welfare state. These criteria, in their turn, play a decisive role in defining the foundation of reform of the welfare state and the explicit way in which this reform should be carried out. If the acknowledged primary function of the welfare state is redistributive, it is appropriate to judge its effects using criteria of equality and distributive justice. However, if its fundamental function is insurance, the correct measurement of assessment is efficiency. As Atkinson (2004) stresses, it would not be expedient to evaluate an institution which predominantly acknowledges redistribution as its goal on the grounds of efficiency.

Identifying a different priority between the different functions carried out by the welfare state presupposes that it is possible to distinguish them. In this regard, it is worth noting that by supplying insurance, the welfare state can determine *ex post* a different distribution of resources across individuals. The purpose of this redistribution, however, is not so much to guarantee equality of endowments among different agents as to provide protection against the above-mentioned social risks, which do not have coverage in the private market. At the same time, and still with an insurance objective, the welfare state enables individuals to smooth their income over the life-cycle, favouring redistributive flows whose motivation does not necessarily relate to the objective of promoting greater equality. These considerations suggest a conclusion which we deem important: observation of redistributive flows generated by the workings of some institutions of the welfare state must not necessarily be interpreted as proof that a redistributive function has been performed. In general, analysis of the respective roles of insurance and redistribution within the welfare state requires joint consideration of the revenue and expenditure sides. As to the former, one should examine the different forms of financing used and their actual effect on the subject who is formally required to pay. As to the latter, one should take account of how benefits are determined and assigned.

Taking the pension system as an example, a pay-as-you-go scheme financed with social contributions and which distributes benefits linked to an individual's salary history, or to contributions effectively paid, can be interpreted as an insurance mechanism. Indeed, this type of scheme allows an individual to set aside a sum that is given back to him/her once s/he has reached retirement age. In this context, the use of contribution limits or of allowance limits to calculate the expected benefits marks the introduction of some redistributive elements. A predominately private pension system is not, however, without redistributive elements as long as contributions enjoy tax breaks financed by the general taxation system.

Finally, we would stress that, although the specific institutional design adopted may embody one or other of the functions *ex ante*, the actual distribution flows and the weights of their various components depend on the intersection between the institution design and economic and demographic variables: these being, to cite some examples, the structure and assumptions of competition in the labour market, longevity between different social groups, and access capacity to services.

4.4 The welfare state: the models

Any analysis of the role, effectiveness and impact of the welfare state requires adequate representation or modelling. The current economic literature proposes various approaches to the study of the welfare state. First, there are conflicting ideas about the fundamental characteristics that distinguish the economic context in which the welfare state operates, with evident and immediate consequences on its role and the effects which it produces. Likewise, there are differing ideas about how the welfare state or some of its specific components should be represented.

According to Arrow's view, referred to above, a *second-best* framework, the presence of risk aversion and the benevolence of the social planner are fundamental to the analysis of the role of the welfare state. By contrast, there is a different intellectual position where the idea of *first best* and the individual's neutrality to risk prevails. By way of example, we quote Hassler *et al.* (2003):

> We assume that individuals are risk neutral, abstracting from a standard alternative motivation for the Welfare state, i.e. that a government can deliver the insurance missing markets fail to provide…Our assumption of risk neutrality and the fact that redistribution is distortionary, imply that any allocation with some redistribution would not be Pareto-optimal. Thus, the Welfare state would not survive if the future path of redistribution were set by a utilitarian planner attaching any arbitrary sequence of positive weights on current and future generations. In this sense, the survival of a Welfare state would constitute a 'political failure'…

This view completely marginalises the insurance function of the welfare state. As we shall discuss shortly, it also predetermines the way in which the welfare state is represented. Moreover, the inclusion of information asymmetries or other market imperfections in this analytical framework does not imply that the government should attend to them. In fact, according to Hassler *et al.* (2003), there are not only market failures but also government failures, where the government is not a benevolent agent seeking to maximise the collective well-being, but is represented by bureaucrats or politicians motivated by personal or party interests.

In addition to the opposing views on the economic environment in which the welfare state operates, there are also further differences in the literature concerning the way in which the welfare state is represented. In this regard, we can distinguish between contributions which analyse certain components and those which concentrate on the welfare state as a whole.

4.4.1 The welfare state in the macroeconomic dimension

On the one hand, the relatively recent attention directed by macroeconomic theory to the welfare state has highlighted some previously marginalised themes. On the other hand it has led to a grouping of complex institutions into an object which, on a theoretical level, is almost always represented as a transfer of an unconditional fixed sum, financed by proportional contributions, in a static environment with no uncertainty. Most of these characteristics are present, for example, in the study by Alesina and Perotti (1997), in which they analyse the effects of the welfare state on a country's competitiveness.[1] These modelling choices have major implications: first, they establish an unambiguous association between the welfare state and redistribution; secondly, for the purpose of econometric analysis, they impose identification of an empirical magnitude for the type of *policy* represented theoretically. For most analyses, this coincides with the amount of the monetary transfers carried out by the public sector alone, and it is interpreted as the amount of redistribution performed by the welfare state.

The association between the welfare state and redistribution is particularly problematic in contexts where economic performance and not total welfare is used as a measure of the effectiveness of public intervention. This approach precludes any evaluation in terms of equality. As we argued at the outset, there are many objectives that characterise the welfare state and, consequently, many criteria that should be adopted to evaluate its effects. By contrast, in the macroeconomic literature we find a unilateral choice of the welfare state's objective – redistribution – and of the variables used to measure its impact – competitiveness or economic growth. The almost exclusive attention paid to this latter aspect obscures the role of the welfare state, since it eliminates alternative criteria by which other objectives can be evaluated. If the welfare state is inserted into a theoretical framework which, by construction, delivers optimal results, it ends up being an unjustified cost to society.

Whilst the approaches and the choices described above can be criticised for the reasons stated, they nevertheless have the merit of highlighting some elements relevant to appropriate investigation of the welfare state's impact on economic functioning. To refer again to Alesina and Perotti (1997), the extremely simplified representation of the welfare state which characterises their model corresponds to a significant articulation of the economic context in which the welfare state works. The typical viewpoint of a closed economy is superseded by explicitly examining the interdependencies among countries; the relevance of the market conditions in defining the effects of particular welfare policies is fully spelled out. The assumption of competitive labour markets is abandoned, so that analysis can be made of the incidence of contributions that do not necessarily burden the workers who formally pay them.

4.4.2 The institutions of the welfare state

In general, studies that concentrate on some specific parts of the welfare state allow the latter's more complete articulation. They are more flexible in identifying the objectives and impacts of the different forms of expenditures than are the previously-discussed studies which view the welfare state as a single institution. But within these studies it is still possible to identify opposing views on the role and impact of each specific institution. In order to present these differing concepts, we now refer to the literature which analyses social security, and in particular pension systems, furnishing examples relative to two specific themes: the effects of social security on savings and, more generally, on incentives.

The pioneering study by Diamond (1965) is a reference model with which to analyse the impact of the pension system on savings and on the accumulation of physical capital. In this model we make a comparison of two alternative systems – pay-as-you-go and fully-funded – on the assumption that no type of mandatory savings pre-exists when the social security system is introduced. Here the differences between the two systems consist solely in the financing method. The conclusion drawn is that the pay-as-you-go system is associated with a lower level of savings, and therefore of capital, than is a fully-funded system. The latter, on the assumption that liquidity constraints are absent, leaves the level of savings unchanged compared to a situation without a pensions system: the only effect that it generates is a perfect replacement of voluntary savings with obligatory savings. Diamond's results have often been used to argue that a move to a fully-funded system would guarantee higher levels of savings compared to the current levels (on this, see Feldstein and Liebman, 2002), where an increase in savings is considered one of the objectives which pension system reforms should pursue.

There are alternative viewpoints, however. Consider, for example, the study by Orszag and Stiglitz (2001), in which they highlight the importance of choosing an appropriate starting point if one is then to be able to derive the impact that a pension system reform would generate on savings. This view suggests that Diamond's (1965) assumption of the absence of any form of protection is inappropriate for evaluating the effects of reform; and so too is a complete assimilation of voluntary savings with mandatory savings within a fully-funded scheme, given the fiscal concessions enjoyed by the latter.

Over time, on the basis of the original comparison between pay-as-you-go and fully-funded schemes, description of the system has been enriched on numerous dimensions, and so too has the array of variables used to measure the impact of alternative institutional models.

Again in regard to the effects of social security on savings, we maintain that important insights can be gained by considering the degree of means-testing with which the benefits of the pension system are distributed (Feldstein, 1987; and Atkinson, 1999). As demonstrated by Atkinson (1999), the abandonment of a pay-as-you-go system based on universal benefits in favour of a fully-funded system associated with means-tested benefits and which performs a redistribution function, on the one hand allows a reduction in pension costs by decreasing the number of potential beneficiaries, but on the other, may not bring about the expected increase in total savings, owing to the problems of moral hazard that are generally introduced by means-testing.[2]

Secondly, it should be borne in mind that the concept of 'accumulation' has been expanded. The impact of human capital on accumulation has been added into analysis of the effects of alternative pension systems on savings, and therefore on physical capital (Merton, 1983; and, more recently, Casarico, 1998; and Boldrin and Montes, 2005). The inclusion of human capital in the analysis further enlarges the group of relevant variables on which to measure the effects of different pension systems. It also makes it possible to detect relevant properties of pay-as-you-go systems which shed new light on their role in the economy. Indeed, it has been shown that pay-as-you-go financing can promote investment in human capital where the latter cannot be used directly as collateral. Furthermore, pay-as-you-go can create intergenerational ties that, if exploited, overcome the limited access to credit for investment in education.

Mention of investment in human capital brings us to the more general theme of incentives, where, in particular, we ask whether the presence of the welfare state generates changes in individual behaviour. In this regard there are opposing viewpoints which, totally or in part, reflect alternative descriptions of the underlying economic environment, as we pointed out at the start of this section. In particular, the view stressing the welfare state as a redistributive institution depicts it not only as an instrument of protection for less productive individuals, but also as a factor hindering entrepreneurship. To quote Feldstein (2005):

> The impetus for broader social insurance reform comes from the recognition that existing programs have substantial undesirable effects on incentives and therefore on economic performance . . . Social insurance programs impose costs that must be weighed against the benefits of overcoming market imperfections.

Alternatively, when there is space for an insurance function, the protection offered by the welfare state may encourage risk-taking. In this framework, it is not always true that the welfare state reduces inequality: to quote Sinn (1995), 'With any pre-tax income distribution the variance of post-tax incomes is clearly reduced by redistributive taxation. However, people may react by taking more risks so that pre-tax inequality rises.'

The foregoing brief survey shows that the possibility of achieving precise analytical results depends heavily on the assumptions made in theoretical models. It also shows that the progressive broadening of the analysis, obtained through careful and less rigid formulation of the hypotheses, generates non-unilateral conclusions. From this it follows, in our opinion, that given the fundamental role of the welfare state in a society, analysis and interpretation of its role and effects can benefit from adequate historical and institutional investigation. The historical and institutional evolution of the welfare state can in fact provide a valid guide for discrimination between alternative analytical settings and yield more knowledgeable applications of economic theory, such as we seek to provide in the last part of this chapter.

4.5 The welfare state: a brief historical investigation

Here we briefly recall the goals that have been historically attributed to the welfare state, referring in particular to its largest component: social security.

Germany was the first country to introduce a complete system of social security. It began to do so in 1880 – health insurance was introduced in 1883, while insurance for old age was introduced in 1889 – financing the system by contributions and paying benefits linked to workers' incomes. Given these characteristics, German social security has always been viewed as an insurance-based system that guarantees individuals protection against the risks of long life, short-sightedness, and the failure of financial institutions in which they have invested their savings. Other countries, among them Italy, adopted Germany's insurance-based model from the outset. Others – for example Denmark, New Zealand and Great Britain – initially opted for an alternative model in which the distribution of benefits was subject to means-testing, and they adhered to a social protection model largely aimed at reducing poverty (Cutler and Johnson, 2004). The evolution of these systems was, however, marked either by the transformation of the initially means-tested benefits into universal benefits, or by the combining of universal benefits with means-tested ones, with a net dominance of universal transfers in terms of expenditure.

A similar evolution is exhibited by the United States, where, according to Moss (2002), the introduction of social security was the second phase in the development of the *risk manager* role that the state began to assume from 1800 onwards. After the state had provided an insurance framework for business, it concentrated on workers: the Social Security Act of 1935 marked the beginning of the American welfare state. In 1939 an amendment referring to provisions for old age was introduced. The benefits were extended to workers' partners and their survivors and were no longer calculated on the basis of workers' contributions, but on the amount of time that they had worked and the average wage received during the contribution period. This choice led to the adoption of a Bismarckian model of social security in the United States.

It seems correct to conclude that, historically, the goal attributed to the welfare state by those who worked for its initial construction was to provide insurance. As Moss (2002) reports, when the SSA of 1935 was enacted, Roosevelt declared that: 'We have tried to frame a law which will give some measure of protection to the average citizen and to his family against the loss of a job and against poverty-ridden old age.' The idea of supplying protection and insurance seems to have motivated the choices made in the founding years of the welfare state; the objective of redistribution, although present, seems to have been secondary. The redistributive effects generated *ex post* by the welfare state were accepted as a natural component of the insurance mechanism and did not involve particular costs; intervention by the welfare state was never conceived as a form of charity, but as a mechanism which helped private individuals meet needs that they could not satisfy by themselves.

4.6 The welfare state: an institutional analysis

It is necessary first to define the criteria with which to measure the allocative and redistributive activities performed by the welfare state.

In this section we do not simply refer to the public component of welfare but also consider the more composite way in which real institutions can provide social protection. According to the Eurostat definition, 'Social protection encompasses all interventions from public or private bodies intended to relieve households and individuals of the burden of a defined set of risks or needs, provided that there is neither a simultaneous reciprocal nor an individual arrangement involved' (Eurostat, 2007). There are two problems with this definition which must be dealt with if comparisons are to be made possible: the role played by private institutions, and the individual actions to be deemed relevant.

It is true that not all the individual activities relating to the typical functions of the welfare state sectors can be incorporated into an operational notion of a protection system. An acceptable distinction could be based on the existence and use of fiscal tax breaks. In this way an equivalence is established between direct public intervention and support for private choices and activities so that analysis of the distributive and allocative effects of the different institutional models is not excluded *a priori*. Analysis restricted to public sector spending would not allow an evaluation of the total effects of the activities covered by social security. Most importantly, it would preclude any analysis of the distributive effects attributable to types of welfare states characterised by a different division of competencies between the public and private sector.

Other ambiguities arise in the comparative analysis of social security systems. In particular, the interconnections between the fiscal system and direct intervention are often difficult to evaluate. Interventions to support the family may consist in direct payments or in concessions or fiscal reductions: direct payments show up in international statistics, whilst tax breaks are totally ignored by them. Monetary flows are typically shown gross of direct taxes: when national tax rates vary, the effects of the same amount of public expenditure are obviously different.

Table 4.1 reports data from the Social Expenditure Database of the OECD, where all expenditures other than health have been included in the figures for Welfare. On comparing countries, we note that total social expenditure in the USA is equal to 26.3 per cent of GDP, a value in line with those of Italy and the UK, and lower than the German, French and Swedish ones.

A simple direct comparison of public expenditures shows a strong divergence between the United States, where expenditure does not exceed 16 per cent, and Europe, where it typically stands at around 25–30 per cent. But if one also considers private costs, there is an overall convergence between the two models of social security in terms of expenditure.

Table 4.1 Public and private social expenditure as a percentage of GDP (at market prices), 2003

	Health			**Welfare**			**Total**		
	Total (%)	**Public** (%)	**Private** (%)	**Total** (%)	**Public** (%)	**Private** (%)	**Total** (%)	**Public** (%)	**Private** (%)
France	8.9	7.6	1.3	22.1	21.1	1.4	31.0	28.7	2.7
Germany	9.0	8.0	1.0	21.3	19.3	2.0	30.3	27.3	3.0
Italy	6.3	6.2	0.1	20.2	18	2.2	26.5	24.2	2.3
Sweden	7.1	7.1	0	27.2	24.2	3.0	34.3	31.3	3.0
UK	7.3	6.7	0.6	20.1	13.9	6.2	27.4	20.6	6.8
US	12.5	6.7	5.8	13.8	9.5	4.3	26.3	16.2	10.1

Source: OECD, *Social Expenditure Database 2007*.

Table 4.2 Net and gross social expenditure as a percentage of GDP (at factor cost), 2003

	Net social expenditure			**Gross social expenditure**		
	Total (%)	**Public** (%)	**Private** (%)	**Total** (%)	**Public** (%)	**Private** (%)
France	32.2	29.4	2.8	36.2	33.1	3.1
Germany	30.8	28.8	2	33.9	30.5	3.4
Italy	25.6	23.6	2	30.3	27.7	2.6
Sweden	30.9	28.8	2.1	38.7	35.1	3.6
UK	28.2	22.1	6.1	31.4	23.7	7.7
US	27	18.6	8.4	28.2	17.4	10.8

Source: Our elaboration based on OECD (2007a), Table 5.5.

This convergence is confirmed if one considers net monetary payments – that is, after-tax social benefits. These results are shown in Table 4.2: in Sweden, spending net of taxes (in terms of Gross Domestic Product) decreases from 39 per cent to 31 per cent, while that of the United States is 27 per cent, not far short of the European level and above that in Italy. These data largely confirm the argument recently advanced, amongst others, by Esping-Andersen (2002), who maintains that the differences between the US and the Scandinavian countries are a matter, not of total welfare resource allocation (as a percentage of GDP), but of the public–private expenditure mix.

Further differences emerge in this framework of overall convergence in total spending. Apart from the relationship between private and public spending, the United States also spends more on health care – 12.5 per cent versus an average of 8 per cent in Europe – and less on welfare (as defined above) – 14 per cent in 2003 in the United States versus a European average above 20 per cent – a difference also due to lower pension spending in the former.

In light of these data, the question arises as to whether the different levels of spending in the two components, health and welfare, of the social protection system and the different roles of the private and public sectors have an impact on access to payments, and therefore on the effective outcome of social protection systems in terms of insurance and redistribution.

4.6.1 The pension system

The pension system in the United States is divided into two distinct components. The public part, social security, is universal in nature and disburses decreasing payments as income rises. A 65-year-old pensioner, who started work at the age of 22 and who has always had a salary equal to 45 per cent of an average salary, obtains a pension of 55.9 per cent of his/her final salary (in 2006, roughly $780 per month). The replacement rate decreases to 41.4 per cent for a worker who has received an average salary, and the level is 28.9 per cent for a worker who has always paid contributions at the maximum level allowed, which in 2006 was set at a yearly income of $94,600, delivering a pension of approximately $27,000 on an annual basis (SSA, 2006). The method of calculating the pension payments is therefore progressive: proportional contributions, at least up until an upper limit, guarantee higher benefits for those with lower incomes.

Private pensions, together with public ones, cover both public workers and also a significant number of private ones. Data referring to March 2006 show that 60 per cent of workers in the private sector have access to a pension plan, but that only 51 per cent of them actually participate (see Table 4.3).

Access and actual participation are not distributed uniformly in the population. Participation rises rapidly as income grows and is higher for workers in large companies, in the sectors with trade unions and for full-time workers. From this it follows that, first, private pensions are an important source of income for the well-off elderly population; on the other hand, they are quite irrelevant for lower-income groups (Artoni and Casarico, 2003). Secondly, the fact that these private pensions are

Table 4.3 Percentage of workers participating in retirement and healthcare benefits, by selected characteristics, March 2006

Characteristics	Retirement benefits			Healthcare benefits			
	All plans (%)	**Defined benefit (%)**	**Defined contribution (%)**	**Medical care (%)**	**Dental care (%)**	**Vision care (%)**	**Outpatient prescription drug coverage (%)**
All workers	51	20	43	52	36	22	49
Worker characteristics							
White-collar occupations	60	22	53	57	41	24	54
Blue-collar occupations	52	25	40	60	38	25	57
Service occupations	24	7	20	27	18	13	27
Full time	60	23	51	64	44	26	60
Part time	21	8	16	13	10	7	12
Union	80	68	44	80	63	48	77
Nonunion	47	14	43	49	33	19	46
Average wage less than $15 per hour	36	10	31	38	23	14	35
Average wage $15 per hour or higher	70	33	58	71	52	32	67
Establishment characteristics							
Goods production	64	31	51	70	49	29	66
Service production	47	17	40	47	32	20	44
1 to 99 workers	37	9	33	43	24	14	40
100 workers or more	67	33	54	63	50	31	60

Source: US Department of Labor, *National Compensation Survey*, March 2006.

destined for relatively privileged workers and have associated tax breaks on the contributions made by private individuals implies that there is a regressive character to this part of the American welfare system. This regressive part is reinforced by the possibility that employers' contributions may be shifted on to final prices. In any case, it is fair to say that the degree of progression implicit in social security is largely off-set by the uneven distribution of private pensions.

The previous considerations help to explain why the American pension system taken in its entirety absorbs fewer resources than does the European one. According to our data, in 2003 payments for social security and for private pensions amounted to 9.4 per cent of Gross Domestic Product for the United States (in Table 4.4 we have selected benefits for OASDI (Old-age, Survivor and Disability insurance) and for railroad retirement, and pensions and profit sharing). This value is approximately three points less than the European average expenditure on old-age and survivors of 12.1 per cent (EU-15 average, Eurostat data).[3]

As stated, the replacement rates of social security are noticeably lower than those exhibited by public pensions in Continental Europe, which are set – in conditions of contribution limits for the beneficiaries – at around 70 per cent. In the United States, if we consider only both public and private pensions (always with conditions of maximum contributions), we can achieve replacement rates that are similar to, if not higher than, those of European countries.[4] As we have observed, this is only applicable for public workers, and for roughly 50 per cent of private sector workers, while for those people who only have a public pension and have near average remuneration, the difference[5] with respect to European countries is remarkable.

Although the differences in replacement rates guaranteed by the public sector explain some of the differences in spending, there are a further two factors which affect the total cost of pensions. First of all, the proportion of the US population aged over 65 is 12.4 per cent, also due to the high levels of immigration over the past ten years, as opposed to a value between 16 per cent and 19.3 per cent in the major European countries (OECD, 2007): if the USA had a share of elderly population in line with the European average (around 18 per cent), pension expenditure in the USA would be 3 percentage points higher.[6] Secondly, retirement age should also be considered, an aspect to which we shall return shortly.

At this point, we can go back to our original distinction between the insurance and redistributive functions of the welfare state. The former has the goal of preventing a fall in the standard of living, with at

Table 4.4 Welfare expenditure in USA, 2005

	Billions of dollars	%GDP (GDP = 12455,8)
Federal government transfers to persons	**1078,6**	**8.7**
Benefits from social insurance funds	894,7	7.2
Oasdi	*512,3*	*4.1*
Hi	*332,7*	*2.3*
Railroad retirement	*9,2*	*0.1*
Other (unemployment)	*40,5*	*0.3*
Veteran benefits	34,2	0.3
Other (Assistance and unemployment)	199,7	1.6
State and local government transfer to persons	**402,3**	**3.2**
Medical care	315,0	2.5
Other	87,3	0.7
Benefits paid by pension and welfare funds	**1253,0**	**10**
Pensions and profit sharing	609,9	4.9
Private	*344,2*	*2.8*
Public employees	*265,7*	*2.1*
Private insurance funds	**643,1**	**5.2**
Health insurance	581,0	4.7
Life insurance	18,3	0.1
Worker's compensation	43,8	0.3
Total	**3377**	**27.1**
Total-health	**2148,3**	**17.2**
Health	**1228,7**	**9.9**
Employer contributions for:		
Employee pensions and insurance funds (Domestic industries)	933,2	7.5
Government social insurance (Domestic industries)	433,2	3.5
Government social insurance (Government)	64,3	0.5
Employee pensions and insurance funds (Government)	299,6	2.4
Employee contributions for:		
Publicly administered government employee retirement plans	51,1	0.4
Government social insurance (Domestic industries)[1]	448,3	3.6
Total	**2229,7**	**17.9**

Note: [1] includes also *self-employed contributions*.
Source: US Department of Commerce, *National Economic Accounts*.

least a minimum level of income during retirement. It is conventionally believed that a replacement rate of between 60 per cent and 70 per cent guarantees achievement of this objective by a large part of the population, although this does not prevent future reductions in replacement rates or higher pension age limits in response to demographic or economic conditions. The redistribution function is performed either by guaranteeing a minimum treatment regardless of personal history, or by favouring particular segments of the population or specific career profiles.

We can interpret the two models of welfare on the basis of these distinctions. The European Model pursues an insurance function with universal features and guaranteed replacement rates. By contrast, the US Model is characterised by limited application of the insurance principle. If adequate replacement rates can be obtained for incomes which have double protection, public and private, the part of the population that relies exclusively on social security has relatively low replacement rates which rapidly decrease in the case of middle incomes.

4.6.2 The health care system

In the health area, the insurance principle entails that an individual has the right to adequate care whatever his/her level of income. The progressive redistributive element is apparent in two aspects: when payment for services which are probabilistically the same for everyone over the life-cycle are financed by proportional contributions, or when health care is guaranteed also for individuals who are unable to pay or contribute owing to insufficient income.

As previously for old-age protection, here we compare the European, universal model of health care against the American one, which is characterised by marked segmentation of the population. For a large part of the population in the United States, health insurance is linked to the job, even if only 52 per cent of private workers participate actively in medical care insurance (Table 4.3). Individuals who are difficult to insure, because they are either poor or elderly, are protected by federal programmes. Finally, a significant component of the population, 15 per cent, has no form of insurance at all. It is clear that in the US there is a major limitation to the insurance principle which generates peculiar distributive effects.

Private medical insurance schemes, essentially directed at the active population, enjoy significant tax breaks[7] in the form of non-taxable premiums.[8] In light of the characteristics of the population covered by private medical insurance, it is reasonable to conclude that there is an implicit redistribution element in their funding which works in favour of the relatively wealthy sector of the population, which, in the absence of tax breaks, would face higher spending. By contrast, the fact that the poor and the elderly are protected by federal programmes financed by general funds implies the existence of a progressive redistribution which helps this group.

Europe is very different. In accordance with insurance principles, all citizens are obliged to finance most health spending through contributions paid during their entire lifetimes. Judging from the data, the European health care system is less onerous in terms of resources used. Health care spending in European countries is between 6.3 per cent in Italy and 9 per cent in Germany, as reported in Table 4.1, while in the USA it is above 12 per cent.

Our analysis points to two conclusions. The fundamental difference between the social protection model of Continental Europe and that of the United States arises from a wider application of the insurance principle in the welfare and health sectors, with the effect that, in Continental Europe, spending is moderate in health care and relatively liberal in pensions. If one considers the possibility of access to tax breaks and the distribution of private benefits in the United States, it seems that many mechanisms work regressively in that country. By contrast, the European model appears to be essentially neutral.

4.6.3 Interpretation of institutional differences

We now propose an interpretation of the differences that we have brought to light. Here economists' expertise may not be comprehensive enough, for their analyses may go awry when they are not sufficiently cautious or have ideological prejudices. We shall restrict our treatment to only a brief overview.

The development of a universal, indiscriminate welfare state, based on coherent insurance principles, has been favoured by the political and ideological hegemony of social democracy in post-Second World War Europe. Certainly, this is not comparable to the same period in the United States, when company welfare developed enormously.

The behaviour of the trade unions has played a fundamental role in the construction of the social protection system. To our knowledge, American trade unions have always been very careful to protect the interests of their members and often have strong representation in large companies. The role of the trade unions has been substantially different in Europe, where a much more fragmented productive system, plus the greater homogeneity of populations within national borders, have led to a search for universal solutions, after the first phase when institutions were concerned only with industrial workers.[9]

In the US the existence of minorities, fed by the inflow of migrants of various origins, has obviously influenced the behaviour of politicians and unionists and, through them, the process by which the welfare system has been constructed. The employees of large companies, where trade unions had a significant role, generally belonged to the white majority. Within those companies, and in the public sector as well, company pension and health insurance plans were formed which, as we have seen, have in recent years covered half of private workers. It is no coincidence that an important recent study by Hacker (2002) on the welfare state in the United States deals with 'The Divided Welfare State'. In our view, the limited application of the insurance principle in regard to some citizens' fundamental rights is only possible when large minorities exist with a country. In other words, it seems difficult to think that countries with strong ethnic and cultural homogeneity can drastically limit access to medical care or reserve particularly generous pension mechanisms for only part of the population.

Other explanations seem less convincing. For example, it has been argued recently that Europe has an intrinsic preference for redistributive policies: on the basis of surveys, the opinion of Europeans seems to be that social and income position is a matter of luck rather than individual merit (Alesina and Angeletos, 2005). According to these authors, this view explains the introduction in Europe of redistributive policies in the guise of the welfare state. However, our reconstruction of the similarities and differences between the European system and that of the United States advises caution when interpreting the results of the surveys just mentioned.

On the basis of our historical and institutional reading of the two social protection models, we now intend to return to economic theory. In particular, we will inquire whether historical and institutional analysis is useful for integrating, qualifying and evaluating the current interpretations of the effects of the welfare state on individual behaviour and on the macroeconomic performance of a country or a geographical area.

4.7 A return to economic theory

4.7.1 Incentives

The above brief survey of the theoretical literature highlights that the latter seems to favour the redistributive element over the insurance aspect as the main justification for the welfare state. To investigate this finding further, let us first address the question of the impact of the welfare state on incentives. The dominant opinion, as expressed by Lindbeck (1995), is that the welfare state is a disincentive to work because it reduces the difference in income between those who work and those who do not. Derived from elementary microeconomic theory, this point of view has been supported by numerous econometric investigations that estimate a high average elasticity of labour supply to net income.

Although there is by no means consensus on these results at an econometric level (Poterba *et al.*, 1998; and Alesina *et al.*, 2005), it is appropriate to recall an important criticism by Lindert (2003), who, when discussing the specific disincentive effects of the welfare state, states that

> the main limitation of this work is that most of it has been done in the wrong laboratory. Most of the studies try to use non-policy variation to infer the effects of policy changes. The large data sets consisting of surveyed households in one country don't provide the real world laboratory in which the national tax and benefit structure is transformed from a relatively free market economy into a high budget welfare state.

What is meant by creating the 'right laboratory' in which to study the shift from a free market economy to the welfare state? Since we are unable to give a general answer, we propose two examples relating respectively to female workforce participation rates and to the average retirement age. Common to both examples is the consideration that evaluation of the incentive or disincentive effects of social welfare mechanisms should be conducted with a larger framework and not restricted to individual benefits alone.

With reference to female workforce participation, the data show that this is particularly high in Sweden, where the welfare state is generally considered to be rather generous. A significant, though not recent, analysis (Rosen, 1996) claims that the increase in employment in Sweden has been driven mainly by local government, which is characterised by an employment structure in which female labour predominates. An expansion of local public services, and therefore of child care and elderly assistance, has led to a corresponding growth of the presence of women in the labour market, in various productive sectors.

Obviously, expansion in some services, and the ensuing exit of some fundamental activities from the family, have led to a correspondingly general increase in contributions and taxation. Rosen writes: 'the most important finding is that the welfare state encourages excessive production of household goods and discourages production of material goods'. In the same line, Lindbeck argues that: 'the reduction in after-tax returns discourages participation in the taxable activities needed to finance public expenditures'. It seems difficult to agree with this latter point if we look at the Swedish participation rate, which is the highest among developed countries, even ten years after the publication of Rosen's paper. Moreover, the claim concerning the excessive production of non-material goods or personal services seems doubtful. The access to the market economy made possible by the expansion of public services has simply determined the appearance and monetary compensation of activities which would have been performed anyway, albeit within the family so that they were not reported in national accounts. One can say that the possibility to carry out 'productive activity' outside the family has given greater efficiency to the Swedish economic system, as well as having a positive effect on the country's birth rate.

Analysis of exit mechanisms from the workforce yields interesting insights which can be related to the effects of the enormous economic transformations of the past decade. In an illuminating analysis referring to the most developed areas of the world, Iversen and Cusack (2000) state that 'the increasing productivity, the change in the composition of consumption, the saturation of demand coming from traditional sectors of the economy have been the main factors of change'. On the other hand, 'a large part of the employment changes have been resolved by the entrance of young workers in the service sector and in the early withdrawal of workers from traditional sectors'. Governments have responded in two main ways to these structural and irreversible changes: they have maintained the same regulation of the labour market, activating forms of social protection like early retirements, or they have kept the age of retirement relatively high, activating forms of employment in services with low wages, part-time employment and low productivity.

This analysis illustrates the contrast between the European and the Anglo-Saxon models. Bearing in mind that early retirement takes different forms in different countries, it is worth looking at some details.

First, the choice of early retirement seems to have temporary and demarcated effects, as shown by the substantial convergence of exit rates from the labour force. The data on the average exit age from the labour force weighted by the probability of withdrawal from the labour market, calculated by Eurostat and interpreted by us as the average pension age, show that in Europe the average age of exit from the labour force was 61 in 2005; in Sweden and the United Kingdom, it was the higher age of 63 years.

Table 4.5 Average exit age from the labour force

	2001	2002	2003	2005
EU-25	59.9	60.4	61	60.9
France	58.1	58.8	59.6	58.8
Germany	60.6	60.7	61.6	n.a.
Italy	59.8	59.9	61	59.7
Sweden	61.7	63.2	63.1	63.7
UK	62	62.3	63	62.6

Source: Eurostat, Europe in Figures, Eurostat Yearbook 2006–2007.

In the United States (until 2003), total social security benefits are paid from the age of 65 onwards. Retirement between the ages of 62 and 65 leads to a reduction in benefits:[10] in 2004, 75.5 per cent of retirees received a reduced pension because they stopped work before the age of 65 (SSA, 2006). Referring to public pensions, the exit age from the workforce in the United States was 63.7 in the same year.

Secondly, a high retirement age applies only to those who receive public pensions. As a matter of fact, access to private pensions comes about at a significantly lower age than that foreseen for public pensions, above all for those workers enrolled on defined benefit plans. These plans have been traditionally used to encourage or allow workers to quit work between the ages of 55 and 60. In defined contribution plans, those who retire early are penalised only if they retire before they are 59.5 years old. A recent survey concludes that 'people covered by any type of plan will retire earlier than those not covered, and people with a defined benefit plan will retire earlier than those not covered . . . The median actual retirement age is 62', which is lower than the age characterising *Social Security* (Munnell *et al.*, 2004).

A theoretical analysis should investigate which social protection model provides the most appropriate response to large structural modifications: either early retirement with adequate benefits, as has been the case in Continental Europe, or the shift of the redundant workforce to sectors of low productivity and low wages. In any case, even in the United States workers employed in firms providing private welfare have managed to retire early with high benefits. These two examples concerning female participation and retirement age show that the incentive and disincentive effects of the welfare state should be analysed in an appropriate framework, and certainly not one limited to consideration of individual benefits alone.

As a final observation, we would point out that recent events show that welfare systems not only have an insurance function but are also productivity-enhancing mechanisms. They facilitate the exit or outplacement of redundant workers following the adoption of new technologies or the relocation of traditional productions. This has occurred in Europe. In the United States, the articulation of private pension systems has shown how important it is for businesses to have an instrument to induce the labour market exit of workers who are insufficiently productive. In general terms, an association between access to social benefits and complete participation in a productive process is apparent in the history of the entire western world: if we exclude the strictly assistance components, which follow a specific logic and are of a modest amount anyway, access to the welfare state guarantees protection against risks uncontrollable by those who have taken part in the economic process.

4.7.2 Savings

A second problem in interpretation of the role and effects of the welfare state concerns the link between individual savings and pay-as-you-go pension systems. We have already suggested that an influential body of literature maintains that a pay-as-you-go system brings about a level of savings lower than that which could otherwise be obtained with a fully-funded system. This theory is backed up by a number of econometric investigations which confirm the analytical conclusions (Feldstein and Liebman, 2002).

In this case, too, doubts arise concerning the robustness of the results. Given the theoretical and empirical uncertainties, it is useful to reflect on historical experience. In the United States, a major role has been played by a private fully-funded system based on defined contribution plans which, in recent years, have assumed greater importance than defined benefit plans more similar to the public pay-as-you-go system. In Europe by contrast, with the exception of the United Kingdom, funded mechanisms are still of marginal significance.

The evolution of pension systems can be correlated to the level of savings. In the United States the level of personal savings has slumped in the last two decades: from 10 per cent of disposable income in the first half of the 1980s to 1.4 per cent in 2002–03. To quote Bosworth (2004):

> The decline in the overall saving appears to have begun in the last half of the 1980s, and it was initially evident in the non retirement

> components, which fell to zero and remained at that level throughout the 1990s. Over the past four years, saving outside of the retirement accounts has averaged −1.7 per cent of disposable income.

While retirement savings have substituted for other forms of investment, the data show that they have also fallen sharply:

> Retirement saving also fell steadily throughout the 1990s as a share of disposable income; and in the 2002–03 period, the percentage devoted to retirement account saving was less than half that of the 1980s. Saving within pension funds and IRAs accounts for 40 per cent of the drop in the personal saving rate between its peak in the early 1980s and 2000–03. (Bosworth, 2004)

There is a marked difference during the same years in Europe, particularly in the cases of Germany and France, where no fall at all has been recorded in personal savings, which have always been higher than 10 per cent.

It is never wise to identify rigid, causal connections between economic variables. One can only observe that in the United States and the United Kingdom, the development of forms of capitalisation has not led to an increase in personal savings.

There are other noteworthy features to consider. Between 1985 and 2002, the percentage of workers investing in a pension fund operated by their employer remained practically steady, although more recently a slight drop has been recorded (Munnell *et al.*, 2004). *Personal Pensions* were introduced in the United Kingdom in a period of brisk stock market activity and with strong fiscal incentives. However, they were only subscribed to by a modest number of employees. In addition, the recent campaign to promote *Personal Accounts* in the United States does not seem to have been particularly successful.

In light of these experiences it is possible to maintain that most workers consider savings in pension funds to be substitutes for other traditional forms of savings with the same amount of risk. It is also possible to maintain that the introduction of specific fiscal tax breaks in favour of pension savings accentuates the process of substitution without affecting the level of total savings.

Furthermore, it seems to be confirmed that the welfare state, in all of its sections and also therefore in the pension component, is seen as an insurance mechanism against risks that the individual cannot control, rather than as a way to widen the risk area in compensation for possible but uncertain higher future earnings.

On an analytical level, the foregoing discussion has obvious implications for the derivation of the theoretical structures required to deal appropriately with the connections between savings and social security. Nor should we forget that recent analysis in behavioural economics has dealt with these themes, in our opinion achieving important results. In particular, the fact supported by numerous experiments that individuals are more sensitive to losses than to gains should explain why it is difficult to transform pension systems from mechanisms whose goal is to guarantee a certain income level into purely financial instruments, which are seen as extremely uncertain in their results. Consequently, it seems inappropriate to refer to the incapacity of individuals to correctly evaluate greater future gains from uncertain investments. The same process of substitution between pension and non-pension savings in the US can be easily related to the existence of extensive tax breaks which discriminate among investment forms with the same levels of risk.

Generally, it is our opinion that a closer integration between psychology and economics would yield greater understanding in this area. This includes improved comprehension of the reasons why certain welfare state institutions are embedded in the collective consciousness, and identification of areas of reform compatible with the collective goal of providing a complete system of social welfare. At this point, it is worth citing Kahnemann (2003), who writes as follows: 'Psychological theories of intuitive thinking cannot match the elegance and precision of formal normative models, but this is another way of saying that rational models are psychologically unrealistic.'

4.7.3 The macroeconomic context

In our attempt to identify the fundamental elements of a sound theoretical model, we focus finally on the validity of analyses regarding the macroeconomic effects of the welfare state. We have already mentioned a typical model where social spending is purely redistributive. Such spending is financed by distortionary taxation which produces a loss of competitiveness and negative effects on economic growth, whose magnitude increases with social spending and the amount of trade unionism in the workforce, excluding countries where trade union power is mostly centralised. This analytical structure, with the necessary variations, has been used widely to explain the different economic performances of the United States and Europe in the past decade (Table 4.6).

We have already focused on some problematic aspects. Ignoring company welfare has led to a failure to consider the roughly 7.5 per cent of GDP paid into employee pensions and insurance funds (See Table 4.4). Its

Table 4.6 Average annual per capita rate of growth (percentage)

	1951–72	1973–82	1983–92	1993–2002	2000–05
US	2.4	1.3	2.4	2.0	1.8
Italy	4.6[1]	2.8	2.3	1.4	1.0
France	4.0	2.1	1.7	1.5	1.4
Germany	5.1	2	1.8	1.1	1.4
UK	2.3	1.4	2.2	2.3	2.2

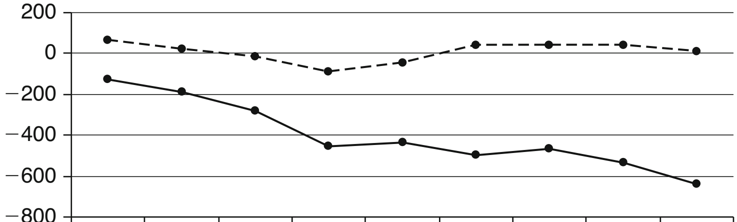
Note: [1] It refers to the period 1952–1972.
Source: Ciocca (2003), OECD in Figures 2006–2007.

impact is fundamental on costs and, therefore, on the competitiveness of American businesses. From the integration of company welfare with public welfare, we can see that the contribution burden of the United States is at almost the same level as that of Europe. Given the concentration of benefits in large companies, it is reasonable to conclude that the effects on competitiveness are particularly strong in those sectors which are exposed to international competition.

Apart from the need to define the size of the welfare state correctly, here we would stress that it is not appropriate to establish rigid causal connections between macroeconomic performance and the welfare state. Three aspects should be considered when looking at recent economic evolution.

First, external constraints have been completely ignored by the United States, which has accumulated an enormous debt, whereas in the decade 1997–2005 the current account in the euro area was on average balanced (see Figure 4.1). Secondly, the fall in the propensity to save has certainly supported the high expansion of consumer demand, which has been an important factor in the strong economic growth of the United States in recent years. Moreover, the increase in income inequality in the United States and in Europe has been associated, only in the United States, with a strong increase in family debt that has certainly supported some parts of total demand, and therefore the growth of the entire system. Finally, the use of economic policy – both fiscal and monetary – has been very aggressive in the United States, whereas in Europe, the process of monetary unification in the absence of a federal government with effective economic powers has been accompanied by much more passive behaviours.

Given all of the above-mentioned facts, it does not seem reasonable to assert that poor economic growth in Europe is due mainly to



	1997	1998	1999	2000	2001	2002	2003	2004	2005
US	−125	−190	−283	−454	−435	−499	−467	−535	−639
Eu15	67	24	−17	−93	−44	39	37	41	9

Figure 4.1 Current accounts (in 1000 million ECU/EUR)
Source: Eurostat/Bureau of Economic Analysis, http//:epp.eurostat.ec.europa.eu

the different configuration of the welfare state, or perhaps to a more rigid labour market. Some time ago any analysis of macroeconomic outcomes would have emphasised the importance of the distribution of income, the role of macroeconomic policies and the effects of external constraints, if respected. Constructing models that ignore these elements by assumption may lead to a wrong diagnosis and inappropriate remedies.[11]

4.8 Conclusions

We have argued that, in its origins and in its current form, the welfare state is essentially a large-scale insurance mechanism. Thus confirmed is Arrow's intuition that the presence of incomplete markets has led to the formation of non-market social institutions with the aim of satisfying essential needs.

By way of summary we may say that theoretical elaborations should take account of this fundamental characteristic of welfare systems. They should avoid analytical stances that contort the subject studied by giving importance to purely redistributive aspects in the form of unconditional monetary transfers. These transfers take place in all countries, but they are of only marginal importance.

In our opinion, there are several contributions which move in the right direction, although it seems that they are metaphorically 'squashed' by representations where the welfare state unjustifiably removes resources from those who produce them in order to favour the poor and inept.

Referring to the state in a social context at the end of the nineteenth century, Pantaleoni (1898) wrote:

> . . . this union for the inept intends artificially to break the force which continuously propels all economic activity, namely, the selfishness of individuals, that is, their competition, and since it cannot suppress and substitute the latter, it wants to artificially neutralise its effects, taking away the prize of victory from those who win the battle of life to give all or part of it to those who have lost.

History, in light of postwar economic and social development, as well as the current articulation of welfare systems, shows that Pantaleoni was wrong.

Although we are sure that modern society needs a welfare system, the question of which institutional set-up is appropriate remains an open one. In all systems, private and public components come together. Recent experience and comparison among different social welfare systems should enable evaluation of the functionality and efficiency of private insurance mechanisms, as well as the conditions which guarantee services of adequate quality in the public arena.

On a purely economic level, protection mechanisms must adapt to the characteristics and evolution of the relevant environment. In some cases, reforms concern unavoidable needs (typically tied to demographic evolution). In other cases, interventions seem to be either unjustified or in conflict with the fundamental goals of the welfare state. In many cases, problems related to the financing and the dynamics of total expenditures for welfare purposes are a result of inadequate economic policies in a broad sense.

Notes

1. For further examples, see the ideas proposed by Razin *et al.* (2002) and Hassler *et al.* (2003) as they study respectively the impact of an ageing population on the size of the welfare state and on the survival of the welfare state according to the voting methods used in the political process.
2. Atkinson (1999) shows that it may be optimal for some agents to reduce their savings to zero in order to pass the means test and be entitled to receive the benefit.
3. In Table 4.4, private and public welfare spending and the relative financing method are drawn from the national accounts of the United States for 2005. Private and individual components of health care and some welfare expenditures are not shown. These items are on the contrary included in the OECD data shown in Table 4.1.

4. The typical formula for defined benefits plans calculates the pension by multiplying the number of years of contributions by 1 per cent of the final wage. In 1999 social security accounted for 38 per cent and private pensions for 19 per cent of the income of families with elderly members (Artoni and Casarico, 2003).
5. Ignoring private pensions, 'workers in average earnings in OECD countries can expect their post-tax returns to be worth just under 70 per cent of their earnings after tax. The countries with the lowest net replacement rate are Ireland and New Zealand which have just basic pensions schemes and net replacement rates of less than 49 per cent. The United Kingdom and the United States have slightly higher replacement rates of around 50 per cent' (OECD, 2005, p. 14).
6. This is obtained considering that pension expenditure in the US is around 9 per cent of GDP, with a share of over 65 around 12 per cent, indicating that one percentage point of the population over 65 is associated with 0.75 per cent of pension expenditure over GDP.
7. For more information, see US Office of Management and Budget (2004).
8. The fact that insurance premiums are characterised by strong dynamics implies that tax expenditure linked to health financing is large and continuously increasing. It is sufficient to remember that premiums have grown in recent years, at an average rate of 10 per cent, compared to a growth in salaries and prices of less than 3 per cent (Kaiser Family Foundation, 2005).
9. On the issue of cultural diversity across countries in the current process of European integration, see Chapter 8.
10. From 2003 to 2023 the retirement age giving entitlement to a non-reduced pension will increase progressively to 67 years.
11. On this point, see also Chapter 5.

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5
Social Models, Growth and Key Currencies

Lilia Costabile and Roberto Scazzieri

5.1 Introduction

Is there a trade-off between social protection and economic growth? Cuts in social protection and welfare expenditures have been advocated as a recipe for faster growth in Europe, both in the recent past, when Europe as a whole was 'typecast' as a 'sclerotic under-achiever' (*The Economist*, 14 July 2007, 'Can Europe's Recovery Last?', p. 13) and during its subsequent recovery. In both the press and economic journals, this approach proposes the American Model as the successful alternative to the 'European Social Model', considered either as a whole or in its regional specifications ('the French Social Model', etc.).[1]

In fact, empirical evidence on the relation between growth and government size is inconclusive, and theoretical arguments do not provide unconditional support for beliefs in a possible trade-off between growth and the welfare state (Atkinson, 1999; Agell *et al.*, 2006). Consequently, it seems appropriate to enquire whether other factors should be brought into the picture in order to explain growth differentials among countries.

This chapter focuses on the international monetary system, and the roles played by different countries within it. Section 5.2 explores how this international setting may impose an asymmetric discipline/flexibility mix on countries' macroeconomic policies, thereby influencing their models of growth, and contributing to growth differentials.[2] Section 5.3 considers how monetary unification has enabled 15 European countries[3] to re-shape – though certainly not abolish – the constraints binding their policy options. We raise the following questions: within these new conditions, is economic growth compatible with one single social model, or with a variety of welfare systems? Is it necessary for Europe to relinquish its welfare-oriented system or should it rediscover and implement a model centred on citizens' welfare? In sections 5.4 to 5.6 we explore the set of new possibilities, and we conclude that the choice between welfare state retrenchment or expansion plus restructuring is not predetermined. It will depend on the preferred model and measures of growth, wealth and welfare. Section 5.7 concludes our chapter.

5.2 Flexibility and discipline in the international monetary system

This section presents a simplified analysis of how the asymmetric discipline/flexibility mechanism may work in practice and affect the potential for economic growth in different countries.

International transactions involve international means of payments – namely, liquid assets accepted at low transactions costs – which produce well-known efficiency gains by removing the need for a 'double coincidence of wants'. While, in principle, the functions of an international currency may be performed by a variety of mediums,[4] under the current system the national currencies of certain countries work as the international money. Adopting a definition originally proposed by Williams (1949), we call them 'key currencies', while 'key countries' are the nations which issue them (henceforth K will denote 'key').

An international monetary system based upon K currencies is asymmetric because international liquidity comes into existence as the debt of the central banks of these countries and remains dependent on their policy choices. The implications will be discussed presently. In order to focus on the basic logic of the argument, we assume that the world is inhabited by one K country, while J countries represent a multiplicity of nations issuing 'own currencies', and figuring as K's main trade partners. The US dollar has been the dominant K currency since the end of the Second World War.[5]

5.2.1 The international circuit of money

(1) A key currency is widely used in international transactions as the currency in which payments are made (vehicle currency), and in which imports and exports are quoted (quotation currency). Moreover, it becomes widely used in international lending–borrowing contracts, of both the short- and the long-term variety, thereby working as a standard of deferred payments. Finally, because of its pivotal role in international transactions and its superior liquidity, the international currency

also becomes a store of value, both for private investors and for central banks. Consequently, it also functions as the 'intervention' and 'reserve currency', in which exchange market support is operated and foreign reserves are held. Central banks' motivations include transaction and precautionary purposes (because of lack of synchronisation in international sales and purchases) (Graziani, 1979), competitiveness, insurance against speculative attacks, and other causes as discussed below. Irrespective of the changing weight of these complementary motivations, what emerges is the 'institutional' necessity, for J countries, to hold reserves in K-denominated instruments.[6]

Thus, in this monetary system, an international (private and institutional) demand for the national currency of one country is generated. This confers upon this country the asymmetric position of widely selling its currency to the world. Country K may be viewed as the provider of 'the public good of international money', although a more realistic interpretation is that K provides 'the private good to itself of seignorage, which is the profit that comes to the seigneur, or sovereign power, from the issuance of money' (Kindleberger, 1981b, p. 248). Seignorage arises because the only things that J countries can give in exchange for the dollars they buy are the goods they produce, since their own national currencies, given that these are not the international money, are worthless for country K.

In order to reduce the implicit tax paid to the seigneur, J countries may seek to economise on their demands for money balances; but, as long as the K currency retains its role as an international currency, they will not reduce their demands to zero. According to estimates, foreigners held between 50 per cent and 60 per cent of the total outstanding stock of US dollars (Portes and Rey, 1998).

In practice, seignorage income is earned through a variety of channels, one being the spread between yields on US foreign assets and liabilities. Because central banks typically hold their reserves in US Treasury bills, US liabilities are heavily weighted towards liquid, low-yield debt instruments, while US assets are typically equities. This portfolio composition effect helps to explain why US investment income remains positive even when its net external position deteriorates (Cline, 2005; Gourinchas and Rey, 2005b; Lane and Milesi-Ferretti, 2005).

The related welfare redistribution may not be trivial. Gains from direct and indirect seignorage for the US economy have been estimated at 0.2 per cent of US GDP (Portes and Rey, 1998). Rodrik (2006) estimates the social cost for developing economies of their foreign reserves holdings at about 1 per cent of their cumulative GDP.

In sum: because in the international economy, just as within the national borders, money buys goods, the international monetary system has a built-in mechanism whereby goods are transferred from J-countries to K, with a corresponding welfare redistribution. Note that this asymmetry would not arise under the alternative institutional arrangement of a (possibly 'utopian')[7] supranational money.

Call this asymmetry 1.

(2) K's reliance on J's demand for its money makes its expansionary monetary policies relatively easy and convenient, so that the country is able to finance its demand flows towards the rest of the world, for both consumption and investment purposes. As this constraint on monetary policy is relaxed, country K may become prone to finance systematic current account deficits with the international money. Although alternative choices are possible, in the post-Second World War period, large current account deficits started in 1982 and have been a constant feature of the US economy since then (with the exception of 1991), hitting an all-time high of 6.5 per cent of GDP in 2006 (IMF, 2007a,b).

Deficits must be matched by corresponding surpluses in J countries. As the world economy grows, it is beneficial for all if the international means of payment grows correspondingly, thereby preventing liquidity constraints on international transactions. The expansion of international liquidity contributes to export-led growth in J countries, because their current account surpluses are on the other side of K's deficit. They accordingly benefit as a result. But they are not in a position to do what K does, namely to issue the international money to pay for their deficits.

Call this asymmetry 2.

(3) Since a high proportion of country K's income buys foreign rather than home-produced goods, it may be at a risk of paying for the high income elasticity of its imports with a downward pressure on domestic production.[8] This risk can be reduced: public expenditure is a good device with which to pull home production up in order to compensate, at least partially, for the import-determined downward push. Thus, expansionary fiscal policies are desirable in K and, in addition, accommodating monetary policies are relatively cheap, given the relatively elastic demand for the international currency.

By contrast, a more severe fiscal stance is desirable for J countries, because expansionary fiscal policies may crowd out exports, directly or via their impact on domestic consumption.

Call this Asymmetry 3.

(4) In accounting terms, current account deficits are matched by surpluses on the financial side of the balance of payments, implying that the deficit country is a net borrower from the rest of the world. Accounting aside, it is interesting to ask what the economic mechanism behind these identities might be. Jacques Rueff provided a vivid illustration of this process in the course of a very interesting exchange with Fred Hirsh, about fifty years ago:

> What is the essence of the regime, and what is its difference from the gold standard? It is that when a country with a key currency has a deficit in its balance of payments – that is to say, the United States, for example – it pays the creditor country dollars, which end up in its central bank. But the dollars are of no use in Bonn, or in Tokyo, or in Paris. The very same day, they are re-lent to the New York money market, so that they return to the place of origin. Thus the debtor country does not lose what the creditor country has gained. So the key-currency country never feels the effect of a deficit in its balance of payments. And the main consequences is that there is no reason whatever for the deficit to disappear, because it does not appear.
>
> Let me be more positive: if I had an agreement with my tailor that whatever money I pay him he returns to me the very same day as a loan, I would have no objection at all to ordering more suits from him. (Rueff and Hirsch, 1965, p. 3)

What emerges is the picture of an international circuit of money in which debts 'go increasing indefinitely'.[9]

In the time that has elapsed since Rueff's clear illustration many important transformations have occurred, but the 'essence of the regime', we believe, has not changed. The relevant capital cities have moved from Europe to emerging, developing, and oil-exporting economies (although the Japanese Central Bank is still loyal to its role as a large buyer of dollar-denominated assets). But some of the underlying mechanisms have been reinforced rather than weakened by decades of globalisation.

Reserve/imports ratios started to rise sharply at the beginning of the 1990s in emerging, developing, and oil-exporting economies; they have now reached unprecedented levels at 71.4 per cent, and are projected to rise to 80 per cent in 2008 (IMF, 2007a, tab. 35). As in Rueff's diagnosis, because of the 'special international status of the dollar as the leading reserve currency... the saving flowing out of the developing world have been directed relatively more into dollar-denominated assets, such as US Treasury securities' (Bernanke, 2005). Private investors, in turn, may have been encouraged to buy US assets by their central bank's support of the external value of the dollar (Roubini and Setser, 2005; Galati and Wooldridge, 2006, discuss the direction of the causal link between private and official holdings).

In the 1990s and in the present decade, saving inflows were channelled towards investment, and they contributed to growth via their impact on interest rates, stock and property prices, and wealth effects on consumption.[10]

Many observers have considered the fact that J countries lend to country K, a 'superpower', and not *vice versa*, to be a disturbing paradox (for instance, Roubini, 2005).[11]Two decades before Roubini, Triffin (1984) had similar worries. But, to some extent, this systematic borrower/debtor position is conferred on the US by the relaxing impact of its monetary 'sovereignty' on policy constraints.

To sum up: owing to the very 'special international status of the US dollar', capital flows from J countries into country K. By contrast, domestic resources are diverted from domestic uses in J, where they could be allocated either to investment (in countries still under-stocked with productive capital), or to higher consumption and welfare expenditures to improve living standards.[12]

Call this asymmetry 4.

5.2.2 External adjustment

Does country K live beyond its means? Yes and no: yes, because every year it buys and uses up more goods than it produces (that is, its national saving is negative), meaning that foreign countries are financing the excess spending. No, because it finances this excess by selling assets, namely claims to its future income. In other words, K may be living beyond its *current* means, but only temporarily, because it may be prepared to live *below* its means in the future. This is what debtors normally do by exchanging current consumption (by importing goods) for future consumption (when they pay off the loan). Thus, in order to give a more precise answer to the question just raised, we need to inquire further into this issue.

(5) If a country is a systematic borrower, its debt will cumulate over the years, as the growth in payments to factor-service income to foreign investors accompanies the increasing holdings of assets by foreigners. Growth in these payments worsens the country's current account deficit,

while its net debtor position deteriorates, thus creating the potential for a 'debt trap'. A country's external debt is sustainable, according to standard definitions, if its external debt/GDP ratio is constant at some target level. Otherwise, this debt will explode. However, capital gains from exchange rate depreciation may add a further degree of flexibility (in addition to the portfolio composition effects considered above).

Why does country K benefit from depreciations in its currency? For all countries, depreciation improves competitiveness, and consequently reduces their current account deficits. But it is only for country K that a depreciation also has the very convenient effect of improving its net foreign position, thereby reducing the required amount of trade adjustment.

There are two sides to this valuation effect. On the one hand, a depreciation of the international currency increases the value of domestic currency returns on K's holdings of foreign assets, which are denominated in foreign currencies (Tille, 2003; Lane and Milesi Ferretti, 2005; Obstfeld, 2004). On the other hand, if foreign creditors bought assets denominated in the K currency *before* its depreciation, they now incur a loss that is obscured, but not eliminated, by the fact that the value of a unit of the K currency is still worth one unit after depreciation (and, consequently, the nominal value of K's liabilities is unchanged). This loss would be made more visible by reckoning the loan, for instance, in terms of the amount of goods that foreign countries had originally to forgo for each dollar, and similarly reckoning the new value of the US debt after depreciation. In some way, this side of the valuation effect amounts to a 'debasement' of the unit of account in which K's international debt is denominated. Debasement is a well-known device used by indebted sovereigns to reduce the real value of their outstanding debt.[13]

Thus, by working both on domestically owned foreign assets and on externally owned domestic assets, a depreciation determines a net wealth transfer from J countries to country K.

These valuation effects can play a substantial role in international adjustment. According to recent empirical estimates, this channel has historically (from the 1970s onwards) contributed about 30 per cent to financial adjustment in the US (Gourinchas and Rey, 2005a).[14]In conjunction with portfolio-composition effects, valuation effects may also help explain why the US, a nation with a high deficit-to-GDP ratio, did not see its net external position deteriorate from 2001 to 2006 (IMF, 2007a, chap. 3). As the IMF (2005, p. 128) admitted: 'These results are consistent with – but not necessarily evidence for – the notion that the United States enjoys a reserve currency premium.'

Are J countries in a position to resist the wealth transfers produced by these exchange rate effects? Only to the extent that they are willing (and allowed) to buy virtually unlimited amounts of dollars at the going price, thus exerting a stabilising influence on the exchange rate, namely by 'pegging' to the dollar. This is what the Central Bank of China has been doing for many years, although it started to give in to western pressures for it to revalue the renminbi in July 2005.[15]

The distinction between 'Bretton Woods' and the current regime is relevant in this context. In 'Bretton Woods', the US dollar had an 'anchor', gold, which imposed some degree of discipline, although one may dispute the extent to which this constraint was binding in reality. Faced with US external imbalances, owners of dollar-denominated reserves and other financial assets may have asked to convert them into gold. Thus, because the US had to sell the required amount at the fixed rate of US$35 per ounce of gold, it might have faced a severe drain on its gold reserves.

This 'gold rush' (namely a massive conversion of dollar reserves into gold) was, for many years, only a virtual possibility. Nevertheless, De Gaulle at some stage tried to convert France's dollar reserves into gold, on the grounds that the international exchange needed 'an unquestionable monetary basis which does not bear the mark of any individual country' (De Gaulle 1965, quoted in Rueff and Hirsch, 1965). In August 1971, when the Bank of England also tried to convert its dollar reserves, that marked the end of the system of fixed exchange rates.

In the post-Bretton Woods system, with inconvertibility, this discipline effect vanishes, and a pure debt–credit relationship is established between countries (Quadrio Curzio, 1982). This makes the discipline even weaker on country K, which may become more willing to run sustained external imbalances because this specific cost (though not other inconveniences) of exchange rate depreciations has been reduced.

By contrast, for J countries a depreciation of their own currencies implies an increasing burden of their external debts, because these are typically denominated in foreign currencies (see Eichengreen *et al.*, 2005 on this 'original sin' of developing economies).

Call this asymmetry 5.

The consequences for growth of the asymmetries considered above can be summarised as follows.

First, K's reliance on continued demand for the international currency, both as reserves and for private uses, makes expansionary monetary policies relatively easy because, as Rueff explained, whatever amount of money is created, it immediately returns to K's Central Bank, or to K's financial and capital market.

Secondly, capital inflows may help finance country K's investments to an extent well above its savings, as happened in the US during the 1990s and in the first years of the present decade.[16]

Thirdly, K experiences a model of growth led by domestic demand. Symmetrically, the growth of the J countries is export-led.

Fourthly, because country K specialises as the locomotive of the world economy, the rest of the world needs K's demand for foreign goods, and – in return – is willing to accept K's liabilities.

Fifthly, when K's net financial position becomes risky or unsustainable, external adjustment may occur via exchange rate adjustments, which, as we have seen, are helpful on both sides of the balance of payments ... And the process is ready to start again.

Obviously, supply-side considerations are also relevant to growth in both economies. For instance, country K may combine expansionary macroeconomic policies with strong 'supply-side' conditions, such as strong productivity growth.[17] Similarly, in country J, supply-side factors (such as a large 'reserve army of labour') and/or reforms (such as labour market deregulation) may prevent wages from rising in line with productivity growth, thus encouraging profits, savings and exports. Nevertheless, the international monetary system adds an important dimension to the mechanisms of growth-with-global imbalances, because in this monetary system country J needs K's money, and hence K's demand for goods 'made in J'; K, in turn, may become dependent on the goods made in J in order to satisfy the needs of its population.

5.3 New constraints and opportunities for Europe

What is the role of Europe in this context?

In the Bretton Woods era, European countries played a role as J countries which other countries subsequently inherited, and will probably pass to other countries in the future (Dooley, Garber and Folkerts-Landau, 2003). Today Europe is playing a new role, which is partly the result of spontaneous evolution within the international monetary system, but is also part of an independent project aimed at lifting some of the existing constraints.

The world economy is made less simple than our two-type-country model by the emergence of this third country (let us call it *E type*), and its new currency, the euro.

Real world developments – if analysed in this three-country framework – help us answer our first question. Growth differentials between Europe and the USA may – to a substantial extent – depend on the different roles of K- and E-type countries, for at least two reasons.

First, while Europe is a developed economy, the euro has not to date enjoyed the privileges of being an international currency, in spite of increasing currency diversification in its favour.[18] Consequently, almost by default, it has been unable to rely on the asymmetries referred to above, although the situation may be changing rapidly at present.

Secondly, the required credibility of the new currency could not be established without imposing additional constraints on the joining countries' macroeconomic policies, both on the monetary and the fiscal side. 'Convergence' criteria were needed to make the euro 'credible' at its birth, and to maintain it in good health thereafter. This objective required the joining countries to adopt sound monetary policies as a means to keep up the external value of the new money and, in addition, to pledge, so to speak, not to undo with their fiscal policies what they were building via monetary policy. Relaxed fiscal policies may lead to free-rider problems and generate pressure on the European Central Bank to monetise current deficits; in the longer run, they may call for unexpected inflation as a means to cut the real value of high public debts. Therefore, European macroeconomic policies have been constrained by the need to strike a difficult balance between 'credibility' and economic expansion.

For both of these reasons, Europe and the USA have enjoyed very different combinations of discipline and flexibility in their macroeconomic policies. The discussion of the endogenous virtues of alternative systems, and of their relative growth proclivities in the last decade or so, may benefit from consideration of these factors. Their neglect may explain why the institutions of the welfare state have been blamed as the main 'institutional culprit' in recent interpretations.

The relationship between the welfare state and economic performance needs to be reassessed in the light of the new conditions determined by monetary unification in Europe. The euro is the result of an independent choice made in order to introduce more competition into the international monetary system, and to protect European interests within it (for instance, through less dollar-denominated reserve holdings in Europe and more euro-denominated reserves elsewhere). In turn, as the euro becomes able to promote the opportunity for a 'softer' balance of payment constraint (Mundell 2000, pp. 69–70) – that is, a reduced need for *systematic* surpluses – degrees of flexibility in European macroeconomic and welfare policies increase (for instance, as international demand for eurobonds as an investment vehicle rises). Although other interpretations of its rationale are possible, one *logical* implication of the euro is that it creates more room for higher domestic demand via a reduced pressure for export-led growth. In this framework, well-devised welfare policies may be instrumental in achieving both a higher domestic demand and (as we will see below) a stronger competitive hedge.

The remaining part of this chapter conducts tentative exploration of the new alternatives open to Europe in this new economic context.

5.4 Wealth and welfare revisited

In the opening passage of the *Wealth of Nations*, Adam Smith forcefully points out that there is an important relationship between the wealth of a nation and the welfare of its citizens:

> The annual labour of every nation is the fund which originally supplies it with all the necessaries and conveniences of life which it annually consumes, and which consist always either in the immediate produce of that labour, or in what is purchased with that produce from other nations. (Smith, *WN*, Introduction and Plan of the Work, p. 1)

The above passage calls attention to the relationship between the 'wealth' of a nation (ultimately, its labour fund) and the availability of goods and services necessary for human life. Smith's definition of wealth is in no way limited to the supply of marketed goods and services. From Smith's point of view, the wealth of nations includes 'social common capital', as it has recently been defined by Hirofumi Uzawa (Uzawa, 2005).[19] Arthur Cecil Pigou, taking up a suggestion by Marshall, stressed the relationship of wealth with welfare, but he narrowed the definition of *economic* welfare to 'welfare arising in connection with the earning and spending of the national dividend, or, in other words, of those parts of the community's net income that enter easily into relation with the measuring rod of money' (Pigou, 1912, p. 3). Partha Dasgupta and Karl Göran Mäler have emphasised the need to detach cross-country comparisons of social welfare from comparisons in terms of gross domestic product (GNP) or net national product (NNP): 'social well being in a country is higher (lower) than in any of its immediate neighbours if the value of the difference in the flow of consumption services between them plus the difference in the value of aggregate net investment between them is positive (negative)' (Dasgupta and Göran Mäler, 2000, p. 86). This proposition leads to the conclusion that 'social welfare is higher today than it was yesterday if the economy is wealthier today', so that 'cross-country comparisons of NNP [or of GNP] tell us nothing about differences in social well being excepting under empirically uninteresting circumstances' (Dasgupta and Göran Mäler, 2000, pp. 84–6). Dasgupta and Göran Mäler's result suggests that Pigou's definition of economic welfare in terms of national dividend is too narrow, and it calls attention to Adam Smith's definition in terms of a *fund* capable of delivering a *flow* of goods and services. As pointed out by Giorgio Fua', the most distinctive feature of Smith's definition of national wealth is that 'the notion is established by considering an object . . . which is a collection of things . . . defined from a dual point of view: their attitude to satisfy the needs or at least the tastes of life; the way in which they are obtained, that is through the carrying out of human labour' (Fua', 1957, p. 21).

Smith's conception does not entail any presumption that the wealth of a nation should be measured primarily by the quantity of traded commodities available to that nation directly or through international trade. Smith's criticism of the mercantilist association between the wealth of a nation and its *treasure* (its current account surplus) suggests that, in his view, treasure is not a secure basis for an increase in national wealth.

Indeed, Smith argues that, under certain conditions, a persistent current account surplus may be associated with the gradual contraction of national wealth. This would be the case if a nation were to expand its treasure (its current account surplus) by becoming less and less able to meet the needs of its citizens.

Smith points out that production and division of labour are the primary means by which it is possible to increase wealth *as welfare*. However, the characteristic of labour activity that is foregrounded here is the provision of human needs, *not* the provision of goods through markets.

Smith's wealth comparisons are based on the measurement of wealth as *labour commanded*. This is the quantity of 'external' labour (labour of other individuals, or of other countries) that any given individual (or country) has at their disposal through the sale of their assets (material goods, financial activities, or even working activity itself).

Smith's conception of 'labour commanded' is a powerful tool for wealth analysis. Its most distinctive feature is that it distances the measurement of wealth from the availability of treasure, and makes the 'command' on labour a general capacity to be realised in a *variety of conditions*. Labour commanded (and the wealth associated with it) can derive from the performance of useful activities or from the availability of useful assets. In general, the labour commanded by any given nation derives from a *portfolio of labour-commanding resources* (some associated with production activity, others with the ownership of natural or financial assets).

The labour-commanded view suggests that the wealth of any given nation may be stationary, increase or decrease as result of changes in its portfolio of labour-commanding resources. Three principal cases may be distinguished. In one case, the wealth increase may result from an expansion of productive activities leading to increasing exports and to an increasing current account surplus (export-led wealth increase). Here, the command on labour increases owing to competitive advantage and international trade. A second case is that in which the command on labour (thus, available wealth) increases merely as a result of treasure appreciation (increased value of financial assets). In a third case, the command on labour increases as a result of the greater production of goods and services that are not traded internationally. Here, the increased command over labour may be associated with the expansion of social, educational or environmental activities (and is independent of a current account surplus). Finally, an increased command on labour may be induced by an *upgrading* of the production of goods and services (independently of whether or not they are internationally traded). For example, the labour commanded by a typical service activity at time t may be greater than the labour commanded by that activity at time $t-1$.

In short, any given country has more labour commanded at its disposal if there is an increase in the overall command on labour associated with its activities or its endowments. A country with a highly developed division of labour is normally wealthier than a country in which division of labour has a narrower scope.

The theory of entitlements is closely associated with the labour-commanded view originally formulated by Smith. This theory suggests that the *bundle of entitlements* upon which the average citizen of any given country may lay claim measures the average welfare in that country. To conclude, there is an important tradition in economic theory which holds that the measurement of wealth cannot be detached from the measurement of welfare.[20]

5.5 Welfare, trade and growth policy

5.5.1 A taxonomy of welfare policies: capacity promotion vs well-being promotion

The average welfare of the citizen of any given country differs in its structure according to whether we consider *capacity development* or *well-being*. Capacities are associated with productive abilities and may be promoted by educational policies.[21] Well-being is associated with objective living conditions or the satisfaction of needs and desires: the health care system and social insurance are among the appropriate policy instruments. Of course, there may be considerable overlaps between actions promoting the development of capacities and actions directly promoting the well-being of individuals.

Capacity promotion and well-being promotion may be ends in themselves, or they may be instrumental to the achievement of *other goals*. And these goals may be sharply different in the two cases. Capacities are inherently *intentional*. This suggests that, in certain cases, the development of capacities makes individuals (or groups) better able to perform the tasks or functions that may be assigned to them. In particular, some of these tasks may be instrumental to the production of traded goods and services. In this way, capacity development can both be an objective in itself and a means to achieve a better performance in the formation of marketable wealth. The direct promotion of well-being has different implications. For well-being is *not* inherently intentional: unlike capacity promotion, well-being promotion is not directly instrumental to the promotion of competitiveness on international markets.

The distinction between capacity development and well-being development suggests that welfare policies may take two alternative routes. In one case (*capacity promotion*), welfare policies target the productive potential (in a wide sense) of human beings. In the other case (*well-being promotion*), welfare policies target the objective living conditions or the 'feeling potential' of human beings.

It is possible to design welfare policies in which the emphasis on capacity promotion is detrimental to well-being. This may be the case if policy promotes certain capabilities disproportionately more than others, so that the overall balance is lost. On the other hand, it is possible to design a welfare policy in which well-being is promoted at the expense of capacity development. For example, a welfare policy may promote the alleged well-being of consumers simply by increasing their purchasing power without targeting the structure of consumer expenditure (and thus, presumably, forsaking the goal of deeper changes in consumer capacities, as explained presently).

5.5.2 The impact of welfare policies upon trade performance and capital flows

The two welfare policies have different economic consequences. It is generally acknowledged that capacity promotion (for example, through better educational systems) is likely to increase the productive potential of a given economy, both quantitatively and qualitatively. This may be associated with increased competitiveness and better performance on world markets.

It is less well known, but no less important, that well-being promotion may induce a significant taste improvement in the average consumer, making her able to demand more sophisticated goods as services (especially if well-being promotion induces a change in consumer capacities). Although this situation is not immediately translatable into macroeconomic consequences, a more sophisticated demand structure may induce a significant transformation of the internal market for high value-added goods, and thus indirectly become an important incentive for the development of sophisticated technical abilities.

Carlo Poni and Neil McKendrick have produced historical examples where such a promotion of consumer capacities has led to a striking increase in international competitiveness. Carlo Poni has argued that the commercial and industrial development of the towns of northern and central Italy in the Middle Ages was stimulated initially by domestic demand for sophisticated consumer goods (a feature he associates with the relatively 'horizontal' distribution of purchasing power in the upper social strata of the urban population) (Poni, 2001). A similar argument has been put forward by Neil McKendrick in regard to the consumer revolution in eighteenth-century Britain. In this case, the expansion of middle social strata enabled the mass consumption of high-quality consumer goods and the development of the corresponding technical skills for their production (McKendrick, 1970; see also McKendrick, Brewer and Plumb, 1982). In both cases (medieval Italy and eighteenth-century Britain) consumers developed sophisticated 'niches of taste', which in turn encouraged the development of technical abilities and ultimately affected in a positive way the international competitiveness of locally produced goods and services.

Through these channels, welfare policy may be an important instrument of trade policy. But, as we have seen, its effects may differ enormously according to its target and structure. Virtuous or vicious circles may be set in motion, depending on policy design. A welfare policy based upon capacity promotion may induce increased competitiveness. However, this increase may come at the expense of well-being (especially if a policy of unbalanced capacity promotion is pursued). Similarly, a welfare policy based exclusively upon transfers of purchasing power may reduce competitiveness on world markets (especially if that policy is associated with a constant or slowly adjusting structure of consumer expenditure). In both cases, a *vicious circle* arises, in which well-being and capacity are conflicting objectives and may ultimately weaken each other in the long run. But it is important to point out that welfare policy may also induce a *virtuous circle* of welfare and competitiveness improvements. As our historical examples show, a policy of well-being promotion aimed at the development of consumer capacities may go hand in hand with a policy of capacity promotion aimed at the development of producer capacities. We may expect such a policy to improve the export performance of the productive sectors originally stimulated by the expanded domestic demand for sophisticated (or new) consumer goods.

In addition to their effects on trade policies, different approaches to the welfare of nations may be associated with different approaches to international finance. Our argument can be restated by looking at the two sides of a country's balance of payments. On the current account side, a capacity-oriented welfare policy is likely to directly encourage the active promotion of technological capabilities, and more generally the active governance of competitive advantage on international markets. For example, an active educational policy may be part of this approach (although education may also promote capacities that are not necessarily instrumental to the promotion of competitiveness on international markets).

Turning to the financial side, welfare policy is similarly double-edged with respect to international capital flows. Capacity promotion may require very substantial capital inflows, and thus be associated with a policy of relative openness to international capital markets. On the other hand, substantial public investment may be a condition for the promotion of capacities. In this case, constraints upon capital flows may be likely, if taxation of income and wealth is the principal source of state finance.

To sum up, welfare policies may exert an important influence upon the formulation of trade policy and international monetary policy. However, *this influence is not unambiguous*. A capacity-oriented policy is generally associated with a free trade policy in commodity markets, but it may also be associated with demands for restrictions on international capital flows if the financing of capacity promotion depends primarily (or exclusively) on taxation. Similarly, a well-being-oriented policy may eventually induce restrictions on free trade both in the commodity and capital markets if internal demand expansion takes place independently of any significant development in consumer capacities.

As a final point, it is important to note that, in our evaluation of different types of welfare policies, we have thus far assumed the international monetary system as a given constraint. Consequently, we have tried to assess the positive or negative impact of these policies on the required trade and current account surplus. However, as we argued above, these surpluses may become a less binding constraint following the current gradual introduction (via the euro) of a multilateral set of monetary arrangements. This weaker current account constraint opens up an entirely new scenario where welfare policies acquire some degree of autonomy.

5.6 A trade scenario and a welfare scenario: alternatives for Europe

At the beginning of the twenty-first century, Europe is faced by two alternative policy scenarios. In the first of them (the *trade scenario*), Europe takes the system of international monetary arrangements as given, and on that basis determines its set of welfare policies. In the second scenario (the *welfare scenario*), Europe takes a system of welfare institutions as given, and on that basis determines its trade policy. This distinction is based upon a rule of decomposition in the policy domain. This rule stipulates a given objective and moves back from that objective to the set of policy options compatible with it.[22] The rule of decomposition in the analysis of economic policy has interesting implications. In particular, it entails that the feasibility of welfare and trade policies may depend upon which hierarchy of goals is considered. The trade scenario renders welfare policies feasible or unfeasible depending on whether or not they are compatible with the stipulated rules of trade. The welfare scenario makes trade policies feasible or unfeasible depending on whether they are compatible with the stipulated welfare objectives.

It is important to emphasise that a *range of different policies* is available within each scenario. Even accepting the trade scenario as a datum, welfare policies may be an important instrument for the achievement of the stipulated trade objective (a current account surplus).[23] If this perspective is accepted, some current policy proposals pursued at the European level suggest an export-led (or mercantilist) point of view. The idea that there is a trade-off between the welfare of an economic area and its competitiveness is a mercantilist proposition that was long ago criticised by Daniel Defoe.[24] We have argued that, even within the trade scenario, the contraction of welfare expenditure and social rights as a necessary condition for international competitiveness is *but one option*. Indeed, approaching the trade scenario through growth-promoting welfare policies may in principle overcome not only the alleged growth/welfare trade off, but also the trade-off between welfare expenditure and the financial sustainability of public debts (see also Pasinetti, 2000).[25]

Similarly, a range of different trade policies is available if the welfare scenario is considered. In this case, we may expect policies to differ according to whether capacity promotion or well-being promotion is being pursued. Capacity promotion is compatible with unlimited free trade if capacity investment is financed through international capital (rather than with internal capital or taxation). Well-being promotion is compatible with unlimited free trade if the expansion of internal demand is associated with the development of consumer capacities. In general, however, the welfare scenario makes free trade desirable *along a continuum of possibilities*. For example, with a capacity-oriented policy, free trade in commodity markets may be more likely than free trade in capital markets, and free trade in capital markets may presuppose a specific structure of investment finance for capacity development. On the other hand, with a well-being-oriented policy, import-substitution may be preferred to free trade in an initial phase (when consumer capacities have not yet developed to a sufficient degree). In a later phase, import-substitution may be dropped and the emphasis of trade policy may shift to free trade (presumably, first in the markets where a competitive advantage has been acquired, later in the markets for other goods and services).

5.7 Conclusion

Should Europe relinquish its welfare-oriented social system, or should it rediscover and implement a model more actively centred on the welfare of its citizens? We have answered this question in two steps.

First, we have proposed an analysis of growth differentials between Europe and the USA that, contrary to other interpretations, does not blame them on European welfare institutions. Focusing on the international monetary system, we have shown that asymmetries arising from the role of the dollar as the international currency influence the growth paradigms adopted by the USA and its trading partners, with large savings flows from the periphery financing growth in the centre.

Secondly, we have interpreted European Monetary Unification as an attempt to evade or soften these international constraints, thus making room for a model of growth that combines 'capacity promotion' (namely the promotion of productive abilities and competitiveness), with social well-being. A menu of policy options is available to promote the preferred mix between these two objectives. We have also argued that a wider choice may be open between the 'trade scenario', where competitiveness and external surpluses are the dominant policy objective, and a 'welfare scenario', where welfare objectives are taken as given and trade policies adjust.

Actual choices will reflect equilibria determined by existing institutions, beliefs and the contrasting influences of interest groups.

Notes

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1. France is a recurrent target in this literature. In *The Economist*, 4 June 2005 ('It is Chirac, Stupid', p. 12), the recommendation was to stop pretending that 'the French social model is still valid', and that 'no trade off exists between social protection and economic growth'.
2. We take for granted the powerful effects of supply-side factors, including productivity and technology gaps, reserves of labour, energy and materials (which may be present in some countries and absent in others), and so on.
3. Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Slovenia, Spain and, finally, Cyprus and Malta, which joined in on 1 January 2008.
4. Such as gold or silver, national currencies as in the present system, or a supranational money, as Keynes had hoped at Bretton Woods, noting that 'the problem of maintaining equilibrium in the balance of payments between countries has never been solved, since methods of barter gave way to the use

of money and bills of exchanges' (Keynes, 1980, p. 21). This diagnosis, we will argue, is still valid.

5. Scale effects, inertia, as well as geopolitical factors determine the establishment and survival of national currencies as the international money. Classic references are Cohen (1971) McKinnon (1979), Kindleberger (1981a), Aliber (1982) and Krugman (1984). Historically, the dollar was established as a consequence of the USA having both accumulated large reserves of gold in the interwar period and financed the Second World War against Nazism.
6. To give an idea of the orders of magnitude involved, the reserves held by monetary authorities worldwide totalled $4.9 trillion in 2006, equivalent to 11 per cent of world GDP. The share of US dollar-denominated instruments in total reserve holdings was 70 per cent in 1970; it fell to 50 per cent at the end of the 1980s (as the Japanese yen and the Deutsche Mark increased relatively in value); it then rose again, peaking at 70 per cent in 2001, but lost some ground thereafter, reaching 66 per cent in 2006 (Wooldridge, 2006).
7. The Keynes Plan was 'perhaps Utopian', as its author explained, 'not in the sense that it is impracticable, but that it assumes a higher degree of understanding, of the spirit of bold innovation, and of international co-operation and trust than it is safe or reasonable to assume' (Keynes, 1980, p. 33).
8. As noted by Summers (2004), the anomaly that the elasticity of US imports with respect to domestic growth is greater than the elasticity of US exports with respect to foreign growth has not disappeared in the last thirty years.
9. It is interesting that Kant, as early as 1795, observed exactly the same tendency in the monetary system of his time, and also pointed out one of its particularly unpleasant consequences: 'a credit system under which debts go increasing indefinitely ... is a dangerous money power. This arrangement – the ingenious invention of a commercial people in this century – constitutes in fact a treasure for war, exceeding the treasures of all other States taken together. It can only be exhausted by the ensuing deficit of the exchequer, which may be long postponed by trade prosperity and its impact upon production and profits.

   This facility for waging war, combined with the inclination of rulers towards it (an inclination that seems implanted in human nature) is therefore a great obstacle to perpetual peace. Its prohibition must be made a preliminary article of it, all the more so as the inevitable bankruptcy would encompass many other states in the eventual ruin, without any fault on their part' (I. Kant, *Perpetual Peace. A Philosophical Essay*, as quoted in Triffin, 1984, p. 75).
10. In addition, factors related to globalisation, such as reduced 'home-bias', may have weakened the responsiveness of capital flows to interest rate differentials (Blanchard *et al.* 2005; IMF, 2005). Foreigners have even been willing to earn negative real interest rates on US short-term securities for some periods (Summers, 2004).
11. By contrast, 'equilibrium' interpretations focus on the superior efficiency of US capital markets (Caballero, Farhi and Gourinchas, 2006), or on invisible

'collateral services' provided by the USA (Dooley, Garber and Folkerts-Landau, 2007). Bernanke's 'saving-glut' hypothesis (2005) combines 'the special international status of the dollar' with the 'superior efficiency of US financial markets'. Alternative interpretations of global imbalances are discussed by Eichengreen and Park (2006). Godley (1995) is a pioneering study on global imbalances.

12. China, for example, has sacrificed domestic welfare for investment and export-led growth.
13. Neapolitan monetary economists in the seventeenth and eighteenth centuries used to call this the '*alzamento*' (the 'raising') and argued that the *alzamento* may be brought about by deliberate debasement of money, determining a rise in the price level. For studies on the distributional effects of money injections, see Costabile (2004, 2005).
14. Because exchange rate adjustments are not 'surprise' events in their findings, these authors ask why rational investors should be willing to hold US assets 'knowing that these assets would underperform'.
15. For evaluations of 'currency manipulation charges' on China see Frenkel and Wey (2007) and McKinnon and Schnabl (2006).
16. Between 1993 and 2000 the average savings rate in the US was 16.8 per cent of GDP, while the investment rate was 19.4 per cent. Subsequently, between 2001 and 2006, the savings rate declined to less than 14 per cent while the investment rate remained unchanged at about 19 per cent of GDP. The gap between investment and national saving in all these years was financed by capital inflows. In all these years the savings–investment gap was substantially nil in Europe, as both savings and investment rates were substantially constant at about 20–21 per cent of GDP (IMF, 2007, p. 281, table 43).
17. Eichengreen and Park (2006, p. 7) argue that the productivity growth differential (estimated at most at 0.5 per cent in the period 1995–2001) between Europe-15 and the US is too small to support the claim 'that it has been driving the behaviour of investors'.
18. Galati and Wooldridge (2006) present data on the currency composition of reserves, and related financial developments, and synthesise the debate on possible implications.
19. According to Uzawa, 'social common capital' provides members of a society with those services and institutional arrangements that are crucial in maintaining human and cultural life. It is generally classified in three categories: natural capital, social infrastructure, and institutional capital' (Uzawa, 2005, p. vii).
20. The theory of entitlements gives some insights into the relationship between the wealth of any given country and the extent of the division of labour in that country. This is because, in a country characterized by a developed division of labour, the average citizen may command a larger and more diverse bundle of entitlements relative to the average citizen of a country in which division of labour is less developed. The same holds for the international division of labour. Here, the average citizen of a country whose terms of trade allow access to the full range of internationally traded goods and services commands a larger and more varied bundle of entitlements

relative to the average citizen of a country whose terms of trade allow only limited access to international markets. Entitlement to an expanded set of goods and services (marketed or not) is associated with increased national wealth. The average citizen of any given country is wealthier both when the terms of trade of her country are improving *and* when the set of 'internal entitlements' in that country are expanding. This suggests that the dynamics of the wealth of nations may be affected by conflicting influences: there is no simple chain of causation leading to systematic increases of national wealth.

21. Capacities in our sense are strictly associated with the performance of productive tasks, and are more restricted than Sen's capabilities. See, respectively, Scazzieri (1993) and Sen (1985).
22. The rule of decomposition is an application of Lowe's instrumental analysis since, rather than arguing 'from behavioural premises to terminal states', it searches 'backward' for the determinants of given states' (Lowe, 1976, p. 12). Lowe also emphasised the essentially heuristic character of instrumental analysis (Lowe, 1976, pp. 12–13; see also Scazzieri, 1998). A similar approach is followed by John Hicks in his discussion of optimum theory: '[t]he form of organization by which the optimum is to be reached is not prescribed; the question whether it can be reached by a competitive system is left open. The general character of the path which will satisfy optimum conditions is the sole question that is at issue' (Hicks, 1965, p. 204).
23. However, the trade objective may require the implementation of a specific bundle of welfare policies to the exclusion of others. For example, as we have seen, current account surpluses may be compatible with the implementation of welfare policies aimed at well-being promotion through the development of consumer capacities, or to the implementation of policies aimed directly at the development of technical abilities in export-led sectors. On the other hand, current account surpluses may be incompatible with welfare policies aimed at well-being promotion through the expansion of the domestic demand for *traditional* goods and services.
24. Daniel Defoe, in his *Plan of the English Commerce* (1728), strongly criticised the common mercantilist proposal of low wages as a means to enhance international competitiveness, and denied that 'a country might become rich through the poverty of its people'. In particular, Defoe countered the low-wage proposition by arguing that '[if] …these Gentlemen who are forcing the Consumption of our Manufacture in England (or in any of those countries in Europe where they work cheapest) by their mere Cheapness, are content to reduce the wages of the People who make them, to the rate of those in China or India, there is no doubt they might increase the Consumption and sell off the quantity: but what would be the Advantage? They would sell their Goods and ruin their People; the Benefit of which in the Gross, I confess I do not understand' (Defoe, 1728, as quoted in Heckscher, 1994, II, p. 171). Defoe's argument is echoed in Smith's statement that '[n]o society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable' (Smith, 1976 [1776], *WN*, I. viii. 36).
25. Convergence towards a sustainable public debt/GDP ratio requires that the difference between the rate of interest and the rate of growth be reduced.

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6
Care Regimes and the European Employment Rate

Francesca Bettio and Janneke Plantenga

6.1 Introduction

The expressions 'care work', 'care services' and 'care regimes' have recently entered the vocabulary of the socioeconomic literature located at the intersection of analysis of the welfare state, studies on social policy, and feminist research (Lewis, 2001; Anttonnen *et al.*, 2003; Folbre, 2008). In a broad sense, 'care' is the activity of looking after people unable to take care of themselves. It comprises health care, teaching and special needs education, and the residual category of social care, or simply 'care', delivered mainly to minors, the elderly and the disabled. Although the boundaries among these categories are not clear-cut, because they depend on the inter-relation between the welfare state, the family and the market in a country, the subject matter of the research presented here is mainly social care.

Economists have devoted relatively little attention to how countries organise care activities, and only recently have commentators begun to ask whether it makes sense to talk of 'national strategies' in this regard. By contrast, there is a large body of literature on welfare systems,[1] but it concentrates on social transfers and social security – pensions, income protection, unemployment benefit, but also subsidies to firms – and neglects benefits and services supporting or substituting the care work undertaken by the family or the third sector. Current demographic trends, increasing labour market participation by women, and the diversification of family forms necessitate a change in the research agenda. All of the developed countries, and those of Europe in particular, are currently redefining the division of care responsibilities among the family, the state and the market – a process whose outcome has important macroeconomic implications.

The first step in specifying these implications is to map the supply of care goods and services in countries, and therefore the division of labour among family, state and market. The first attempts in the literature classified countries by analysing the division of responsibilities between state and family as stipulated by law and/or legitimated by practice (Millar and Warman, 1996). For example, in the Nordic countries, both children and elderly people have a legal and individual right to receive adequate care; while in the case of adults and the elderly, the UK does not assign clear responsibility to the family and attributes only partial responsibility to the local authorities, to which it leaves broad margins of discretion in identifying and satisfying care needs.

In an earlier article (Bettio and Plantenga, 2004) we have suggested that the mix of care provisions can be examined in light of the types of resources (inputs) available to families and individuals for the production, purchase or, more generally, access to such provisions. The important distinction in this respect is between informal and formal care. The former refers to unregulated activity which often, but not necessarily, coincides with unpaid work in the household. The latter encompasses activities which are regulated by law or by contract. Whereas the inputs to the informal care sector are basically the caregivers' own time, inputs in the formal care provisions are more diverse and can be classified in three distinct categories: time off, money, and services. Using this framework, existing policies can be categorised as follows:

- provisions concerning time facilities, in particular parental leave, career breaks, reduction of working time, flexitime, etc.;
- monetary benefits, including family allowances, social security, social assistance and tax allowances, subsidization of domestic services;
- benefits or services provided in kind, for instance, home care services for older people, nursery places for small children.

Based on this categorisation, a set of indicators directly usable in economic analysis can be compiled to compare countries and construct a typology of care regimes. Following this approach, the first part of this chapter updates the typology originally constructed by Bettio and Plantenga (2004). The main objective is to verify how far the idea of national care strategies is born out by the data. By 'strategy' is meant a combination of complementary policies undertaken to pursue an agreed-upon set of goals. As noted above, whether it is permissible to talk of 'strategies' in regard to the organisation of care activity alone is a matter of debate in the literature. The attempt here parallels that of Anttonen and Sipilä (1996) who use the term 'care model' with a meaning similar to that given in this chapter to the term 'care regime'.

Being able to identify and then differentiate care strategies among countries is useful because it gives visibility to a subsystem of activities that are often overlooked by economic analyses, especially macroeconomic ones. Moreover, it yields a 'general equilibrium' account of this subsystem, and thus usefully directs attention to the causal chain set in motion when one of the subsystem's components is altered. It is more useful, the less the components on which the focus is trained are visible. In support of this claim the second part of this chapter explores the implications for the overall level of employment of care regimes where families are more reluctant to outsource care activities to the market or the state. According to the 'marketisation of household production hypothesis', differences in total hours worked and thus in the level of employment among the developed countries depend not only on rigidities or otherwise in the labour market but also on all the factors which prompt the degree of 'outsourcing' of domestic and family care work. Examination of care regimes, we will argue, is important for identifying these factors and their interactions with labour market processes.[2]

Section 6.2 discusses the choice of indicators and evidence thereof. Section 6.3 presents a typology of European care regimes based on the indicators. Section 6.4 looks at the employment implications for regimes that tend to retain housework and care work within the family. Section 6.5 concludes.

6.2 Identifying 'care regimes': the choice of indicators

The indicators that are proposed to construct a typology of care regimes are designed primarily to map the division of labour between the family and the state. Because the market may produce care services on behalf of both the family and the state, it does not appear directly in this mapping.[3] Furthermore, the so-called third or voluntary sector is ignored owing to difficulties in accessing and comparing data across countries. This is an important shortcoming which future research should remedy.

As said, the indicators classify and measure the 'inputs' to care activities following a double distinction. The first is between formal and informal care activities, as previously defined. The second is between time resources, financial provisions in the form of cash benefits, and goods and services furnished or subsidised by the state. Two main categories of beneficiary are covered: children (aged under 15) and the elderly (aged over 65 or over 75 according to the particular problem).

Excluded from the analysis are adults affected by temporary disability (illness for example), the disabled, and the mentally ill. In this case, too, the exclusion is for reasons of accessibility or availability of comparable data, and ought to be addressed by future research.

The choice of indicators was inspired by a large body of literature spanning diverse strands of inquiry which it would be beyond the scope of this chapter to survey or even summarise. It includes analysis of the welfare state, and social policy in particular, the large economic literature on 'household production', with particular reference to the factors influencing the choice between domestic and market activities, the demographic literature on fertility choices, and the feminist literature on the nature of care work. The final choice settled on six indicators that are described below.[4]

6.2.1 Indicator of 'informal' care intensity

This is a synthetic indicator based on two variables:

Ia. The number of adults devoting at least two hours per day to caring for children, or elderly or disabled persons, divided by the number of 'potential beneficiaries'. The latter are children aged under 16 and elderly people aged over 74;

Ib. The share of households which do not pay for regular child care services, divided by the total of households with children.

The synthetic index (Indicator I) was derived in two steps: standardisation of (Ia) and (Ib) in order to obtain a value between 0 and 100 for both; calculation of the average of the standardised values.[5]

An additional indicator (Ic) was used for interpretation, not for construction, of the typology: the share of women devoting more than two hours per day to care work. This indicator tells the well-known story that informal care is disproportionately the responsibility of women, all the more so in the Mediterranean countries. But, because it does not discriminate adequately among countries, this indicator has limited usefulness for constructing a typology.

6.2.2 Index of the 'effective importance' of parental leave

Maternity leave and, more recently, parental leave are perhaps the most 'traditional' and certainly most widespread instruments used to reconcile informal care activity with paid work. Numerous compilations of legislation in the European countries have been drawn up, partly on the urging of the European Commission, which has issued important directives on the matter (Bruning and Plantenga, 1999; Deven and Neulant, 1999; European Commission, 1995, 1997, 2007; OECD, 1995, 2001; Plantenga and Remery, 2005). The predominant opinion in the literature is that generous maternity leave may favour discrimination at entry on the part of employers, but that it may also be an incentive for women to accept jobs that offer it. For women in employment it reduces the risk of work exit without re-entry.

For this chapter a composite indicator (indicator II) was constructed on the basis of:

(a) the duration of parental leave;
(b) the parental allowance in ratio to the minimum wage.

Weeks of leave paid by more than two-thirds of the national minimum wage are counted fully; weeks paid by between one-third and two-thirds of the minimum wage are counted for 66 per cent whereas weeks of leave paid for up to one-third of the minimum wage are counted for by 33 per cent. In order to make a correct comparison, maternity leave is normalized at 14 weeks (Plantenga and Remery, 2005).

6.2.3 Indicators of child-related monetary transfers

Monetary transfers have always been of central interest for analysts of the welfare state. The main forms on behalf of children are tax concessions and family allowances. In this case, there are two indicators:

IIIa. The total amount of child-related tax concessions and cash benefits net of main child care costs like charges for school services or housing costs, and expressed in percentage of family earnings for a representative selection of families.[6]
IIIb. The amount in PPS of family allowances per member of households with children aged under 12.

The first indicator was originally proposed by Bradshaw in the early 1990s and has been updated in Bradshaw *et al.* (2003). For the sake of reliability, this indicator is supplemented with a less sophisticated but relatively solid measure of financial transfers to families with children. These two indicators yield very similar results, in fact, despite the diversity of variables. For that matter, well-known scholars like Gauthier (2000) have shown that total social expenditure on families with children has followed a relatively stable trend in the majority of the European countries since the early 1980s.

6.2.4 Indicator of the availability of child services

Child services are of interest to psychologists and educationists, who recognise their importance in the development of the child, and, more recently, to economists, who also recognise their positive effects on female employment (Blau and Robins, 1988; Del Boca, 2002).

Three types of variables were initially considered for the purpose of measurement:

(a) Children under the age of three cared for by formal arrangements (other than by the family) as a proportion of all children of the same age group;
(b) Children between three years old and the mandatory school age cared for by formal arrangements (other than by the family) as a proportion of all children of the same age group;
(c) The (prevalent) public/private nature of the child care facilities.

It proved difficult, however, to use variables (b) and (c) to construct a salient indicator. First, because in many countries, nursery schooling falls within educational policy and is therefore not an adequate discriminant for the assessment of social care policies in the strict sense; secondly, because data on child care facilities often do not distinguish between private and public, so that it is difficult to identify the role of the state in the creation of supply.[7] As a result, indicator IV only refers to the coverage rate of formal child care facilities for the youngest children and does not distinguish between public and private. It also proved to be impossible to include in construction and analysis of this indicator a further factor of great importance in the balancing of care and work: the opening and closing hours of child care facilities (but also of compulsory schools). The data on this are either lacking or are overly heterogeneous.

6.2.5 Index of the monetary resources available to the elderly

Pensions obviously constitute the most important monetary resource available to families or to elderly persons for the satisfaction of their care needs. Although pensions expenditure can be considered the deferred payment of earnings made during people's working lives, in the majority of European countries it is strongly influenced by transfer policies and can be used as a proxy for them. Indicator V is therefore simply average pensions per elderly person (aged over 65) expressed in Purchasing Power Standards (PPS).

6.2.6 Indicators of the public supply of care services for the elderly

The recent and marked shift in the elderly care sector to the provision of home care requires a distinction to be drawn between the latter and nursery or special housing provisions. Ongoing developments are blurring the distinction between private and market supplies, especially for home care services. Mediterranean families are turning increasingly to immigrant workers to care for their relatives at home, often using pension or other old-age cash benefits to pay for such services (Bettio *et al.*, 2006). In Austria and Germany, especially the former, financial benefits targeted at the elderly – including the Long Term Care Insurance – are often cashed by families to purchase services in the market or to indirectly subsidise family carers rather than obtaining services from the public. Progressive outsourcing of public services in countries like the UK also contributes to blurring this distinction (Simonazzi, 2007). However, the indicators we provide primarily capture publicly supplied or subsidised provisions:

VIa: share of the population over 65 cared for in institutions;
VIb: average number of hours of formal care administered to recipients of home care, weighted by a composite index of disability.

Indicator VIa is straightforward but raises issues of comparability across countries as it was compiled using three sources in sequence: first, OECD for Northern and Continental countries, then national sources from the European 'Dynamics of National Employment Model' Project for Southern European countries and France, and, finally, data from Nordisk Socialstatistik for Finland and Denmark (OECD, 2005; Simonazzi, 2007; Rostgaard, 2007). Because of the past role of the state in residential care and/or the fact that subsidisation is still needed to make the latter accessible to larger sections of the population, public involvement in this sector remains high.

Indicator VIb on home care is derived from data collected within the 'Aged in Home Care' European Project (AdHOC henceforth, see Carpenter *et al.*, 2004) and combines a measure of 'how much' (intensity) and 'how many' (frequency). Hours of care capture the intensity, while the index of disability can be taken to proxy the share of the elderly population receiving care. In effect, it appears that the mean disability varies considerably across countries, with Scandinavian countries displaying bottom values and Italy (the only Mediterranean country included in the survey) recording three to five times the average figure for the Scandinavian sub-group (Table A.6.4, Appendix). On the one hand, the indicator ensures a good degree of comparability since data were collected with the same methodology across countries. On the other hand, it is likely to underestimate the 'social' as opposed to the 'health' component of home care because of the epidemiological focus of the research, and may therefore distort comparison across countries if the balance between these components differs for the same level of disability. However, we have no strong reason to suspect that this is a major distortion. Within Europe, moreover, focusing on the health component biases measurement in favour of public services and thus suits our purposes. The main shortcoming of this indicator is that it covers only eight of our 14 European countries.

As to the previous indicators, various sources were used. Indicators I (synthetic), IIIb and V were calculated on the basis of EU sources, which guarantee a good degree of comparability among countries, among them the European Household Panel (microdata) and Esspross data on social expenditure. The remaining indicators are based on secondary sources selected from those most 'authoritative' in the literature and supplemented with direct information where appropriate. The reference period for most indicators is 2001–04, with occasional observations dating before or after. Individual indicators are set out in the Appendix, together with further details on the calculations and sources.

6.3 Identifying 'care regimes': reading the indicators

Joint analysis of this battery of indicators brings out groupings of countries with common complementaries among the typical features of each of them. A given national profile can thus be viewed as expressing a 'strategy', in the meaning given to the term in the introduction.

The groupings can be identified by means of the statistical techniques – cluster analysis, multidimensional scaling, and so on – used to classify a set of observations according to a similarity/difference criterion. For reasons of rapid interpretation and relatively simple statistical analysis, the multidimensional scaling technique is particularly well suited to small samples like the one examined here. A synthetic measure of distance is calculated between one country and another on the basis of a vector of variables – the indicators. The distances are then plotted on the Cartesian plane, so that the various clusters can be identified visually, with each member of a cluster having lower distance from the other members than from any non-member.

This predominantly visual technique is supplemented with an ordinal classification which has the advantage of being transparent and simple: countries are ranked in terms of each successive indicator and grouped according to the closeness of their respective ranking. For each indicator three levels are distinguished – 'high', 'average' and 'low' – calculating the lower and upper thresholds on the basis of the average value plus or minus half the standard deviation.

The two procedures yielded very similar results. We begin by illustrating the results of the ordinal classification. They are reported in Table 6.1 and show four main groupings, plus some boundary cases. Following Bettio and Plantenga (2004), we call the groupings 'Mediterranean', 'Anglo-Dutch', 'Austro-German' and 'Nordic'.

The first grouping comprises the four Mediterranean countries. In a country representative of this grouping, care work is often informal and family-based. Women are the main caregivers and adults aged over 45 are closely involved (see Table A.6.1 in the Appendix). The supply of in-kind services is rather low; and so too is the practical importance of the resource 'time' (leave). A few exceptions are worth noting. Spain does better than the rest of the group regarding leave provisions since it offers a very long leave, although much of it is unpaid. In addition, Spain scores medium with regard to residential care. Portugal scores medium on the index on informal care and also reaches a medium position with regard to child care services. However, this score may overestimate the level of public provision as we know from other sources that most parents use a combination of formal private services and informal care (Plantenga and Remery, 2005). Italy outperforms the group in regard to pension expenditure as it achieves top rank in pre-enlargement Europe, thus confirming the opinion widespread in the literature that, in the choice between services and transfers, priority is given to the latter, which are delivered via the elderly (Ferrera, 1996). As in the other countries belonging to this sub-group, the family in Italy acts as a social 'clearing house'.

Informal care is widespread in both of the countries in the next grouping: the Netherlands and the UK. Until the 1990s the distinctive feature of this sub-group was the different approach taken to the care of children and the elderly. In the Netherlands, the institutions traditionally tasked with care giving are the family for children, but the state for the elderly. This is the case for the UK as well, although to a less clear-cut extent because local authorities are providers of last resort of elderly residential care, and they have broad discretionary powers. While their distinctive approach is still visible, both countries in the meantime improved the supply of child care and, most notably, moved from institutional to home care for the elderly.[8]

Table 6.1 Care strategies in Europe

	Index of informal care	Care for children				Elderly care		
		Index of leave facilities	Indexes of monetary transfers on behalf of children		Index of public services for children 0–3	Index of public pension schemes	Index of residential care	Index of community care
			Value of net child support package	Family allowances				
Italy	High	Low	Low	Low	Low	High	Low	Low
Greece	High	Low	Low	Low	Low	Low	Low	n.a.
Spain	High	Medium	Low	Low	Low	Low	Medium	n.a.
Portugal	Medium	Low	Low	Low	Medium	Low	n.a.	n.a.
Ireland	High	Low	Medium	Medium	n.a.	Low	Medium	n.a.
UK	High	Low	Medium	Medium	n.a.	High	Medium	Medium
Netherl.	High	Low	Low	Medium	Medium	High	Low	High
Austria	Medium	High	High	High	Low	High	Medium	n.a.
Germany	Medium	Medium	Medium	High	Low	Medium	Medium	Medium
Belgium	Medium	Low	Medium	Medium	High	Medium	n.a.	n.a.
France	Low	Medium	High	Medium	High	High	High	Medium
Denmark	Low	Medium	Medium	High	High	Medium	High	High
Finland	Low	High	High	High	Medium	Medium	High	High
Sweden	n.a.	High	High	High	High	Medium	High	High

Source: Tables A.6.1–3, Appendix.
Note: n.a. stands for not available.

Ireland still seems to be a borderline case between the Mediterranean and Anglo-Dutch groupings, but may be moving away from the former and towards the latter. In common with Mediterranean countries, Ireland relies strongly on informal family labour and provides poor time facilities towards the care of children. It also shares with some of the Mediterranean countries a low level of financial provision for the elderly. As in the UK, however, its supply of residential services for the elderly was traditionally higher than in the Mediterranean.

A third cluster comprises Austria and Germany, countries in which informal care work is widespread, albeit at average levels, and the economic cost to families or individuals – lost earnings from work – is partly off-set by cash benefits, which are medium-to-high for both children and the elderly. The distinctive feature of this grouping is therefore the priority given to monetary transfers, rather than services. This is especially apparent in the case of Austria. The supply of in-kind services is low in this country, so that the family is encouraged to assume the onus of care; however, it is compensated for doing so by generous benefits. At the same time, tax-based allowances targeted at the care of the elderly – which are not accounted for in our indicator but accrue to families in addition to generous pensions – are being used in 80 per cent of the cases to compensate family carers rather than obtaining services (Simonazzi, 2007, p. 13). In Germany too, slightly more than half of the families in receipt of the Long-Term Care Insurance opt for cash rather than market or public services, although the remaining half goes to increase the supply of market and public home care services (ibid.): in our earlier mapping (Bettio and Plantenga, 2004), Germany scored low for home care services while it has now reached medium position.

The final cluster consists of the Nordic countries, which exhibit high or average levels of time resources, financial provisions, and in-kind services, the result being a large-scale 'exporting' of care work to the state (but also to the market) and a consequent major reduction in the amount of 'informal' care. In this case, the state often replaces the family, rather than merely supporting its care activities. The recent novelty is that France has practically joined the Nordic group, scoring medium-to-high in monetary, time and in-kind facilities, for the children and for the elderly. In the past priority in child care has been given to substitute services (such as crèches, nursery schools and after-school programmes), and to benefits, rather than to leave arrangements. However, leave provisions have been augmented at the end of the 1990s, an example being the *Allocation Parental* paid in France for the second child (Fagnani, 1999). Arguably, a residual gap concerning home care for the elderly may not be captured fully by our three-level ranking of Indicator VIb, but is signalled by the fact that the disability level of elderly cared for at home in France is significantly higher than in any of the Nordic countries included in the AdHOC project (see Table A.6.4, Appendix).

France provides perhaps the strongest evidence based on which Rauch (2007) recently argued that a 'Scandinavian Model' no longer exists. Although it must be recognised that care regimes are changing rapidly, Rauch's conclusion partly plays with semantics because the term 'Scandinavian model' can be understood as transcending the geographical area with which it was originally identified.[9]

In contrast, Belgium still stands midway between the Austro-German and the Nordic clusters. The level of financial and real services to children is high, as in Nordic countries and the recent introduction by the Flemish community of a flat-rate insurance care insurance system (MISSOC, 2006) may soon bring services for the elderly in line with Germany. However, the overall indicator for informal care has not gone down to the level of France or of the Nordic countries while that of time facilities is still much lower.

The clustering of countries in the two-dimensional space plotted by the multidimensional scaling technique identifies with sufficient clarity the four groupings that have emerged from the ordinal analysis. All indicators used for the ordinal analysis were also used for this exercise. In order to minimise the loss of information but also the distortion caused by replacement of missing values, Belgium, Ireland and Portugal were dropped from the exercise since each country reports more than one missing value, while missing values for the remaining countries have been replaced with the average for the indicator. Since at least two of the countries being dropped are borderline cases, this has improved the clustering. The Nordic countries plus France cluster clearly to the East, at the maximum distance from Mediterranean countries that cluster to the West and stand very close to one another. In between we find the Austro-German and the Anglo-Dutch groupings, with countries within each group being closer to each other than to any country outside the group.

Caution is, however, required when attributing 'robustness' to the typology identified. The reasons for the caution are statistical, because the data still suffer from problems of comparability and crudeness. But they are also real. Membership of a given group testifies to the existence of a national strategy defined as the enactment of societal priorities and expressing a cultural identity. Consider the diffusion of part-time work in the Netherlands, which has reached proportions unknown elsewhere partly because of the conviction that child care is a family

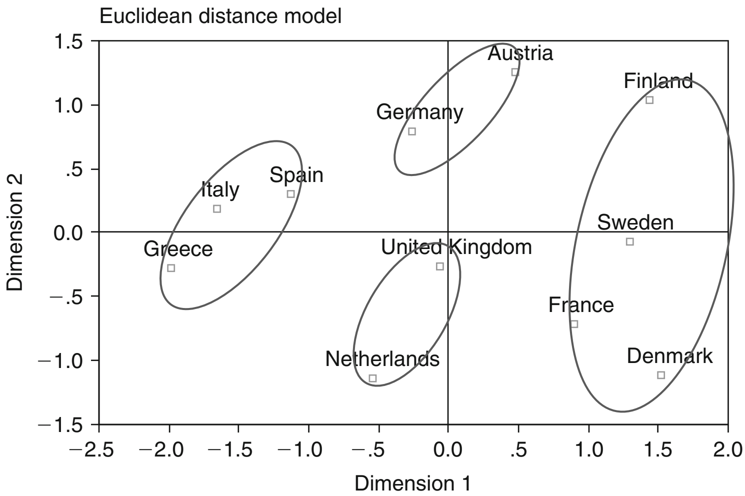

Figure 6.1 Care strategies in Europe: multidimensional scaling*
*Allscal analysis; ordinal model; standardization: mean of 1
Source: Indicators I–VI (Appendix).

affair. Or contrast the 'long family' of the Mediterranean countries, where thirty-year-olds, not necessarily unemployed, are still 'cared for' by their families of origin with early and widespread cohabitation among young people in the Northern countries. These deeply engrained cultural differences sustain very different care regimes. However, where care work is less visible, because it is relegated to the informal sphere, or where it is considered to be mainly a private concern, policies will more likely respond to 'ad hoc' interests and compromises rather than follow a clear national strategy.

6.4 Implications: the 'marketisation hypothesis'

A care regime functions mainly as a 'social joint' ensuring complementarity between economic processes and institutions, on the one hand, and demographic processes and institutions on the other. When these processes and institutions change, so too must the 'joint', in order for new complementarity to be guaranteed. At the same time, because ideas and ideals about care work are core components of cultural identities, care regimes are incentives structures with independent effects on the rest of the economy. The causation process is therefore two-directional, as often happens with economic processes. But here we are more interested in implications than in causes. Hence, we shall not examine the possible origins of care regimes. Instead, we shall look at their capacity to influence, more or less independently, important macroeconomic outcomes, and primarily the labour market.

One implication that we want to investigate is less obvious than it seems: a regime which tends to 'confine' care to the family, and therefore to the informal sphere, inhibits female employment on both the supply and demand sides. In a Cartesian diagram with the classic demand and supply curves, the outsourcing of domestic and care work from the family, or its 'marketisation', shifts both curves. On the supply side, the availability of substitutes for informal care work (paid or otherwise) frees up time to be devoted to the market. On the demand side, the strong sex-typing or occupational segregation distinctive of care services supplied by the market or by the state mean that production of these substitutes generates a disproportional amount of female employment. As is well known, the rise of employment in Europe is mainly the result of increased female employment, and therefore of the outsourcing of domestic and care work from the family. Note that the outsourcing of this work expands the personnel not only of formal care facilities like crèches, nursery schools, care homes for the elderly, and so on, but also of laundries, restaurants, hotels, catering, and medical and social care institutions.

The problem is determining the factors that set in motion this virtual circle between demand and supply. The Nordic Model has found the answer in the state. A well-known finding in this respect is that the degree of occupational segregation recorded in the Nordic countries is among the highest in Europe, precisely because of the almost direct transfer of female work from the family to the public production of substitutes for family care work. This is confirmed by the fact that the correlation between the female employment rate and the share of women working in the public sector is positive and significant (+0.56 in the EU-15: see also Emerek *et al.*, 2002). However, because market economies like the USA have also managed to export a large part of domestic care work, examination should also be made of the other factors that may encourage this exportation.

In a recent article, Freeman and Schettkat (2005) argue that the difference between working time per adult in the USA and EU-15 – a matter of animated debate among economists, but also policy makers – is in reality due to a greater retention of domestic and care work in the family in many European countries (with the obvious exception of the Nordic countries). Around 2002 the annual hours worked per adult in the population (those aged 15–64 years) averaged 1,059 in eight European countries while they peaked at 1,305 in the USA (Freeman and Schettkat 2005: Table 1). The two authors first show that, between 1980 and 2002, half of the difference between the USA and EU-15 in annual time worked per adult was due to the (increasing) gap in the time worked per adult, and the other half was due to the gap in employment rates. In both cases, it is the behaviour of women on the two sides of the Atlantic that makes the difference: in Europe, part-time work (the Anglo-Dutch Model) is much more common, and the employment rate is much lower (the Mediterranean Model). Adopting Becker's 'domestic production' approach, the authors identify the relationship between (i) the opportunity cost (measured by the labour market earnings lost) of domestic and care work; and (ii) the market cost of substitutes as the key variable in the choice between labour market entry or non-entry. They then identify two groups of factors which may influence this relationship: those related to the hypothesis that the USA/Europe difference is due to rigidity of the labour market (labour rigidity hypothesis), and those related to the hypothesis that less domestic and care work is exported out of the household in Europe (marketisation hypothesis). Based on a vast array of empirical research, they conclude that there is no sufficiently strong evidence to affirm that the rigidity hypothesis explains all, or even a large part, of the USA/EU-15 differential in time worked; by contrast, they obtain evidence in favour of the alternative hypothesis – the differing extents to which domestic and care work are outsourced – although they test only the importance of some of the factors concerned, the most measurable ones.

It is interesting to consider the list of factors that Freeman and Schettkat deem relevant to the marketisation hypothesis and compare it with the list of indicators used here to identify care regimes. In their account (Freeman and Schettkat, 2005, Box 2), key determinants of labour market rigidities include unemployment benefits, wage dispersion, minimum wages, employment protection, and marginal tax rates with single taxation, while key arrangements affecting marketisation and employment are:

- Flexibility in working time, since part-time work and ability to choose hours increase supply by allowing workers to deal with family problems;
- Shopping hours. Reducing restrictions on shopping hours can make it easier for persons to work full-time, and may increase retail employment;

- Day care and other child benefit programmes since they substitute for household production time;
- Length of school day, since longer school day or after-school programmes allow women to work;
- Equal opportunity for women, for it can raise pay and shift demand for women;
- Immigration, because the supply of low-skilled immigrants may provide the labour supply with substitutes for household production (such as child care, cleaning services);
- Maternity and parental leave: both ease combining childbearing and market work, with guaranteed job upon re-entry, although they can reduce initial employment.

Some of the factors listed by Freeman and Schettkat as affecting employment via marketisation coincide almost entirely with the indicators proposed here (services, maternity and parental leave). Others are not included among our indicators because of the already-mentioned problems of data availability or heterogeneity (nursery school opening hours). Yet others have not been included because they overstretch the concept of a 'care regime', though they are closely related to it. This is the case of the work schedule – and of part-time work in particular – since it is unclear how far the latter can be viewed as a constitutive part of a care regime. The experiences of the Netherlands, and perhaps of the UK, might suggest that part-time is primarily an expression of a child care strategy that does not favour substitutes to maternal care. In many other cases, however, a reciprocal influence can be envisaged between part-time work and the regulation of working time, on the one hand, and the care regime on the other, but without the former being a constitutive part of the latter.

Freeman and Schettkat's list is not complete, however, because it omits care for the elderly, a sector which falls fully within the compass of the marketisation hypothesis, and which, given the size to which it is growing, may have implications in terms of work hours lost when care is the responsibility of an employed member of the household (usually a woman: Hoskins, 1993; Spiess and Schneider, 2001), but primarily in terms of jobs on the supply side. Freeman and Schettkat's list also omits the influence which cash benefits for families with children may exert on the female labour supply. Can we assume that these benefits always amount to a pure income effect, therefore encouraging retention of domestic work within the household, in whatever form they are paid? And what is the magnitude of this effect?

It is precisely the purpose of research on care regimes to answer these questions.

6.5 Concluding remarks

Despite the inevitable difficulties with data, the indicator-based methodology used in this chapter has enabled identification of sufficiently comprehensive and diversified care work strategies in pre-enlargement Europe. Although a classification exercise has a value more heuristic than analytical – and the one described here is no exception – going beyond the formal institutions of the welfare state has made it possible to introduce certain novelties with respect to the literature on the welfare state. The groupings identified, in fact, overlap only partially with the welfare typologies most common in the literature. Moreover, consideration of time and financial resources together with social services has enabled a clear distinction to be drawn between the two extreme groupings – Nordic on the one hand, Mediterranean on the other – providing further evidence on the distinctiveness of the Mediterranean Model in an exhaustive typology of the welfare state. It has also made it possible to differentiate the Continental European countries between the Anglo-Dutch and Austro-German Models.

However, the interest of an attempt to reconstruct national strategies in the care sector extends beyond the production of a typology, because it enables the analyst to grasp macroeconomic implications often 'hidden' by the scant visibility of care work. Here we have dwelt in particular on the influence of care regimes on the supply of working time in a given country, doing so on the hypothesis that an important determinant of the employment rate is the extent to which domestic and care work is 'exported' from the household to the state or the market.

Care regimes do not only influence employment and fertility – the standard topics addressed in the literature. They are also important for distributive outcomes, a case in point being the incidence of poverty, which tends to increase among households in which the woman does not work. Furthermore, they tend to influence intergenerational transfers and hence the saving and investment behaviour of households. Or they interfere with geographical mobility and price levels in the property market, when moving house has an additional cost in terms of the loss of family care resources. The list of possible implications does not stop here, of course. But the aim of this chapter has been to provide not an exhaustive list, but rather sufficient evidence and insights to encourage further research in this area.

Notes

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1. The seminal contribution was by Esping-Andersen in the early 1990s. For later but equally representative work by the same author see his 1999 volume.
2. The term 'marketisation of household production' is the one used by Freeman and Schettkat (2005), as discussed in the text, but the underlying hypothesis appeared in the literature much earlier, though in a less articulated form and under other terms. Bettio and Villa (1998) first explicitly introduced it as 'abridged tertiarisation' with specific reference to the Mediterranean countries.
3. Although the distinction between market and private provisions is clear in theory, actual measurement may prove difficult, as we shall note further on.
4. Not included is an indicator on leave arrangements for care of the elderly. This is because previous studies have shown the scant practical importance of this measure in the majority of the European countries (Bettio and Prechal, 1998).
5. Standardisation consisted in subtracting the lowest value from each original value, dividing the difference thus obtained by the highest value, and expressing the result as a percentage.
6. The elements covered in evaluating the package are income tax benefits, social security contributions, non income-tested child cash benefits, income-tested child cash benefit, rent benefits, local taxes, child care costs, school costs/benefits, guaranteed child support (alimony) and other country-specific elements (Bradshaw *et al.*, 2003, p. 9).
7. The new EU-SILC panel survey that has recently replaced the ECHP survey affords rich information on child care from which an indicator has been derived for 2004 (European Commission, 2007) measuring the proportion of children in any type of formal care, from public nurseries to private childminders. Although the SILC survey offers harmonised data, their scope on child care facilities as such is less useful from a social policy perspective.
8. The extent of this move is probably exaggerated by the value scored by the Netherlands for the indicator of residential care (2.4: Table A.6.3) which is low in absolute and comparative terms. The figure is taken from the OECD report but is not confirmed by other sources like Rostgaard (2007, slide 9) and would imply a very quick dismantling of what was one of the top suppliers of residential care for the elderly no longer than a decade ago.
9. Rauch examines only six countries based on (very detailed) service-related indicators that, insofar as they overlap with ours, are broadly in agreement (the main exception is highlighted in the previous footnote). However, his analysis does not consider time provisions and cash benefits other than subsidisation of services. His conclusion, therefore, ought to be taken with some care.

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Appendix

Table A.6.1 Informal care indicators

	Synthetic Index of 'informal care',* 2001	Proportion of women among adults devoting at least two hours per day to care work, 2001
Italy	91.6	78.1
Greece	87.2	83.8
Spain	77.7	78.6
Portugal	58.1	85.6
Ireland	74.4	76.4
UK	81.8	71.9
Netherlands	74.2	71.8
Austria	57.2	85.6
Germany	59.1	72.4
Belgium	52.2	73.2
France	36.9	72.1
Denmark	30.8	56.0
Sweden	n.a.	n.a.

Source: Own calculations on ECHP microdata, 8th wave. Data for Sweden are not available.
*The index (or Indicator I) is the simple average of indicators Ia and Ib, standardised. See text for details.

Table A.6.2 Care of children: indicators

	Value of the child support package expressed as a percentage of average earnings, 2001–2002	Amount of family allowances per component in PPS: averages for households with children aged under 12, 2001	Number of parental leave weeks, weighted by level of payment, and normalizing maternity leave at 14 weeks, 2002–2004	Services for children, coverage rate for the age group 0–3, 2002–2004
Italy	2	61.8	24	6
Greece	−5.6	50.0	13	7
Spain	−1.1	64.0	50	10
Portugal	−2.0	152.1	20	19
Ireland	6.9	499.2	13	n.a.
UK	7.5	703.8	21	n.a.
Netherlands	−1.9	416.1	11	35
Austria	17.2	1,054.2	63	9
Germany	8.3	905.3	49	7
Belgium	9.0	599.6	18	55
France	10.9	594.7	48	43
Denmark	7.7	855.1	47	56
Finland	13.9	957.7	107	21
Sweden	10.2	897.8	78	41

Source: Column 1: Bradshaw *et al.* (2003, Table 2). Negative values arise when housing costs and charges for services cancel out the value of tax and cash benefits for children.
Column 2: own calculations on ECHP microdata, 8th wave.
Columns 3 and 4: Plantenga and Remery (2005), revised.

Table A.6.3 Care of the elderly: indicators

	Expenditure on pensions (earnings/contributions-related, old age, survivor) per adult aged over 65 in PPS, 2001	Percentage of the population over 65 years receiving care in an institution,* 2000–2004	Index of home care, 2001–2002 (see Table A.6.4)
Italy	10,815.1	2.1	0.28
Greece	5,539.9	0.6	n.a.
Spain	5,680.0	3.8	n.a.
Portugal	5,640.7	n.a.	n.a.
Ireland	3,765.2	4.6	n.a.
UK	9,778.1	5.1	0.84
Netherlands	11,192.8	2.4	0.93
Austria	11,945.4	4.7	n.a.
Germany	9,452.3	3.9	0.68
Belgium	8,636.5	n.a.	n.a.
France	11,353.2	7.9	0.67
Denmark	7,430.4	9.1	0.90
Finland	7,422.3	6.9	1.00
Sweden	7,954.5	7.9	0.88

Source: Column 1: own calculations on Esspross data for expenditure on pensions (earnings/contributions-related, survivor) and on Council of Europe data for the population.
Column 2: OECD (2005: Table 2.3); Simonazzi (2007, Table 2); Nordisk Socialstatistik Komite (2004) quoted in Rostgaard (2007, slide 9).
Column 3: Table A.6.4 below.
*For France, the number of available beds over the population older than 65; for Denmark and Finland, the share of the elderly population cared for in nursing home or sheltered accommodation: population over 67 years of age in Denmark.

Table A.6.4 Home care of the elderly 2001–2002: details on indicator

	Mean hours of care per week	**Mean MSD ADL (physical disability)**	**Mean MSD HC ADL (instrumental disability)**	**Mean CPS (mental disability)**	**Final indicator: weighted by logarithm of mean disability index**
Italy	1.3	2.8	2.2	2	0.2846
UK	3.3	1.6	1.6	1.0	0.8357
Netherlands	2.6	0.2	0.6	1.0	0.9300
Germany	2.7	1.6	1.2	1.4	0.6825
France	3.0	2.4	1.8	2.2	0.6703
Denmark	2.1	0.3	0.5	0.7	0.8987
Finland	2.2	0.2	0.5	0.7	0.9980
Sweden	2.4	1.4	0.6	0.4	0.8780

Source: Columns 2–5: Carpenter *et al*. (2004, Table 1).
Column 6: own calculations.

7

The Swedish Model in the Era of Integration and Globalisation

Björn Gustafsson

7.1 Introduction

The Nordic countries have long been renowned for being comparatively rich, for having advanced social systems and for placing a great emphasis on equality. Since it affects the largest population of the group, the Swedish system is perhaps the best known.[1] In the 1980s when many rich European countries faced increased unemployment, this was not the case for Sweden. Together with other Nordic countries, Sweden kept social expenditures high and funded these through levels of taxes. From this background it is no surprise that the Swedish Model has come to figure prominently in social policy debate and in academic literature on comparative social policy analysis. An underlying theme in much of this literature is that countries can choose different models of social protection, and that it is meaningful to distinguish between different types of welfare states.

A seminal reference on comparative welfare state analysis is Esping-Andersen (1990). After studying social insurance systems in a number of rich countries, the book proposed a classification based on sociological considerations using 'stratification' and 'decommodification' as central analytical concepts. Historically, social insurance arrangements can differ by occupation, providing adequate protection for those covered. However, such a Bismarck or Continental type of system needs large funds, preserves stratification and can have holes. An alternative model is found in the Anglo-Saxon countries where the provision of welfare is targeted to people who are worse off and are treated differently from the main part of the population. Such a model needs a lower level of funding from the public and employers, but tends to encourage the belief that the poor are different from the majority; it does not promote equality.

In contrast to these models, the Nordic or Social Democratic Model does not promote stratification while it fosters decommodification. There are universal programmes such as basic pensions and child allowances where little means-testing takes place, whereas in other programmes benefits are positively linked to earned income. Sweden is the archetype of the Nordic or Social Democratic Model.

Several themes can be found in the literature succeeding Esping-Andersen (1990). One such critique is that this classification is based on studying social security systems only, while the welfare state is broader in scope. The welfare state not only channels resources between the members of society, but also provides social services. Such services are typically provided by women; the welfare state is not gender neutral. Sweden has assumed a special position in this aspect, as for some years female labour force participation rates have been almost as high as for males. At the same time, most paid care work in the public sector is undertaken by women.

Another theme in the literature following Esping-Andersen (1990) has been to scrutinise the proposed classification system.[2] There seems to be a tendency among analysts to not be satisfied with only three categories. Perhaps most widespread is the idea of including a Southern European system of welfare state. This model differs from the Continental system by giving a much greater scope to family responsibilities. Alternative classifications have been suggested. Comparing such classifications presented in the literature, one finds little agreement regarding specific countries, but this is not the case for Sweden. Despite much energy being expended by social policy analysts, Sweden retains its position as the archetype of a particular kind of welfare state.

When reading the literature and when talking with observers, one is left with the strong impression that the uniqueness of the Swedish welfare state is widely agreed upon. But is the Swedish welfare state better in some sense and therefore worth imitating? This is a difficult question, and the answer depends to a large extent on what the observer means by 'better'. One can find arguments for a recipe avoiding some of the central traits of the Swedish Model as well as arguments for a recipe espousing them.

A strong contention for the former case is that for a period after the Swedish Model was firmly established, economic growth in Sweden was slower than in many rich countries. As a consequence, having once been close to the top of the scale of GDP per capita among OECD countries, Sweden lost rank position – particularly at the beginning of the 1990s.[3] However, this argument is not as strong as it once was; during the last decade the Swedish economy has grown somewhat faster that the entire EU economy, with rates of GDP change similar to those of the United States, see Table 7.1.

Nonetheless, it can be claimed that relevant comparisons cross-country should be based on measures of welfare, and when comparing rich countries, GDP per capita is not a good welfare indicator. Ideal welfare indicators should be comprehensive, start from the microsituations of households and individuals, and take distributional considerations. GDP per capita fulfils none of these properties. Non-market activities are not included in GDP; it is a macro concept which does not take into account the distribution of income or any other measure of individual or household welfare. When welfare measures having the desirable properties are obtained for various countries, Sweden's rank is much more favourable than when comparing GDP per capita.

To take one example: GDP per capita is nowadays clearly higher in the United States (US$39,676 in PPP, 2004) than in Sweden (US$29,541 in PPP, according to UNDP, 2006). However, the two countries trade places in the country ranking according to Human Development (the HDI index) recently published by UNDP (2006). In this ranking for 2004, where GDP per capita is adjusted by measures of life expectancy and education level, Sweden ranks number five while the United States ranks number eight.[4] Further, UNDP also ranks countries by the extent of poverty in the relevant country. According to Human Poverty Index II applied to rich countries, the Nordic countries are faring very well. Of

Table 7.1 Real GDP growth in Sweden, entire EU-27 and the United States of America, 1997–2006 (percentage)

Year	**Sweden (%)**	**EU-27 (%)**	**USA (%)**
1997	2.7	2.7	4.5
1998	3.7	2.9	4.2
1999	4.5	3.0	4.4
2000	4.3	3.9	3.7
2001	1.1	2.0	0.8
2002	2.0	1.2	1.6
2003	1.7	1.3	2.5
2004	4.1	2.5	3.6
2005	2.9	1.8	3.1
2006	4.2	3.0	2.9

Source: Eurostat. Homepage.

the five countries where poverty is reported to be less extensive, four are Nordic. In addition, the country ranked as performing best is Sweden.[5]

From the discussion so far we have concluded that Sweden is different and being different, Sweden can function for some observers as a good example, for others as a bad. This leads to several questions which the rest of the chapter will deal with. They include: How did the Swedish Model come into being and what precisely are its characteristics? Has the model remained unchanged since the beginning of the 1990s, when a deep recession hit Sweden and put great pressure on public funding? Although there may be consensus among observers that the Swedish Model performs better than others in a number of aspects, there are also problems which become clear while listening to the internal social policy debate; this chapter will discuss a selection of such problems. For readers from other countries, such a discussion is of particular relevance if their countries aim to change their systems to become more similar to Sweden's. What are problems that are likely to turn up and how can they be counteracted?

This chapter asks big questions and covers many issues of which much has previously been written. It is necessary to clarify expectations from the outset. To provide full coverage of the questions, an exposition of book length would be necessary – not a single chapter as provided here. In fact, for some readers, even a text of book length would not be sufficient, as seen from the following example: in 1999, when the previous Social Democratic government commissioned a group of researchers to report on changes in the Swedish welfare state and of welfare in the population that had taken place during the 1990s, the investigation resulted in no less than 14 book-size volumes.[6] So the topics, aspects and literature covered in this chapter are by necessity selectively chosen. The text aims to provide an introduction to the literature and debate, rather than providing new answers to research questions or solutions of social policy problems.

The rest of the chapter is laid out as follows: The next section offers some remarks on the history of the Swedish welfare state and a discussion of what characterised the Swedish Model as it appeared around 1990 when the Swedish welfare state had matured. In section 7.3 we report on more recent history when the welfare state was put under severe stress due to a deep recession which generated cuts, followed by a relatively rapid recovery which made the issue of how to fund the welfare state less pressing. Keeping the focus on more recent years, section 7.4 examines ways in which the Swedish welfare state has remained unchanged and ways in which it has changed. Selected hot topics for the Swedish welfare state are discussed in section 7.5. We consider labour supply (particularly the aspects of sickness absence and early exit), the increased period of young adulthood and its problems, and, finally, the situation of immigrants. The chapter ends with a summary.

7.2 History and characteristics of the 'Swedish Model'

Several threads or roots back in history are often mentioned by those who have written on the subject of why Sweden has developed a distinct type of welfare state.[7] One particularly deep root is that feudalism played a considerably smaller role in Sweden than in Continental Europe. Instead, the family farm was the typical production unit in agrarian society. When free farmers took decisions on provision for the poor and on schools, as well as for the funding of the expenditures, the relevant unit of the public sector was the local government. Today much of social service provision still stems from the local government. The farmer representatives were central to many political decisions on the formation and expansion of the welfare state. As this was the case, it is not accurate to refer to the Swedish welfare state as a Social Democratic welfare state. True, most of the expansion of the welfare state took place during the long period from the mid-1930s to the mid-1970s when the Social Democratic Party governed without interruption. However, even within this period the Social Democratic Party was infrequently in majority, thus the welfare state has been a project backed not only by Social Democrats and blue collar workers.

Looking back in history as far as the end of the nineteenth century, we find that Sweden was among the poorer countries in Europe. Due to a lack of job opportunities, major emigration took place, predominantly to the United States. Some observers claim that this is an important background fact in explaining why the Swedish welfare state became universalistic. The argument runs as follows: due to the emigration streams, the population of Sweden was older than in many other European countries. At that time, the typical recipient of poor relief was an old person. A population with a high proportion of elderly residents meant a drain on the coffers of the local governments, and farmers had to be taxed more heavily. Therefore it was in the interest of politicians chosen by the farmers to support a universal system of old age pensions (partly) funded by central government taxes. In 1913, Sweden was the first country to adopt such a universalistic social insurance programme.[8]

While the labour movement, trade unions and the Social Democratic Party are not the only forces to have formed the Swedish welfare state, they definitely belong to the main players. While industrial conflicts and class antagonism thrived during the beginning of the 1900s, changes appeared during the 1930s when the Social Democrats first came into government. Since then, consensus in policy making is a hallmark of the Swedish Model, where a high proportion of workers belong to a trade union. A division of power developed between capital, labour and politicians. The new Social Democratic government abstained from nationalising private industries and let the employers keep the right to decide on day-to-day activities at the workplace; thus the government did not choose a socialist path in those aspects. Capital accepted the new political leadership within its domain, a domain that soon came to include active macroeconomic policy. The mechanism for solving disputes between capital and labour was a framework of collective bargaining, with bargaining at several levels: central, industrial and local. The powerful confederation of blue-collar workers (LO) strived to minimize wage differences between workers doing similar jobs at different establishments, and to establish wage floors at a level which made it possible to live on full-time wages. Such a wage policy not only has egalitarian goals; it also promotes economic growth through structural change as it leads to high costs for inefficient establishments that will be forced to close. If trade unions were not satisfied with the outcome of collective bargaining, they could try to influence the government's policy. For example, the labour protection laws introduced during the 1970s, which are still in place today, were the result of pressure from trade unions. These laws limit the employer's right to fire workers and specify procedures to use when laying off workers due to personnel reductions.

At the end of the 1940s, trade union economists Gösta Rehn and Rudolf Meidner formulated a full programme that had strong implications for macroeconomic, industrial and labour market policies. The ideas of Rehn and Meidner provide a blueprint for the Swedish model as it appeared from the mid-1950s onwards. We will not go into the programme in detail, only noting that several aspects of the programme and other ideas from the period are still central elements of the Swedish Model.[9] One such element is the ambition of full employment and rapid economic growth. As the Swedish economy is rather small, this requires export-led growth. Export-led growth in turn means an open economy and movements toward free trade have in modern times always been central for Swedish policy makers. Another requirement for growth is a positive attitude towards new technology and to structural change. Rapid expansion in some sectors and firms also means that workers have to accept the risk of personnel reductions and lay-offs at the plant level. But such an acceptance is not unconditional and the burden of such necessary changes should be shared. True, relatively generous unemployment compensation systems should exist, but active labour market policy fostering market work in expanding sectors and plants is much better. Along these lines, Sweden came to be a leader in building up labour market training programmes for the unemployed and for people at risk of becoming unemployed. Swedish active labour market policy which aims to promote structural change is not only characterised by its large size, but also by a strong tendency to try new programmes.[10]

On the whole Sweden was not a leader in the creation of social insurance programmes. Nevertheless, significant events did occur, such as the increase in pension benefits in 1948, the same year in which flat-rate child allowances (nowadays comparatively generous) were introduced. The comprehensive sickness benefit system was launched in 1955, and, after considerable political debate, the supplementary pension system started to collect funds in 1960. When these systems were in place, social insurance in Sweden had received much of what still characterises it.

Many parts of the Swedish system of social insurance are universal in the sense that all workers belong to one system administered by the social insurance office. The main exception is the unemployment benefits system which is closely connected to the trade unions, though fully regulated by law and, to the very largest degree, funded by the central government budget. The system is individualistic in the sense that it is the worker, rather than his or her family that is insured, and benefits are independent of family status. Benefits typically have a floor, meaning that there is a lowest guaranteed level over which benefits are income-related up to a ceiling. The fact that benefits are income-related for many workers means there are incentives for increased labour supply, a characteristic still in place. Funding comes from social security contributions and from the public budget. Evaluated over a single year, considerable redistribution takes place in such a social insurance system. This is particularly true after the system expanded during much of the 1960s, 1970s and to some extent also during the 1980s.[11]

While the Swedish model in the domain of social insurance developed to be what might be labelled a 'universalistic Bismarck system', in the sphere of social services it could long be labelled a 'Beveridge system'. That means that the public sector provides basic services for all, services that are mainly funded via the public sector. However, while earlier the portion of workers employed in the public sector was comparable with what was found in the United Kingdom, for example, this changed from the 1970s onwards. Sweden experienced a rapid increase in labour force participation rates among females, leading to increased proportions of workers employed in the public sector. Instead of becoming homemakers, newer cohorts of married women worked for wages, many in the realm of local government.[12] Such a development was reinforced by changes in tax policy and family policy.

In 1971, an important reform in the tax system changed the assessment unit for the progressive income tax from the couple to the individual. As a consequence, incentives for increased market work rose rapidly for the spouse with the lowest income, typically the wife. Local governments were first encouraged financially and thereafter required to establish high quality child care centres serving ever-larger fractions of pre-school children as well as young schoolchildren. Thus in 2004, not less than 76 per cent of all children aged one to five were admitted to child care centres (the average cost for such an placement is 142,000 SEK, or approximately €15,300) and in addition 7 per cent to a family care home (a private home, contracted and funded by the local government).[13] In addition, the system of maternity leave benefits was transformed into a system of parental leave benefits. Its rules have been changed, many times of which a majority have entitled parents to longer spells of leave and increased replacement rates. Furthermore, there are incentives to work built into the system, as benefit levels are based on the parent's wages. As this is the case, it is highly rational for a young adult to first gain a foothold in working life before becoming a parent. While most benefits in the parental leave systems are paid to mothers, there is clear policy concern for fathers to be larger users.

To reiterate, Sweden's distinct type of welfare state was developed in the 1970s and to some extent during the 1980s. In it, entitlement to many programmes is universalistic and income testing only takes place in residual programmes such as the system of Social Assistance. Key social services are provided by the local governments and mainly funded by public revenues. Female labour force participation is high, encouraged by various public programmes as well as the tax system, and many women work in the public sector. The central state is responsible for many active labour market programmes and attitudes towards change in work life are rather positive. Income and other indicators of welfare are relatively equally distributed. Such a description effectively illustrates the reality existing during the 1970s and 1980s. To what extent does this description apply to more recent reality? This is the theme of the next sections.

7.3 The 1990s and onwards

Patterns of change can be complicated, an assumption which especially applies to the development of the Swedish Model. One can easily maintain that the first impulses of movement away from the Swedish Model came as early as the mid-1970s. Such an argument stems from the Social Democratic Party losing the big debate of establishing 'Wage Earners' Funds', a system whereby private ownership of industries would gradually be transformed to funds controlled by workers and their representatives. In response, the electorate voted in a non-Social Democratic government in 1976, and the approximate forty-year spell of Social Democratic rule had ended. To many observers' surprise, however, it turned out that the new government did not adopt fundamentally different policies. When the Social Democrats were back in power in 1982, they actually found a larger public sector than when they had left six years earlier, and that the trend towards income equalisation had continued.

The next period with the Social Democrats in power lasted from 1982 to 1991 and is a period of complexity in respect of the Swedish Model. On the economic side, collective bargaining at the central level (though not at the industrial and local levels) broke down in 1982, signalling weakened trade union power. From being rather low, wage inequality started to increase, as did income inequality. This period was also one of deregulation of the credit market and excessive bank mortgage lending created a financial bubble that eventually burst in 1990. Furthermore, it was a period where the prominence of full employment as a key goal of economic policy was replaced by low inflation. It was also a period of major tax reform. One component was changing the tax base to become broader, as well as separating capital income into one component subject to a lower and proportional rate. Another component was revised tax scales, meaning lower levels of progressivity for top income earners. Such changes in the economy support claims that the uniqueness of the Swedish Model was diluted during the 1980s. On the other hand, it can be noted that female labour force participation rates continued to increase in the 1980s to become almost as high as for males. During these years the share of the labour force employed in public sector areas, such as the child care sector, continued to expand rapidly and it was a period of improved rights in the parental benefit system.

In 1991 the Social Democrats were voted out of government, but the years with the new government coincided with great turbulence as the economy slipped into a deep recession. This recession was more severe than in many other rich countries and came abruptly. GDP fell by 5 per cent from 1990 to 1994, and the unemployment rate rose from 4 per cent (2 per cent open unemployment and 2 per cent in active labour market programmes) to 14 per cent in 1993. In addition to this, and just as serious, the labour force shrank. While in 1990, 84.5 per cent of the population aged 16–64 was in the labour force, the corresponding proportion fell to as low as 78.2 per cent in 1995.

The widespread drops in employment caused significant income losses for the households, but these were partly offset by payments from the unemployment compensation system, expansion of labour market programmes and less taxes paid by households. By necessity, such drains on the public coffers led to rapidly increasing public budget deficits that had to be counteracted. This was followed by increased taxes as well as cuts in public expenditures, and to 'save the welfare state' became a top priority for the Social Democrats when they regained power in 1994 – a position they held until the defeat in the parliamentary elections in September 2006.

In Sweden, the 1990s will be remembered as years of rapid macroeconomic change. The decade will also be remembered as the point at which Sweden moved closer to the rest of Europe. In 1991 Sweden applied for membership to the European Union which led to membership in January 1995 (together with Finland and Austria).

Similar to many other EU countries, Sweden faced challenges of an ageing population and new cohorts of young adults starting to work at higher ages than before. During the 1990s the insight that the pension system, if left unchanged, would not be financially sustainable spread widely within the political realm. As a compromise across most political parties, a new system came into effect in 1999 and is still in place today. The system gradually phases in people born in 1938 to 1953, and applies fully to those born later. The Pay as You Go system was changed from one in which benefit levels are fixed in real terms at the time of retirement, to a system with fixed contributions where levels of benefits are automatically put at a balancing level. At the single worker level, then, this means a closer relation between contributions to the system and pension received. Incentives for older workers not to leave the labour force are high, and the labour force participation rate for people over age 60 is on the rise. In the new system, a minor part of the contributions are reserved for the worker to invest in one of a large number of authorised pension funds. Thus while the system is still largely a Pay as You Go system, elements of a funded system have been introduced.

7.4 Continuation or change?

What are the new aspects of the Swedish Model, and what are the aspects that have ensured continuity since the beginning of the 1990s? First, at the time of writing (September 2007) the unemployment rate is 5 per cent. This is rather low compared to what was observed at the beginning of the 1990s, though not particularly low when compared to the corresponding rate in other rich countries. Yet compared to the situation in Sweden for many years before the deep downturn in the beginning of the 1990s, it is definitely a high number.

Secondly, what happened to household income? As a consequence of the deep recession and the subsequent policy changes, household income in Sweden developed rather unfavourably. Although GDP growth registered positive figures from 1994 onwards, it was not until 1999 that average equivalent household disposable income was back to its 1991 level. Such a long, deep downswing was historically unprecedented in modern Sweden. While the 24 per cent recovery in average disposable equivalent income that occurred between 1996 and 2000 is remarkable, the increase in real income for the period 1991 to 2003 as a whole scarcely exceeds 1.5 per cent per annum. Also of relevance is that this was not a development shared equally. Wage dispersion increased particularly among white-collar workers and the rate of return to education rose (Fredriksson and Topel, 2007; Gustavsson, 2006). At the household level, income developed weakly at the bottom of the distribution, while more favourably at the top, thus the distribution of income showed a continued trend towards less equality (see, for example, Gustafsson and Palmer, 2002).

Has the Swedish system of social insurance become less universalistic? Seen over the entire period 1990 to 2006 there are few changes to report. When the economy picked up speed at the end of the 1990s, many of the cuts made years earlier were nullified. Further, shortly after the unemployment rate started to decrease, social assistance receipts also fell. Thus, there is no indication of means-testing provision becoming more important in the transfer system (see Berg, 2004).

However, when the new non-Social Democratic government came into office in the autumn of 2006, it soon announced lowered replacement rates and limited durations of eligibility in the Unemployment Insurance system, and moved towards less government subsidisation of the system. At the time of writing it is too early to know whether or not this will lead to fundamental changes in the system. Interestingly enough, the new government announced that it does not aim to change labour protection laws.

Looking at the funding of social services, we find no general trend of relying more heavily on user charges since the beginning of the 1990s. True, charges have increased for pharmaceutical products and for public health care. Yet working in the opposite direction, a ceiling was introduced for the income-related system of fees for public child care as one part of a reform introduced in stages in 2001–03. In consequence, parental out-of-pocket payments for a child care centre placement dropped from 18 per cent in 2000 to 10 per cent in 2005. This reform benefited middle- and high-income parents by decreasing expenditures, and their incentives to work longer hours increased.

Nonetheless, the 1990s signalled a definitive change in how production and employment developed in various sectors of the economy. Employment in the market-producing sector increased, predominantly during the period of recovery in the 1990s. The expansion of public employment came to a halt when local and central governments had to cut their budgets. It is difficult to say to what extent the cuts have negatively affected quality in the social services. The National Accounts show that in 2005 the number of hours worked in the market production sector were 10 per cent higher than in 1993, while hours worked in local government had decreased by 3 per cent. As a consequence, hours of work in the public sector (local government and central government) declined from 31.2 per cent to 28.5 per cent.

While there are no indications of change in how social services are funded, there are certainly signs of change regarding provision. Traditionally, almost all social services in Sweden have not only been funded by the public sector, they have also been provided within the public sector. Day care centres, schools, hospitals, and clinics have been owned and administered by the government, with few exceptions. Since the beginning of the 1990s, however, the exceptions have become more and more numerous and the trend is clearly towards larger and larger proportions of social services provided by cooperatives, non-governmental organisations and private firms. Within the public sector there are also tendencies for market allocation to play a larger role. In this movement towards market allocation, there are examples of consumers being empowered to make more decisions, for instance, regarding choice of school. The process of privatisation/more market-like allocation is naturally a rather hot political issue and has moved forward at different speeds in different sectors in different parts of the country.

Some examples illustrate the developments. In 1995, 7 per cent of persons working in health care and education were employed in private organisations (including cooperatives, etc.); by 2004 the proportion had increased to 13 per cent. While only 3 per cent of local government costs for social services could be linked to the purchase of social services in 1995, the corresponding proportion had increased to 12 per cent in 2005. A third example is that the proportion of students in secondary schools not run by the local government increased from 6 per cent in the school year 2000/2001 to 13 per cent in the school year 2005/2006 (Statistics Sweden, 2006).

Finally, we turn to the gender aspect of the Swedish model. Does continuity dominate in the development since the beginning of the 1990s, or have there been changes? A change could have occurred when employment dropped rapidly during the first part of the 1990s, thereby fostering a return to more traditional gender roles. This would be the case if the housewife alternative became more attractive and/or if firms that preferred male workers exercised gender discrimination to a larger extent when the supply of workers was high. Speaking against such a development would be the heavy emphasis on subsidising public child care, and, increasingly, the very large awareness of gender aspects in work life shared by all major players of the Swedish labour market.

Looking at actual labour force participation rates, one finds that the deep downturn in the 1990s was remarkably gender neutral. In fact, men were hit first due to their concentration within the market production sector. This gender imbalance was later neutralized when cuts were made in the female-dominated public sector. Looking at time-use studies over a decade, one finds that in 2001, hours of work (among people gainfully employed) had actually increased among women, and the gap across the genders had decreased (from one hour and 13 minutes a day in 1990/91 to 40 minutes in 2001). Steps towards fewer gender differences also appear concerning housework during the same period. Time use for women actually decreased as did the gender disparity (from one hour and 47 minutes per day to one hour and 11 minutes, see Statistics Sweden, 2003).

There is thus no sign that traditional gender roles have become more prevalent in Sweden since the beginning of the 1990s; rather, the developments have gone in the opposite direction. Compared to a social insurance system where benefits and contributions are calculated in an actuarial system, the Swedish system is beneficial for women (Ståhlberg, 2002). This said, one should not forget that the Swedish labour market is profoundly segmented by gender, and that the gender wage gap has not tended to narrow. Further, the gender wage gap is largest at the top of the earnings distribution. There seems to be a 'glass ceiling' perhaps common to several other European countries, though not to the United States.[14]

7.5 The welfare state and the labour market

The Swedish system provides good protection for workers who have established themselves in the labour market. This means that if workers suffer from serious somatic illness, most often this does not have fundamental consequences for their income situation nor for that of their household (Stenbeck and Hjern, 2007). Similarly, the transition from an active working life to retirement most often entails relatively small income consequences. However, generous systems can also have side effects that are well worth considering.

There are two sides of generosity: benefit levels and the number of persons eligible. If eligibility for a programme is widely defined, it becomes difficult to fund generous benefit levels. This became an important problem for the Swedish systems for sickness compensation and disability pension, two systems that are interrelated. At the individual level, a long spell of sickness insurance is the typical path into disability pension receipt. Table 7.2 illustrates the issue at the aggregate level. For people in work active ages it provides information on the number of full-year and full-time equivalents supported in different programmes from 1990 to 2006.

The disappointing information from Table 7.2 is that despite the reduction in the number of persons unemployed, in labour market measures and on social assistance, the total number of persons supported via the public budget diminished only marginally since the first half of the 1990s. This is because there were increases in the number of people supported by disability pensions; the development of number of people supported by the sickness benefit system is also disappointing.

Due to the heavy financial burden placed on Sweden's public coffers by high rates of absence and disability pension, there have been many efforts to understand their causes and find appropriate remedies.[15] In one respect, the development came rather unexpectedly as most health indicators point towards improved health among middle-aged and older residents. One category of possible causes relates to working conditions. Sickness absence varies across sectors and firms. Reforms introduced during the 1990s increased incentives for firms to take precautionary measures to limit absence as they were responsible for funding the first

Table 7.2 Number of full-year equivalences from various benefit systems, 1990–2006 (000 persons)

Year	Sickness benefits	Disability pension	Unemployment	Labour market programmes	Social assistance	Total
1990	211	319	69	61	72	732
1991	203	322	119	98	74	817
1992	187	330	224	125	88	954
1993	163	350	336	157	106	1 112
1994	149	362	340	182	121	1 154
1995	142	362	332	175	117	1 135
1996	124	357	332	190	131	1 134
1997	120	363	320	178	138	1 120
1998	145	364	263	162	127	1 062
1999	180	366	224	142	113	1 025
2000	219	370	216	109	100	1 013
2001	252	385	168	108	99	1 001
2002	270	407	160	113	89	1 032
2003	260	408	191	89	83	1 030
2004	227	433	217	102	84	1 064
2005	194	452	207	118	85	1 058
2006	176	454	178	134	80	1 022

Source: Press Release from Statistics Sweden 2007 no. 231.
Note: Comparability across years is in some cases not perfect, for details see the source.

weeks of absence. However, such measures also increased firms' incentives to screen potential employees for health status, to the disadvantage of people with health problems. Other changes involved a waiting period for benefits – so they were not paid on the first day of sickness absence – and a reduction in the replacement rate.

Other possible causes for the large extent of absence eventually leading to increased numbers of persons on disability pension are related to the rules of the system and their links to other welfare systems – a complicated issue. This includes concerns such as: under what circumstances is a worker entitled to sickness benefits, and how should the entitlement be tested? The system had long relied on workers possessing a strong work ethic and therefore had relatively few checks built into it. What is the role of doctors providing documents from which officials working for the social insurance office base their decisions? At the political level there seems to be agreement that the system has been too inactive and not enough attention to cost reduction has been built into the system.

It appears that during certain periods, more and more health conditions came to qualify for sickness benefits, while there were too few measures for bringing people back to work. As a consequence, more recent reform measures have led to more restrictive judgements on eligibility and to promote more activity from the side of the social insurance office. For these or other reasons, it can be observed that the number of days due to sickness absence peaked in 2002 and has since fallen. Whether or not this reduction will result in fewer people becoming disability pensioners in the future is an open question. Speaking against such a development are recent indications of increased rates of disability pension among young adults. Below we will turn to the issue of the situation of young adults in the matured welfare state.

Common themes for the social policy debate in many rich countries concern to what extent low-producing workers will lose employment and income due to competition from low-wage countries, and what can be done to remedy the situation? For Sweden, such issues centre around two socioeconomic groups in the population, the two groups that in the aggregate have had weaker income development than others: young adults and immigrants. Common to the two groups is that during long periods they have encountered increased difficulty establishing themselves in the labour market, and at the same time their coverage in the social security system is rather weak, or nonexistent due to a lack of work history. Subsequently these two categories dominate the group of people receiving social assistance and of the financially poor (Gustafsson *et al.*, 2007).

When the deep recession hit Sweden at the beginning of the 1990s, it affected young adults and recent immigrants as they were severely overrepresented among people looking for jobs. A major policy response directed towards young adults was a massive expansion of higher education. As a consequence, the new generation entering work life has considerably more years of education than the earlier cohorts. Globalisation and integration within the EU also means improved possibilities for studying and working abroad. However, the transition from youth into adulthood has become a longer and more complex period of life than was earlier the case. Labour force participation is low and unemployment common. For example, in 2006, a year with a good macro economy, only 51.0 per cent of persons aged 16–24 were in the labour force and the unemployment rate stood at 13.7 per cent (the corresponding numbers for people aged 25–54 were 88.6 per cent and 4.4 per cent). The changed period of young adulthood is also visible in young adults becoming parents at higher ages than in the preceding generation, and in perceived health problems being more prevalent among young adults than in the preceding birth cohorts.

Although transition into adulthood has much in common across countries, there are certain important differences.[16] Sweden has a family system whereby the completion of secondary school marks the end of the parents' financial responsibilities for their offspring. Most young adults also soon leave the parental home to start to live on their own. At the age of 24 only a relatively small minority of young adults reside with their parents and they are supposed to have separate finances from their parents. If a young adult attends higher education there are systems of support, including scholarships and loans from the public sector; such measures are not tested against the income of the parents.

The transition into adulthood could be unproblematic if a full-time job was waiting after the completion of one's education. Unfortunately, this is not usually the case. Many school-leavers experience spells of unemployment and economic inactivity. This is the background for why private transfers in Sweden typically run from middle-aged parent to their adult children (see Fritzell and Lennartsson, 2005), and also why many young adults apply for and receive social assistance. This means that the residual system functions as support during the transition phases, while in countries with other social welfare systems the family of origin would have taken the role.

Sweden has received many different flows of immigrants and, as a consequence, the size of the foreign-born population is on the rise. While in 1950 less than 2 per cent of all residents were foreign-born, the proportion had risen to more than 12 per cent by the end of 2005. Earlier, many immigrants were work migrants and their relatives who originated from other countries in Europe, whereas many who came during more recent decades were admitted as refugees or similar reasons, or for family unification. Many recent immigrants originate from countries outside Europe and by appearance and name are not difficult to distinguish from the majority.

Although Sweden put great efforts into integrating recent immigrants into its labour market, it has proven to be a difficult issue. A gap in yearly earnings between immigrants and natives surfaced in the early 1980s and increased until the mid-1990s for different age groups. Thereafter it has continued to increase among older workers and decreased among young adults (Gustafsson and Zheng, 2006). There is evidence that potential employers discriminate job seekers immigrants from 'non-western' countries (Carlsson and Roth, 2007). However, this might not be the full story and fundamental characteristics of the Swedish welfare state can also be suspected to have contributed to the problem. Earnings are more equally distributed in Sweden than in many other countries, meaning that there are few unskilled jobs for newcomers; jobs that can function as springboards to other jobs. Further, there are many relatively generous transfer programmes in Sweden, which might suggest that incentives to work in the organised labour market could be very low or nonexistent. This could particularly be the case for immigrants with many children. In addition, integration policy might not always have been efficient.

It is commonplace to note that the situation of many immigrants in Sweden today is not satisfactory due to serious problems in the labour market. Immigrants and their children make up a disproportionately large part of the poor, and many have living conditions that are clearly less favourable than those of the majority. Many live heavily concentrated in certain urban areas and issues of urban segregation have emerged in the political arena. The situation is also unsatisfactory from the perspective of the majority population because relatively large numbers of immigrants are supported via the public budget.

7.6 Concluding comments

According to many social welfare indicators, Sweden performs rather well compared to most other countries. This is particularly the case when concentrating on indicators that consider the situation of the less privileged. As shown by Munzi and Smeeding (in this volume, Chapter 2), Sweden belongs to the category of low income-inequality countries, but it cannot be claimed to be the country with the lowest levels of income inequality. Within the EU, Sweden is in the forefront concerning social welfare spending on the non-elderly measured as a proportion of GDP, but some other countries are closing in. Sweden used to be a trendsetter regarding the introduction and development of active labour market policy measures. However, nowadays such measures are more widespread, and Sweden does not appear particularly unique in this aspect (Eurostat, 2007). More uniqueness appears when turning to the gender aspect, as Sweden has adopted the two-earner system more comprehensively than possibly any other country in the region. Examples of this are found in the construction of the income tax system, the massive involvement in child care for young children, the comparatively generous parental insurance system and in the high labour force participation rate among females. Consistent with this, women are nowadays well-represented in parliament and central government. This said, it should also been remembered that the gender earnings gap has not tended to decrease, and women are not to any large degree rising to the best-paid jobs in the private sector.

When looking for changes in the Swedish welfare state since the beginning of the 1990s, the picture is somewhat mixed. Most likely, the gender equity aspect appears more clear today than it did earlier. For example, there are no signs indicating that the deep recession at the beginning of the 1990s led to more traditional gender roles. Turning to the universalistic character of the system, it appears to be unchanged, at least up to the autumn of 2006 when the new government came into office. However, a new element has definitely emerged, as the public sector is no longer the dominant provider of social services; market allocation has come to play a larger role within the public sector. In addition, unemployment is clearly more widespread in the population than during the 1960s, 1970s and 1980s.

In this exposition we have also touched upon aspects of the welfare state that might be problematic. It can be claimed that the present Swedish system provides good protection for many risks as well as income support in many situations. However, the experience of the Swedish system of sickness compensation and disability pension points to the need to define under which conditions eligibility can be established. If such conditions are not well defined, the system runs the risk of being financially unsustainable. The other lesson is that a generous system makes the issue of entry into the system critical. In many parts of the Swedish system, entry is connected to a history of work. This means that young adults and recent immigrants form the two main categories facing higher than average problems in maintaining themselves in Sweden, and it is those who come to mind when talking about poverty.

Notes

1. For comparisons of the various Nordic welfare states see, for example, Kautto *et al.* (1999).
2. For a survey see Arts and Gelisen (2002).
3. See Lindbeck (1997) who provides a good survey on research by economists on the Swedish model up to the mid-1990s. At the beginning of the 1990s Lindbeck chaired a government commission charged with diagnosing problems of the Swedish economy and suggesting remedies, see Lindbeck *et al.* (1994).
4. Interestingly enough, the two countries with the highest ranks of Human Development are Norway followed by Iceland – two Nordic countries.

5. The only exception is the Netherlands, a country some observers would classify as having a Nordic welfare state. The USA ranks number 16. Within the European community there is much interest in harmonising statistical reports on social indicators, see Atkinson *et al.* (2002). There are many studies comparing income inequality and poverty in Sweden and other countries using the Luxembourg Income Study. Kangas (2000) is an example where the comparison is based on Rawls' concept of social justice and another using recent data is Munzi and Smeeding (in this volume, Chapter 2).
6. The volumes were published during 2000 and 2001. The summary volume is available in English, see Ministry of Social Affairs (2002).
7. See, for example, Hort (1990) and Gustafsson (1995).
8. See Edebalk (2003). One should remember that this particular programme was not generous in any way and the elderly had to depend on other income sources to manage. Not until 1948 did the benefits in the old age system begin to approach what could be considered enough for a very modest living, and the elderly continued to be overrepresented among those receiving poor relief.
9. One aspect that has *not* survived was to lock in profits in successful firms with the purpose that they would be used for investments, leading to expansion and employment growth. Thus the Swedish Model was long a model promoting the expansion of existing private firms, not for facilitating the establishment of new firms or self employment.
10. For a long time there were few systematic efforts to evaluate the effectiveness of labour market programmes. However, by the establishment of the Institute of Labour Market Policy Evaluation this changed, see http://www.ifau.se.
11. For more information of the social insurance system at present, see http://www.forsakringskassan.se/sprak/eng.
12. Bettio and Plantenga (in this volume, Chapter 6) investigate to what extent there are different care regimes in Europe, finding that the Nordic countries can be considered as one category.
13. For more information on pre-schooling in Sweden see http://www.skolverket.se/sb/d/190. The issue of public provision of child care in Sweden and its economic consequences has been subject to several studies. The literature includes Gustafsson and Stafford (1992); Rosen (1996); Bergstrom and Blomquist (1996); Bjurek *et al.* (1996); and Gustafsson *et al.* (2002).
14. Albrecht *et al.* (2003); see also Booth (2007).
15. See, for example, Arai and Skogman Thoursie (2004), Broström *et al. (*2004); Henrekson and Persson (2004); and Palmer (2004).
16. See, for example, Ryan (2001) or Middleton (2002).

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8

Cultural Diversity and Economic Solidarity

Massimo D'Antoni and Ugo Pagano

8.1 Introduction

Cultural diversity creates obvious problems for the institution and operation of markets. It substantially reduces the liquidity of resources and raises major obstacles against their mobility. It also encourages identification with particular groups, which restricts economic solidarity and often impedes forms of reciprocal insurance outside the boundaries of those groups.

The creation of a common culture and common European institutions must be recognised as a precondition to mobility and exchange; it cannot be taken for granted, as it happens when a purely competitive view of the relation among states is adopted. In order to make this point, this chapter starts by discussing and integrating two different perspectives on the relation between cultural diversity and economic relations. The first considers cultural heterogeneity as exogenous, and studies how it can be an obstacle to economic development and redistribution, by inhibiting convenient economic relationships (in particular, reciprocal insurance contracts), and how it can explain the characteristics and the evolution of economic and political institutions.

The second point of view has been formulated most thoroughly in the works of Ernest Gellner and emphasises that economic transactions require preconditions – among them an endogenously determined level of cultural homogeneity – that are themselves the outcome of a political process. Although the latter perspective is less frequently considered, it can be traced back to an authoritative tradition.

In this chapter we consider the merits of these two points of view. We argue that both of them should be taken into account if a balanced view is to be given of the complex relationship between cultural diversity and economic solidarity within the context of European integration.

The next section discusses the approach prevalent in economic theories that takes cultural diversities to be exogenously given (like preferences in neoclassical theory) and analyses the relationship between cultural heterogeneity and economic policies on this basis.

The third section considers Gellner's thesis that the national states have played a crucial role in the formation of market societies. By creating a common national identity, Gellner argues, they have superseded the marked cultural diversity that typified agrarian societies because the social and geographical specificity of a large part of human resources greatly inhibited the institution of markets. Creation of the 'macro-institutions' of capitalism largely endogenised the level of cultural homogeneity and has made analysis of two distinct problems possible. The first of these problems concerns the complementarity between economic solidarity and cultural diversity, because the former, according to Gellner, may also influence the latter. The second problem is that the endogenisation of cultural diversity enables cultural standardisation and economic solidarity to be used as substitutes, in that both of them are devices that insure individuals against the risks typical of market societies. Individuals can, in fact, obtain just as much well being from a higher level of standardisation (which gives them a greater likelihood of finding alternative employment should they lose their jobs) as they can from a higher level of social protection (which, for example, pays them adequate unemployment benefit as they search for new employment).

The fourth section of the chapter compares the USA and the European Union, pointing out that the latter is confronted by the following paradox: whilst the marked cultural diversity existing within the European Union makes standardisation policies extremely costly, it may also increase the cost of adequate social protection policies which might be a substitute for standardisation. As the French and Dutch referendums on the European Constitution have shown, it is for this reason that European integration may be undermined on two fronts: on the one hand, by excessive standardisation; on the other, by scant social protection.

Finally, the concluding section argues that the project of European integration arises more from the 'Hobbesian' problem of creating common institutions stressed by Altiero Spinelli, Robbins and the other English federalists, than it does from the 'Smithian' problem of fostering competition among nations, and that these roots of the project for European unity should be borne in mind amid Europe's current difficulties, in order to promote a greater community where cultural diversity is not incompatible with common cultural standards, and competition is supported and integrated by social solidarity.

8.2 Heterogeneity and economic theory

As mentioned in the introduction, the predominant view among economists is that cultural differences among individuals are the exogenously given basis on which to identify the most appropriate institutional arrangement (optimal level of centralisation, the amount of redistributive expenditure, spending on public goods, political form), and thus to study all the effects of heterogeneity on economic performance.

8.2.1 Heterogeneity, well-being and economic performance

It is widely believed by economists that heterogeneity (racial, ethnic, religious, cultural) may have harmful effects on a community. This may depend firstly on the fact that the degree of heterogeneity may directly enter the utility function, because individuals attribute positive value to membership of a group of individuals similar to themselves (Alesina and La Ferrara, 2000).

Secondly, it is possible to argue that associated with greater heterogeneity is a decrease in the benefits deriving from the provision of a public good. The explanation for this is straightforward if heterogeneity gives rise to a greater variance in preferences relative to the quantity and quality of the public good provided, as in this case the 'distance' between the preferences of each individual and of the median voter is higher on average. The nexus between ethnic diversity and the possibility of implementing public policies is dramatically evident in developing countries.[1]

The idea that associated with a greater dispersion of preferences is a lower average level of satisfaction with public goods is at the basis of Alesina and Spolaore's analysis (1997; see also Alesina, Spolaore and Wacziarg, 2000) on the optimal size of nations. If an increase in size (because of the inclusion of 'peripheral' populations) augments heterogeneity, and if in addition to these costs we take account of the benefits deriving from size (the presence of scale economies in the production of public goods, the advantages accruing from the breadth of the market, the internalisation of political externalities, or the possibility of mutual insurance among regions), we have a trade-off which enables us to 'close' the model. Optimal number and size will be such that the optimal balance is achieved between the costs of heterogeneity and the advantages of larger size. They are, that is to say, determined by the rational choice of individuals, given their preferences regarding public goods.

Moreover, greater heterogeneity may corrode the reputation mechanisms that support individual interaction in a context of repeated transactions, given that both sanctioning devices and reciprocity mechanisms are more effective, the more homogeneous the group (La Ferrara 2004; but see also Greif, 1993).

Alesina and La Ferrara (2005) consider these arguments to be partly countervailed by some benefits of the heterogeneity of the population: if cultural or ethnic differentiation gives rise to differentiated skills in an economy, a heterogeneous society will be able to achieve a better division of labour and greater innovation. In support of this thesis, Alesina and La Ferrara cite the theoretical works of Hong and Page (1998) and Alesina, Spolaore and Wacziarg (2000), who formalise the existence of a positive relation between variety (or individuals and inputs) and performance.

Cultural heterogeneity gives greater opportunities to achieve an advantageous division of labour. This clearly echoes the idea that a 'melting pot' on the American pattern may produce the reciprocal enrichment of communities and give greater dynamism to the economy.

Various empirical studies seemingly confirm that, while the relationship between heterogeneity and economic performance is negative for low levels of development, it becomes positive for higher levels of income (in the presence of democratic political systems).

8.2.2 Heterogeneity and solidarity

A positive relation is commonly observed between the degree of cultural homogeneity and the extent of welfare policies. Alesina, Glaeser and Sacerdote (2001) attribute the lower level of redistribution in the USA, compared with individual European states, partly to greater ethnic fragmentation.

The thesis that cultural heterogeneity within a community may generate tensions inhibiting the development of economic solidarity (that is, the view that cultural homogeneity and solidarity are fundamentally complementary) can be justified on the basis of numerous mechanisms (Van Parijs, 2004).

Firstly, cultural differences structure the channels of communication and exchange, dividing society into sub-units (which may undermine 'civic' solidarity), and reducing consensus for redistribution traversing the boundaries of each unity. Redistribution loses legitimacy among the less well-off if the more affluent are clearly perceived as belonging to a distinct group, and if linguistic racial, ethnic and religious differences overlap with social and economic ones in respect to which the redistribution takes place.

Secondly, the presence of linguistic and cultural barriers may reduce cohesion among non-affluent groups if these are fragmented, thereby obstructing association in the collective organisations (trade unions, pressure groups) which often advance demands for social protection.

Indirect evidence of the inverse relationship between heterogeneity and solidarity is also provided by empirical studies demonstrating that ethnic differences within a group reduce the level of contribution to the supply of public goods (La Ferrara, 2004).

8.2.3 Some critical remarks

As highlighted by the many analysts, the main difficulties in interpreting the inverse connection between heterogeneity and solidarity stem from two facts.

In the first place, the concept of heterogeneity is not unequivocal, and different specifications of it may have very diverse economic implications. For example, consider the differing implications of two forms of heterogeneity, such as *local* diversity, that is, the coexistence on the same territory of different communities (for instance, immigrants in urban areas, ghettoes, the case of Northern Ireland) and *territorial* diversity between different yet homogeneous areas constituting a single national unit (Belgium, for instance).

In the second place, the characteristics of the solidarity-delivering institutions are also of great importance. For example, consider the difference between welfare policies providing benefits linked to labour market participation, which may encourage integration, and means-tested policies, which – by introducing a high implicit marginal tax rate on lower levels of income – may instead discourage the regularisation of the informal economy and increase alienation among disadvantaged ethnic groups (immigrants for example).

These brief remarks suffice to counsel some caution in the interpretation of cross-country data, which necessarily involve simplifications and lump dissimilar phenomena together. They also suggest that these are matters requiring careful empirical analysis and a solid theoretical basis that are apt to single out the relevant dimensions of heterogeneity.

Here, however, we shall concentrate on a more general criticism that has a close bearing on some of the arguments developed in the next sections. A shortcoming, apparent in many of the studies cited above (and particularly evident in empirical analyses), is that they do not provide a sufficiently 'objective' definition of the variable subject to analysis.

The nature of the heterogeneity, taken as the independent variable, is surprisingly contingent on the particular community being studied. In the United States, skin colour and ethnic origin are of particular importance, while religion assumes secondary significance. Elsewhere, the principal dimension is instead linguistic (as, for example, in Belgium). In Northern Ireland religious membership prevails over other characteristics. This is the problem of the so-called 'salience' of a certain dimension of heterogeneity.

It has been suggested that, in order to deal with the problem, one must 'identify correctly for every country what the salient divisions are' (Fearon, 2003). Apart from the logical circularity of assessing the importance of heterogeneity by identifying its dimensions on the basis of the fact that they are important, we maintain that this solution conceals the fact that the nature and degree of heterogeneity may be viewed as more the effect than the cause of economic processes.

The question can be addressed at a deeper-lying level. The extent to which the problem of identity is central to disciplines different from economics is well known. Historians, sociologists, psychologists and philosophers have provided explanations of the processes of identity formation at various levels (the nation, gender, group, and so on). However, these explanations differ from the economic one in its neoclassical version in that they emphasise the artificial ('constructed') character of cultural, ethnic, national, and even gender identities. The findings of these disciplines therefore suggest that the cause/effect relation can be reversed: although it is undeniable that the presence of heterogeneity affects public policies and economic performance, we may nonetheless ask how economic processes and institutions and public policies have led to the predominance of certain identities, or to the development of differing degrees of homogeneity, and so on.

For example, it is indubitable that crucial processes in the historical evolution of recent centuries have been driven by an endeavour to modify the degree of homogeneity by altering people's perceptions of their identity (consider the role of ideologies and, in particular, the role of nationalisms examined in the next section) – perhaps to a greater extent than cultural differences have determined political aggregations, as neoclassical economic theory suggests.

Why is it that, in a particular context, a difference with respect to a certain dimension acquires economic significance while in other contexts it is irrelevant? The nexus among heterogeneity, economic institutions and political processes is undoubtedly much more complex than is implied by the inclusion of heterogeneity among the 'fundamentals', that is, among the exogenous variables. We should instead envisage these three variables as co-determinants, so that the differences are endogenous to economic development and to patterns of political interaction.

This endogeneity also concerns the relationships among the characteristics that differentiate among individuals. The possibility of differentiation according to a characteristic may depend on the presence, or the absence, of other common characteristics. On the one hand, differentiation according to one characteristic may increase differentiation according to another. On the other hand, the grouping of individuals according to particular characteristics (which, as we shall see, is one of the advantages of federalism) can often only happen if certain other differentiating features are absent. In both political and economic markets, the mobility of individuals, leading often to the formation of diversified groups, is implicitly assumed, but creation of those markets requires the elimination of numerous specific differences and characteristics, that is a high degree of homogeneity in some other relevant dimensions. In the next section, we will try to show that it can only be achieved by means of processes and institutions which are often ignored by current economic theories.

8.3 The creation of the national states: cultural homogeneity and economic solidarity as substitutes

Neo-institutionalist theorists have stressed that the complexity of institutions is often due to the specificity of resources, or, in other words, to the scant liquidity of many of the investments necessary for economic transactions. A resource is said to be 'specific' when its value is reduced significantly outside its current or planned use; conversely, a resource can be 'generic' (or 'liquid') if it has many possible uses.

Williamson (1985) has shown that, when the hypothesis of resources specificity is joined together with the hypotheses of contractual incompleteness and agent 'opportunism', if transactions are relatively frequent, forms of private governance (often sophisticated ones) tend to emerge. The firm, with its internal system of incentives and sanctions, is maybe the best example of private governance ordering.

However, in many cases, private institutions like the firm may perform a 'second-order' or residual role with respect to the macro-institutions, on which we focus in the present chapter. Of great importance in this respect are the writings of Ernest Gellner (1983, 1998, 1999), who has emphasised the role performed by the national states in creating the conditions that have made numerous resources multi-purpose and liquid.[2]

In Gellner's view, the main difference between agrarian societies and capitalist societies consists less in the degree of the division of labour – since this is very marked in the former as well – than in the mobility of the resources required by the process of creative destruction intrinsic to the capitalist system.

The agrarian societies, which preceded the advent of capitalism, were characterised by a marked cultural diversity, both horizontal and vertical, which rendered large part of resources 'specific'. This 'specificity' was much greater than the limited specificity that neo-institutionalist theorists view as characterising capitalism. It prevented an individual from using a certain skill, or a certain body of knowledge tied to a trade or a craft, outside the local context in which s/he happened to live as a member of that social organisation.

Very different dialects were spoken even in neighbouring villages, and the various classes had different languages, customs and traditions. Far from being a problem for the workings of pre-industrial economies, though, this high degree of specificity instead favoured the invariant reproduction over time of the same social and economic structure.

By spreading – and often also by inventing (Hobsbawm, 1992; Hobsbawm and Ranger, 1983) – a homogeneous culture and traditions, the national states eliminated the multiple specificities that had restricted both horizontal and vertical mobility in agrarian societies. Once mobility became possible, it helped reinforce cultural homogeneity, thereby generating a process of reciprocal support between resources mobility and reduced cultural diversity.

The extension of common codes of communication, the sharing by a larger community of the same language and the same institutions – in short, a homogeneous culture – made the costs of investing in human capital easier to bear, because the consequent ability to respond to adverse shocks through mobility provided individuals with insurance against these risks, as when displaced workers transferred their skills to other regions or other sectors.

The increased liquidity of resources favoured innovation and creative destruction, restricting the likelihood that expectations of future failures might inhibit the investments necessary for innovation.

The creation of the macro-institutions necessary to augment the liquidity of resources, and thereby make a market economy possible, was a process neither straightforward nor automatic. Agrarian institutions have dominated large parts of human history, and only in very specific historical conditions has it been possible to break away from these forms of economic organisation.

In agrarian economies, the presence of numerous cultures specific to territories and social classes immobilised and stagnated societies in which cultural barriers prevented individuals from being remunerated for their abilities. At the same time, the immobility of those societies favoured their cultural differentiation and thus created a highly stable institutional equilibrium, which was very difficult to leave.

Two conditions engendered a relation of reciprocal reinforcement between mobility and cultural homogeneity, thereby fostering transition to a modern industrial economy. The first was the presence of a political authority with dominance over a particular territory. The second was the existence of a 'superior culture' which, because it was recognised as such by the majority of the population, could be easily established by the political authority in the territory under its domination. To use Gellner's terminology, the ideal conditions enabling creation of the macro-institutions complementary to a market economy were the presence of both a 'groom' (a state with dominion over a particular territory) and a 'bride' (a superior culture recognised as such). Their 'marriage' generated a reciprocal reinforcement between cultural homogeneity and resource mobility that combined with greater economic stability. Table 8.1 shows the results of the presence or absence of one or other of the two spouses.

The wedding of groom and bride (case A) led to the formation of the first national states in France and Britain. But Italy and Germany, which pertained to case B – presence of the groom (a recognised superior culture and language) but absence of the bride – had to postpone the marriage until they completed the process of national unification. The opposite situation (case C) of the presence of a groom-state and the absence of

Table 8.1 Political authority, culture and the creation of nation-states

	Loyalty to a political authority	**Absence of loyalty to a political authority**
Presence of a single superior culture	(A) First national states (France, Britain)	(B) National unification (Italy, Germany)
Presence of diverse superior cultures	(C) Multicultural national states (Switzerland, Belgium)	(D) Conflict and/or ethnic cleansing (Yugoslavia, Turkey and Greece)

a (single) bride-culture is more problematic: it led to dramatic failure in the case of the Austro-Hungarian Empire and has been successful only in some instances (Switzerland and Belgium), also by virtue of multilingualism and federalism. Although case C is a rather rare combination and is not explicitly considered by Gellner, it is particularly interesting (Van Parijs, 2003) because it comprises many of the problems now confronting Europe, where EEC institutions face a very high degree of cultural diversity, and, in many respects, it will be the focus of the next section. Finally, attempts to imitate the classic model of the national state in the absence of both bride and groom have led to violent conflicts and various forms of ethnic cleansing (the former Yugoslavia, Turkey and Greece are among the most dramatic examples of case D).

Cultural standardisation and the creation of a shared national identity are not the only instruments with which national states can counter the risks deriving from the creative destruction intrinsic to capitalist development. The national state has historically relied on a second device as well: the creation of shock absorbers able to neutralise the worst effects of such risks. In Sinn's words (1996, p. 260): 'the government budget is by far the largest risk absorption device available'.

In many cases technology yields high labour productivity only by developing skills that are difficult to transfer to another job (or, in the language of this chapter, are highly *illiquid*). It is customary to distinguish between specificity relative to the firm and specificity relative to the sector. Each of these cases gives rise to problems and solutions with distinctive features (and to different 'types' of capitalism, as the growing body of literature on the varieties of capitalism stresses). In the presence of technologies which require high labour specialisation, those who invest in human capital are exposed to serious risks of redundancy if the firm or sector is 'pushed out of the market'. For various reasons, markets are unable to provide insurance against such risks, and this lack of coverage may inhibit investments. In other words, a market failure ensues which may justify public intervention in the form of some kind of social protection.

We therefore interpret the social protection system as an insurance device which provides coverage against otherwise uninsurable shocks that affect investments in specific human capital. This view has too often been neglected in the current political economy debate. It originated with Domar and Musgrave (1944) and has recently been effectively reprised by, amongst others, Barr (1992) and Sinn (1995, 1996). As an insurance device, the welfare state may enable the undertaking of productive investments by risk-averse agents. This point of view is adopted, for example, by Estevez-Abe *et al.* (2001) and Iversen and Soskice (2001). They explore the nature of the relation between diverse welfare state 'models' and the degree of specificity and intensity of investments in human capital and show that these investments are associated with a higher level of protection, in the form of both employment (employment protection legislation, other institutions providing job security, etc.) and unemployment protections.

In other words, the national state encourages agents to invest in human capital both by exploiting the complementarity between cultural homogeneity and economic solidarity, and by using the most suitable combination of these two instruments.[3]

Note that, following this logic, it is possible to identify both a relationship of complementarity between cultural homogeneity and solidarity and one of substitution between the two instruments available to the national state.

On the one hand, if the endogeneity of the degree of cultural diversity is recognised, it is possible to appreciate the influence exerted by mutual solidarity policies on the degree of cultural homogeneity. Such policies may lead to the sharing of particular values, and they may reduce the cultural diversity that in agrarian societies frequently marked – often ostentatiously – social differences. Economic solidarity, therefore, is not only influenced by the degree of cultural homogeneity, it is also complementary to it.

On the other hand, it should be clear that policies aimed at increasing cultural standardisation and social protection give rise to increasing marginal costs: cultural standardisation entails decreasing returns because, as languages, codes and rules are standardised, the cost of losing characteristics specifically useful in particular contexts increasingly outweighs the advantages accruing from their versatility;[4] the extension of social protection creates increasing problems of reduced incentives (the standard moral hazard effect) that, above a certain level, may exceed the advantages deriving from risk reduction. It is therefore possible, with relatively bland hypotheses, to construct a simple formal model where the two instruments are substitute, that is, where the optimal level of social protection is a decreasing function of the level of cultural homogeneity reached by a certain collectivity (D'Antoni and Pagano, 2002). Because both of these devices serve the same purpose – that of reducing the risks connected with the development of the capitalist economy – the more intense use of one of them reduces the need to resort to the other.

We would point out that, whereas most of the literature surveyed in the previous section drew the conclusion that the 'optimal' level of economic solidarity is an increasing function of the level of homogeneity because homogeneity makes solidarity less costly in terms of consensus, our interpretation leads to the opposite conclusion.

The optimal mix between social protection and standardisation depends on the specific costs that each of these two policies produces in a given community. The determinants of these costs are, for example, the initial degree of heterogeneity and the costs entailed by the generalised acceptance of common standards (cultural, linguistic, legal).

8.4 Beyond the limits of nation-states: the European Union and globalisation

Traditional national states have been able to make the best use of both complementarity and substitution relationships between social protection and economic homogeneity. The spread of a single culture has stimulated a sense of economic solidarity and consensus for adequate social protection, and these in their turn have enhanced the cultural integration of the population. At the same time, the national state can choose the best combination between cultural homogeneity and social protection in order to insure its citizens against the risks of specialisation in a changeable market society, thereby leaving the private sphere to deal with a relatively minor problem of insurance against the risks of specificity.

In our view, the recent institutional evolution has given the European Union the difficult task of recasting the mix of cultural homogeneity and social protection in a context where the adoption of appropriate social protection policies is particularly problematic.

While nation-states have played a fundamental role in the creation of the relatively 'liquid' resources characteristic of markets, the mechanism of reciprocal reinforcement between cultural standardisation and market mobility does not restrict the force of its dynamics to within the boundaries of national states. The latter, with their narrow boundaries, transform themselves into impediments against the markets whose development they initially fostered.

Some countries (particularly the United States, with its frontier in first real and then symbolic movement) display the advantages of broader aggregations, and they seem to have developed a sense of 'global mission'. Their economic power induces them to extend their language and culture well beyond their national boundaries. The other countries undergo this process of cultural standardisation, which they had previously carried forward within their boundaries. Because of the different capacities to exploit the opportunities of globalisation, their citizens divide between 'provincials' and 'cosmopolitans' and the mix between social protection and the liquidity of the skills which guarantee people's incomes become controversial. The 'provincials' feel that the increasingly restricted liquidity offered by the market defined by the national culture makes them vulnerable, and they would willingly replace it with greater social protection. The 'cosmopolitans', who have considerably more liquidity, are instead concerned to reduce the costs of social protection, since they do not need its benefits.

Globalisation has introduced contradictory pressures. On the one hand, because the opening up of markets increases the mobility of tax bases (primarily capital income), it also increases the costs of redistribution, and therefore jeopardises the sustainability of a European-style welfare state. On the other hand, open economies of small size are those that benefit most from a developed social protection system able to counter the risks due to imported shocks.

It may be argued that, by reducing the costs of mobility, the increasing standardisation introduced by the European Community institutions provides a safety valve for regional shocks, with the consequence that it is less necessary to resort to social protection devices.

However, it is possible to show (Arachi and D'Antoni, 2004) that this conclusion is incorrect in a context where, despite the formal elimination of barriers among states, the mobility of individuals is still greatly restricted (for example, by a persistently high level of cultural and linguistic heterogeneity).

In the presence of limited labour mobility, economic integration (specifically, the growing integration of capital markets, which enables firms to respond to globalisation by 'relocating' production) may in fact increase the riskiness of investments in human capital. In other words, the asymmetric integration of production factor markets distinctive of Continental Europe, where the mobility costs for labour are very high compared, for example, with the USA, reduces the risks for firms, but increases those borne by less mobile human capital. The result is an inefficiently low level of investment in specific human capital, and the need to fall back on skills which are more liquid and generic but in many cases less qualified. In this context, social protection functions as a corrective which restores an adequate level of profitability to investments in specific human capital, and this increases the productivity of the system. The benefits of social protection are therefore enhanced by greater international integration.

It is indeed true that the costs of social protection are increased by capital mobility, because in a context of integration the costs of the taxation weighing upon labour are difficult to shift to capital. However, if the former effect (increased benefits from protection) prevails over the latter (increased costs of protection), the optimal level of protection will be an increasing function of the degree of economic integration.

Another important issue is production diversification within each country. Countering sectoral shocks by means of redistribution requires production to be sufficiently diversified. In a world where economic integration is proceeding much more rapidly than political integration, the number of sectors present in a single country tends to diminish. Each country tends to specialise in the sectors where it has comparative advantages over other countries. This comes about not only via the resources considered by the standard theory of comparative advantage but also via the comparative institutional advantages that characterise countries (Hall and Soskice, 2001).[5]

Because the absence of political integration rules out the 'first-best' solutions of reciprocal insurance among individual countries (that is, a utopian International Welfare State), optimal productive specialisation should be pushed to the point where the 'gains from trade' that it yields are greater than the risks of restricting the number of productive sectors, in terms of the countries' higher vulnerability to sectoral shocks.[6] However, while the citizens of a country privately appropriate the benefits of specialisation, reciprocal insurance among productive sectors is a public good subject to the classic problem of free-riding (Bowles and Pagano, 2006). In the absence of first-best solutions, national states must choose between two difficult alternatives. The lack of public intervention, in fact, gives rise to an inordinately high level of risk due to the excessive reduction of the number of productive sectors in each country. Instead, a public policy designed to curb a country's productive specialisation is difficult to implement, and it is likely to prompt 'rent-seeking' behaviour by firms, which apply a pressure to survive well above the threshold constituted by their usefulness for reciprocal insurance among sectors.

Although in principle 'federal' aggregations of states may provide a way out of these dilemmas, absent a strong political authority it is difficult that such aggregations could exploit the relationships of complementarity and substitution between social protection and cultural homogeneity in a manner resembling what happened in traditional nation-states.

Considered as a whole, the United States and the European Union differ from the traditional national states in two main ways.

The USA was the first aggregation to demonstrate the advantages of more extensive markets in which all resources (primarily labour) increase their liquidity and their value. Unlike the traditional national states, however, the USA is characterised by a combination of resources liquidity and social protection that is substantially weighted in favour of the former. While the breadth of the market and a homogeneous cultural and legal space have considerably increased the liquidity of resources, the stratification of ethnic groups due to successive waves of immigration have restricted economic solidarity and the possibility of adequate investments in social protection. In a certain sense, in contrast to the traditional national states, the USA has replaced social protection with extensive cultural standardisation.

Europe, considered as a whole, is the polar opposite of the United States. Greater social solidarity within individual states (the majority of which were originally traditional nation-states) combines with marked linguistic and cultural diversity among them. The integration process makes the social protection provided by the national states of the European Union increasingly less effective (and a European welfare state is at the moment a politically difficult alternative). Yet, unlike the United States, Europe cannot count on a high liquidity of resources (because of the great cultural and linguistic diversity of the EU Member States). The forceful introduction of legislative and cultural standardisation, accompanied by limitations on social protection, is a very costly policy in Europe, and it may bring about increasingly fierce reactions against the project for European integration. Although the spread of English, the Erasmus student exchange programmes, the 'Bologna process', and many other initiatives have been useful in shaping a single European culture, it should not be forgotten that the multiplicity of European languages and traditions is widely viewed as an asset which should not be sacrificed for the sake of mobility and the market.

The traditional national states, mainly because their educational systems were based on national syllabuses, were able to reduce to a great extent both 'horizontal' cultural differences among different geographical areas and 'vertical' ones among ethnic groups and social classes in the same geographical area.

If the traditional national state is depicted as case (1) in Table 8.2, the United States can be represented as case (2), where strong horizontal cultural homogeneity among the country's various states and regions is no longer matched by the vertical homogeneity that was once an important feature of the traditional national states. In almost every region of the USA, in fact, ethnic groups are vertically divided into a hierarchy

Table 8.2 Vertical and horizontal cultural homogeneity and differentiation

	Vertical cultural homogeneity	**Vertical cultural differentiation**
Horizontal cultural homogeneity	(1) Social and regional solidarity (*traditional national states*)	(2) Regional solidarity without social solidarity (*United States*)
Horizontal cultural differentiation	(3) Social solidarity without regional solidarity (*Europe*)	(4) Absence of social and regional solidarity (*The future of Europe?)*

ranging from WASPs to Hispanics down to Blacks. The country has a considerable capacity for solidarity which leads to redistribution among its various regions (for instance, consider the hurricanes which hit areas of the southern United States). However, this solidarity is severely limited when, as in the case of New Orleans, horizontal differences coincide with vertical ones among areas inhabited by whites and blacks. It is therefore no accident that the guarantees covering American citizens against job losses and other hazards of market societies consist more in the liquidity of their investments in human capital than in forms of social protection. In fact, homogeneity among states and the redistribution mechanisms operating among them make the region of the country in which one lives largely irrelevant, whereas ethnic differentiation – also due to relatively recent immigration – makes adequate social protection difficult to guarantee.

The European Union differs from the traditional national state in a manner which is the reverse of the United States, and can be represented by the combination of horizontal differentiation and vertical homogeneity (case (3) in Table 8.2). Internally, the EU Member States – which were previously traditional national states – are vertically more homogeneous than the United States, but precisely for this reason are horizontally more differentiated. As a result, while redistributive policies are (still) possible within individual EU Member States, redistribution among them is minimal compared with the United States. Increasing immigration from the poorer countries of the European Union, and high levels of immigration from non-EU countries, may sooner or later lead some countries of the Union to case (4) in Table 8.2, where both the conditions which characterised the traditional national states are lacking. In this situation, 'more cosmopolitan' citizens may regard the greater opportunities offered by the European Union as sufficient compensation for the slackening of social protection. But 'more provincial' citizens may suffer from both the increased competition due to immigration and the gradual disintegration of social cohesion policies. And both categories of citizens may under invest in human capital in so far as, unlike the traditional national states, the European Union is unable to a achieve a reasonable mix between cultural standardisation and social solidarity.

To summarise: Europe differs from the United States in that it is unable to substitute (except to a minimal extent) social protection with the increased liquidity of human resources. Europe as a whole is therefore necessarily in need of a higher level of protection. However, the complementarity and substitution relations between cultural homogeneity and social protection imply that Europe is now in the paradoxical situation where forms of European social protection are extremely difficult for the same reason that they are so necessary. The absence of cultural homogeneity hampers the introduction of the social protection policies that, in Europe, are necessary precisely because of cultural diversity and the consequent illiquidity of many human resources. In Europe, the complementarity between economic solidarity and cultural homogeneity makes it impossible to achieve their satisfactory combination.

If Europe's current problem is viewed as an imbalance in the mix of social protection and cultural standardisation provided by the European Community institutions, it is possible to account for the apparent paradox of the French referendum on the European Constitution, where the latter was accused of being both too courageous and too timid. For some, the Constitution was excessive because it called for acceleration of the standardisation process; for others, it was insufficient because it did not combine standardisation with adequate social protection policies. In effect, therefore, these were two sides of the same dilemma.

8.5 Two views of federalism

According to Abba Lerner (1972, p. 259), the relation between economics and politics could be framed in the following way:

> An economic transaction is a solved political problem. Economics has gained the title of queen of the social sciences by choosing *solved* political problems as its domain.

Years before, as it grew increasingly evident that international political problems would lead to war, Lionel Robbins (1937) – while emphasising the merits of economic science – made the shortcomings of this approach very clear. He did so in an essay which, through the good offices of Luigi Einaudi, reached and influenced Altiero Spinelli and Ernesto Rossi in their confinement on the island of Ventotene. Referring to the tradition of Smith and Bentham, Robbins (p. 50) wrote that 'in their preoccupation with the discovery of the laws of the market, they were apt to take the market itself for granted'.

Whilst it was true – Robbins contended – that economic transactions could resolve certain economic problems, it was the task of politics to create the conditions that made those transactions possible, and to develop certain complex institutions such as markets. The two perspectives on cultural diversity and economic relations we have discussed at length in the previous sections of this chapter can be seen as corresponding to the different views of Lerner and Robbins on the relation between market and politics.

The federalist movement, initiated in England by Beveridge and Robbins and then developed by Spinelli and Rossi, had precisely the aim of creating the political conditions in which international – and primarily European – markets could operate.

Conversely, the model of federalism that emerges from a large part of economic studies on the relationship among heterogeneity, the structuring of the levels of government, and public policies, belongs to the tradition that, since Adam Smith, has regarded competition and the elimination of monopolies as the best way to increase social well-being. Decentralisation of the state's powers and their reciprocal competition in a setting where factor mobility can be obtained simply by removing monopolistic barriers have been viewed as devices to improve efficiency.

Competition may be an ingenious solution for the problem of heterogeneous preferences in the provision of public goods. This conclusion is synthesised in the 'Tiebout conjecture' which, notwithstanding the abstractness of its assumptions, suggests that combining the multiplicity of the jurisdictions with the mobility of the individuals may attenuate the problems caused by heterogeneity by encouraging individuals to cluster into culturally homogeneous units. When the existence of a large number of jurisdictions is reconciled with the need to guarantee sufficient economies of scale for states, transactions among states and individuals enable the latter to cluster according to their preferences and ethnic-cultural characteristics (Alesina and Spolaore, 1997). In each state or jurisdiction, the higher degree of homogeneity among individuals allows each of them to benefit in the best way from the particular public goods that they desire. Thus we have a typical success by the 'queen of the social sciences': 'economic transactions' generate 'solved political problems'. If the economies of scale were not important, so that having large states would be of little use, the 'supply' of states would be rich enough in number and diversification to make democratic decisions within states largely useless: competition, in fact, would be the best guarantee for the citizen-consumer.

There is no doubt that this mechanism might prove useful (perhaps in a less extreme form) for some of the dimensions of heterogeneity examined in section 8.2. But the problem still remains that the low (virtually zero) costs of mobility assumed in Tiebout-like models (such as Alesina and Spolaore, 1997) presuppose that for a good number of those dimensions homogeneity has been achieved which enables individuals to cluster together according to other, heterogeneous characteristics. It will be possible, for example, to move at low cost to states with the desired mix of taxes and public goods if there exist a language, an occupational structure, and an educational system similar to those in the state of origin. It is not usually recognised that it is homogeneity along some dimensions which enables people to cluster in jurisdictions that are heterogeneous in other dimensions. This twofold nature of federalism induces emphasis to be placed on the 'Smithian' aspect when these homogeneous characteristics can be taken for granted, but it shifts the emphasis to a problem that we may call 'Hobbesian' where what is at issue is the construction of common ground among diverse states with often conflicting interests.

Smithian federalism is typical of political aggregations with strongly homogeneous national identities which decentralise some functions to peripheral units. Individuals may move freely among states, either because one of the latter (which is now the federal state) has created a strong common identity which makes the cultural identities of the individual states belonging to the federation largely irrelevant (for example, the German Federal Republic), or because the individual states and the federal state have developed *pari passu* (for example, the United States of America). The Hobbesian problem of limiting the sovereignty of the peripheral units in order to ensure the emergence and development of common characteristics has, in this case, already been solved by the prior existence of a national state (which has changed into a federal authority) or by the synchronous development of peripheral and federal authorities.

The roots of European federalism are instead markedly Hobbesian, and they date back to the tragic events of the two world wars. From their confinement on the island of Ventotene, Altiero Spinelli and Ernesto Rossi criticised those who wanted simply to restore the European democratic regimes on conclusion of the war with no endeavour to forge a federative pact among them:

> Whereas at a national level, the intelligent restorationist realizes that it is not possible to rely simply on the good will of citizens, but that it is necessary instead to establish a solid body of laws backed by coercive power in order to curb and direct individual activities, relationships among states are still based entirely on the good and peaceable will of each them, the assumption being that the interest of an individual state entirely coincides with the interest of all states. (Spinelli and Rossi 1944, p. 36)

As Norberto Bobbio (2004, p. xxxv) has pointed out, the federalist view takes Hobbes as one of its referents. It extends the reason that induced Hobbes to wish for the birth of the state to the level of the international order, and it arose when, during the Second World War:

> [I]n the minds of some, the central idea gained ground that the essential contradiction responsible for the crisis, war, misery and exploitation afflicting our societies is the existence of sovereign states, geographically, economically and militarily isolated, considered by the other states to be competitors and potential enemies, and each living with respect to the others in a state of *bellum omnium contra omnes*. (Spinelli and Rossi 1944, pp. 3–4[7])

This view recognises the fact that 'the equal right of all nations to organize themselves into independent states' has in the end brought about a grave 'crisis of modern civilization'.[8] The problem of federalism therefore becomes that of restricting the sovereignty of national states while at the same time constructing a common cultural identity that partly replaces the well-established identities of individual states. The role of the federal state – the cultural and legislative homogeneity and inter-state economic solidarity which Smithian federalism of the USA assumes as its point of departure – has become the crucial problem of European federalism. In this case, the problem has not been that of fostering Smithian competition among states, but rather of restricting Hobbesian competition among political units with the strongly-defined cultural identities that led to two world wars.

Although European integration has brought increasing benefits of a Smithian type, the central problem is still that of identifying institutions which allow a closely integrated common market to operate efficiently – and, in particular, the institutions that ensured the existence of a common culture and sufficient economic solidarity within the national states that are now members of the European Union.

We believe that Europe must firstly engender a dynamic of reciprocal reinforcement between moderate cultural and linguistic standardisation and moderate mobility that does not excessively erode regional and national identities. Secondly, Europe must introduce forms of redistribution among the European countries that will naturally complement the increasing specialisation of states, but at the same time do not impede the formation of a sense of European solidarity. Finally, in Europe the national welfare states must protect their citizens in a situation where the enlargement of markets, because they involve the productive factors asymmetrically, do not provide adequate protection, but on the contrary seemingly increase the risks of investment in human capital. All of the items of this challenging agenda raise delicate Hobbesian problems of (moderate) transfers of sovereignty from the national states to the European Union. If they are successfully resolved, we may one day be able to say that some 'solved political problems' have generated numerous and beneficial 'economic transactions'.

Notes

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1. Easterly and Levine (1997) consider the effect of ethnic diversity on development in Africa. They find evidence supporting the thesis that ethnic diversity induces polarisation and rent-seeking behaviour, thus reducing consensus on the provision of public goods essential to development.
2. For a survey of Gellner's works which emphasises their importance for the economic literature, see Pagano (1995, 2003). Other approaches, such as Anderson (1991), stress the need for identity (recently considered also by Akerlof and Kranton, 2005) as one of the essential ingredients in the formation of national states.
3. It is in this institutional context that firms and other agents are confronted by the residual problems of specificity that require, according to neo-institutionalist theory (Williamson, 1985), costly and complex forms of private governance. In the absence of national macro-institutions, the specificity problems facing private agents would be considerably more onerous. They would require numerous types of guarantees for specific resources which,

although they offered locally appropriate solutions, would greatly restrict market mobility. A serious shortcoming of neo-institutionalist theories, therefore, is that they take the macro-institutions that make resources liquid for granted.

4. The less specific a skill or characteristic, that is the more liquid it is, the less productive it will be in its best use. By standardising languages, codes and rules, we make them less tailored to each specific context. Hence, there is clearly a limit to standardisation.
5. Comparative institutional advantage differs from standard comparative advantage because it depends on the specific merits of the institutions a certain nation (in comparison to another) which may favour the advantageous specialisation in certain sector (instead than in another sector). A consequence of comparative institutional advantage is that increasing economic integration may increase institutional diversity because each country specialises in those sectors where it has a comparative institutional advantage – a tendency that may be (partially) offset by other characteristics of globalisation (see Pagano, 2007).
6. It is assumed here that the shocks affect asymmetrically different sectors of the economy, so that for a single country having a larger portfolio of sectors means having better opportunities to pool risks by a suitable redistribution mechanism.
7. This passage, which is part of the preface, was in fact written by Eugenio Colorni and undersigned 'Il Movimento Italiano per la Federazione Europea'.
8. Spinelli and Rossi (1944, p. 9). Spinelli and Rossi were well aware of the fact that 'the ideology of national independence has been a powerful factor for progress'; 'it has enabled paltry provincialism to be overcome' and it 'has eliminated many of the obstacles that circulated/impeded the circulation of people and goods'.

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Conclusion

Lilia Costabile

1 This book has investigated the relationship between the economic and the social dimensions of the European project. The results of our research suggest that an integrated approach should be taken to economic and social objectives, on the grounds that the welfare state can contribute to achievement of both efficiency and equity goals. For this reason, our analysis differs from two alternative interpretations which propose a dichotomised vision of the economic and social dimensions.

The first of these other interpretations maintains that European integration should be a strictly economic project aimed at the construction, enlargement and consolidation of a free trade area, the elimination of any remaining barriers to the operation of markets, and deregulation. Supporters of this view also propose a suitably tailored institutional structure of policy making such that the social prerogatives of EU institutions are severely limited. Setting aside for the moment how prerogatives should be allocated at different levels of government, and simplifying for the sake of clarity, this interpretation essentially argues that the welfare of European citizens should be promoted not so much by the institutions of social protection, often seen as plagued by rigidities and inefficiencies, as by the greater economic efficiency brought about by free markets via increased competition, lower prices, higher growth, and higher employment creation. In this version of the 'trickle down' argument, the economic dimension normatively prevails over the social dimension, and the achievement of welfare objectives is, at most, a by-product of the unhindered operation of free markets.

On the opposite side, some authors take a negative view of the economic dimension and consider the building blocks of European economic integration to be synonymous with 'negative integration' (Scharpf, 1999), namely the demolition of the principles of social protection which used to characterise European nation-states. In the words of one of these authors, the 'EU inaugurated EMU and Single market regime, with its effective ban on autonomous policies of setting exchange rates, interest rates and fiscal debt, as well as controlling capital movements and movements of goods and services across national borders ... amount to considerations of social protection being trumped by those of the competitiveness of the national economy of member states' (Offe, 2006, p. 50). The economic dimension is in this case seen as suffocating the social dimension, and this is considered a loss from the normative point of view. We maintain that this position on the one hand neglects some positive repercussions that economic integration – primarily the EU-inaugurated EMU – may have on social Europe, according to the more benign interpretation developed in this book; while on the other hand, and complementarily, it seems – to some extent – to 'buy into' the logic that the pursuit of competitiveness and efficiency requires the demolition or radical cutting back of social protection systems. We, however, do not accept this conclusion.

More generally, the analysis developed in this book does not support these dichotomised interpretations. Underlying our position is not a generic syncretism between the ideals of efficiency and those of social justice but rather the main finding of this book: namely that many versions of the 'equality–efficiency trade-off' (and, more generally, of possible trade-offs between social protection and economic performance) do not survive closer scrutiny. Neither theory nor comparative analysis of existing economies seem to prove the superior efficiency of less equitable systems.

2 This section summarises our main results and draws some implications for EU social policy, focusing on three main issues: firstly, can welfare states produce efficiency gains, given their different but interrelated objectives of providing social insurance, redistributing resources, offering care services, and maintaining social order? (sect. 2.1); secondly, what is the structure of policy making best suited to reaping these possible gains in the EU? (sect. 2.2); thirdly, how is the EU social dimension affected by European *economic* integration, considered as part of the current equilibrium – or lack thereof – in the international economy? (sect. 2.3).

The reader should bear in mind that going through this section is obviously no substitute for a careful reading of the preceding chapters, since many nuances and much relevant information are omitted here for reasons of space.

2.1 How can welfare states promote both equity and efficiency objectives? We begin by developing insights from the modern theory of the welfare state and maintain that systems of social protection perform both redistributive and insurance functions. Redistributing resources among citizens is regarded as an independent objective if it stems from a social preference function including a sufficiently high *inequality aversion parameter* (Atkinson, 1970). The *insurance* function of the welfare state promotes *efficiency* by remedying market failures: the lack or underdevelopment of private insurance markets to cover a number of risks owing to information asymmetries and adverse selection (Barr, 1992). In practice, both motivations are at work, and both analytical filters are used in this book. Three chapters (1, 4, and 8) focus mainly on the insurance function.

Atkinson considers (in addition to the other issues discussed below) some recent claims, based on incentive problems and cost arguments, that social protection should be reduced. He makes the point that, because in our second-best world renouncing the social insurance objective of welfare policies entails efficiency losses, a more efficient alternative is to fine-tune institutions so as to remove undesired disincentive effects. In some cases, which he discusses, institutional design in the actual implementation of these policies already takes care of these unwanted effects.

The theory of social insurance is also the guiding principle of the study proposed by Artoni and Casarico, who argue that a limited application of the insurance principle tends to produce both more inequality *and* less efficiency at the same time. According to their comparative analysis, this may be the case of the US social insurance system (health and pensions), owing to such factors as segmentation, limited coverage, the public/private expenditure mix, lower replacement rates for public pensions, and the system of tax allowances for private health insurance. For instance, the greater amount of resources absorbed by the US health care system compared to its European counterparts is matched by far less than universal coverage (15 per cent of the US population is not covered).

The case in favour of the insurance principle as an efficiency-enhancing device is usually restricted to national policies in the current literature. However, in view of our objectives in this book, the focus should be on the implications for Europe, particularly in the aftermath of the EU's enlargement, which has increased cultural heterogeneity within its borders. The point made by D'Antoni and Pagano is that efficiency gains from social insurance rise precisely when cultural diversity increases, because the risks involved in investing in firm- and sector-specific human capital are greater in the absence of a common culture and a common language (which act as shock absorbers and hence as insurance devices). In the new circumstances, the need arises for a European system of social protection, which insures workers against labour market risks and avoids underinvestment in illiquid, yet highly productive skills. Note that this is an *economic* argument in favour of a European system of social protection based on its efficiency advantages. It does not assume that the necessary *political* conditions are present or that they are mature, as also discussed in chapter 8.

The arguments put forward by Atkinson, Artoni and Casarico, and D'Antoni and Pagano substantiate our first conclusion, namely that abdication (or limited implementation) of the insurance function of the welfare state produces efficiency losses in our second-best world. Sounder policy choices include careful design of welfare institutions (to minimize possible disincentive effects); universal entitlements to welfare programmes; and a European system of social protection aimed at encouraging productivity-enhancing investments in specific human capital.

The arguments summarised thus far confirm that the combination of functions – insurance and redistribution – assigned to welfare states implies that there is no trade-off between efficiency and equality if redistribution is the outcome of welfare policies promoting efficiency via social insurance.

If seen from this 'insurance' perspective, redistribution is mainly a by-product of the insurance function of the welfare state, rather than being an independent objective. This book, however, also develops a different but complementary insight that weakens the 'equality–efficiency trade-off' argument by a different route and assigns a more independent role to redistributive policies. As Bowles and Jayadev explain in chapter 3, transfers of resources among citizens help societies maintain social order and ensure compliance with its basic rules. Redistribution via the welfare state is – to some extent – an alternative to disciplinary enforcement in fulfilment of this 'institutional reproduction' function. In the presence of incomplete contracts, monitoring and other enforcement costs are higher in less egalitarian societies because individuals have fewer incentives to cooperate.

Hence the argument put forward by Atkinson (namely that possible incentive problems generated by social protection can be remedied via appropriate institutional design) finds its complement in the point made by Bowles and Jayadev that the alternative solution, namely welfare state retrenchment, may in fact be no solution at all, because incentive problems would reappear in new guise. This broader spectrum of possible outcomes should be taken into account when considering policy switches towards less egalitarian regimes. Data confirm that the 'enforcement–equality trade-off' may be the one most relevant to policy choices, as shown by Bowles and Jayadev's comparative analysis of the US and European countries. *Thus, our second conclusion is that progressive redistributions may not entail efficiency losses or higher costs because the alternative system of order maintenance, namely disciplinary enforcement, is also costly. Because the costs of distributive policies should be set against the costs of abstaining from these policies, the implication can be drawn that the preference for equality may be adopted as an independent criterion of choice across alternative social models and their respective order-maintenance devices*.

Redistribution is also at the centre of Munzi and Smeeding's analysis set out in chapter 2, which focuses on the relations between distributive policies and labour market performance in comparative perspective. Many studies have compared the US and European labour markets, seeking to assess their comparative performances. The study by Munzi and Smeeding, which includes the USA and a large sample of European countries, clarifies some of the issues involved and helps us assess them quantitatively. The authors show that the US model is characterised by a combination of low unemployment rates, a high incidence of low-paid jobs, and low welfare state expenditures. Interestingly, the low unemployment rate in the USA produces a relatively low overall poverty rate in terms of market income. But this country also has by far the lowest incidence of social expenditure on GDP (less than one-third of the average in the countries considered), and the highest poverty rate when measured at disposable income (DPI), that is, after redistribution has been effected via taxes and transfers (17 per cent, against an average of about 10 per cent). In comparison, Europe (with the exception of the Mediterranean countries) performs much better in terms of poverty and inequality reduction: whilst the extent of redistribution effected via taxes and transfers in 2000 was only 21 per cent in the USA, percentages of between 40 and 44 were recorded by the best-performing countries, namely those of Continental and Nordic Europe.

These data, in conjunction with those discussed by Atkinson, show that lower unemployment, although a highly worthwhile objective in itself, is far less advisable if it combines with a high incidence of low-pay jobs, and with high poverty and inequality. *Because, both cross-nationally and across time, poverty rates are more closely related to the incidence of low pay and low welfare state expenditures than they are to unemployment rates, the objective of poverty reduction can only be achieved by integrating full* *employment policies with policies aimed at social inclusion. This is our third conclusion.*

But what if efficiency is the policy objective? Some commentators have argued that the advantages of the US model should be appraised in terms not of equality, but of efficiency. It has been recommended that comparative studies should take account of 'the different mix between social and market protection on the two sides of the Atlantic', social protection and market participation being considered as alternative insurance devices against labour market and poverty risks (Sapir, 2006, p. 378). Consequently, this line of argument suggests that countries should be classified by their 'efficiency', defined in this approach as their ability to promote high employment rates, and/or by their 'equity', measured by a low poverty risk. This classification of countries may seem plausible at first sight, and so too may the inclusion of the USA as a country exhibiting low 'equity' but high 'efficiency' (as in Sapir's efficiency–equity box diagram). But the results are quite different if considerations of *dynamic* efficiency – which are absent from the above-mentioned exercise – are introduced. This requires specific analysis to be made of the conditions of childhood. Focusing on childhood is advisable because 'good cognitive abilities to start with... are an absolute pre-condition for educational attainment' (Esping-Andersen, 2002, p. 9), and hence for dynamic efficiency and growth, which, as now universally acknowledged, crucially require high educational attainment and human capital formation.

Both Atkinson and Munzi and Smeeding provide information on children poverty rates, reporting that they range between 2.9 per cent in Finland and 21.9 per cent in the United States, and that the latter country has an incidence of poverty among children 90 per cent above the average rate. Equally if not more worrisome are the repercussions of parents' low education on their children's welfare: half of the American children of low-educated parents are poor. By way of comparison, in Italy, the next worst-performing country, the percentage is 25.8, while in Finland and Sweden it stands at around 6 per cent. It is particularly welcome news that the United States experienced a fall in overall child poverty in the 1990s. This finding, together with the more successful British experience, shows that policies can be effective in eradicating poverty. However, the USA still had the highest rate of child poverty at both the beginning and at the end of the period, and the limited extent of child poverty reduction via welfare measures (6 per cent in the USA against over 40 per cent on average) is also worrying.

All this sounds an alert to the danger of an intergenerational transmission of social exclusion through the double channel of high overall child poverty rates, and even higher poverty rates among children of low-educated parents. The latter effect may not be negligible, given that, as Munzi and Smeeding report, the number of families who work, but are poor, is between 12 and 15 million in the USA.

Hence the efficiency advantages of the US model may be overestimated in the classifications referred to above because a large mass of low-paid jobs, the dependence of children's welfare on their parents' education and income, and child poverty are possible links in a chain leading to low educational attainment in the young generations. These disadvantages – contrary to the arguments sometimes propounded about the possible positive incentive effects of poverty – are not remedied by social mobility. Recent studies have found that both intra- and inter-generational mobility out of poverty is lower in the United States than in almost every other rich country (see the studies mentioned in chapter 2). *Our fourth conclusion follows from this analysis: distributive policies, besides satisfying a preference for equity towards children, produce dynamic efficiency gains if, by reducing poverty and inequality, they positively influence the welfare and cognitive abilities of children and hence human capital formation.*

The functions of the welfare state considered thus far include insurance, redistribution, and the maintenance of social order through social solidarity. However, there is increasing recognition in the economic literature that the approach based on 'care regimes' yields useful insights because it brings to the fore the needs of households and families, and the way in which they are satisfied in alternative social models. The case of care needs is similar to that of 'institutional reproduction' considered above, in that the satisfaction of such needs is an imperative in all societies, irrespective of their social model. As shown by Bettio and Plantenga in chapter 6, inadequate government financing and/or provision of care services can neither suppress the inescapable need for these services nor eliminate the necessary expenditure in terms of time and/or other resources. They simply shift the burden to families, and particularly to women via their (mostly unpaid) work. This happens above all in the Mediterranean countries, where the low activity and employment rates of the female – and hence overall – population are among the undesired effects of scant support for the family as either provided or mediated by the state (via paid parental leave, monetary allowances, care institutions for individuals at both ends of their lives, and so on). By contrast, in countries where families receive such support, the labour market has a more efficient impact. Across Europe, there is a negative relation between the provision of, and support for, care services on the one hand, and female employment and activity rates on the other.[1] Particularly successful are the Nordic countries, where the public sector drives both the demand and the supply of female labour. *In short: across countries, less social expenditure on care services 'activates' more hidden work within the family. Consequently, the under-provision of these services acts as an 'inactivating influence' on market participation and employment, particularly for women. Because the female component explains a large part of overall activity and employment rates, activating policies in the labour market should act through the provision of care services to families. This remedy would be particularly useful in the Mediterranean countries, where this obvious recommendation has not yet become a policy priority. Again, this policy would promote both equity (as previously unpaid work would be remunerated) and efficiency goals in the form of higher activity and employment rates. This is our fifth conclusion.*

It may at this stage seem obvious to propose the Nordic Model unreservedly as the 'ideal type' for social policies, since it emerges as the most successful from every perspective considered in this book (thus confirming previous rankings, such as the UNPD Human Development Index). This prominence in social indicators combines with the very good growth performance recorded by the Nordic countries in recent years. However, we deemed it better not to rush to a similar conclusion, even though the results presented in previous chapters make such a conclusion plausible in all respects. We therefore decided to examine the Nordic Model with a magnifying glass, so to speak – and in greater detail than is used in other parts of the book.

Bjorn Gustafsson's 'insider's view', presented in chapter 7, offers anything but a stereotyped image of Sweden after the changes made to its welfare system since the 1990s. As the author shows, the Swedish Model now has new problems, such as an increase in income inequality and wage dispersion; dysfunctions in the systems for sickness compensation and disability pension; unsatisfactory integration of immigrants into work; and low activity rates among young people. As the author points out, only 51.0 per cent of persons aged 16–24 were in the labour force in 2006, and their rate of unemployment was as high as 13.7 per cent (although one should keep in mind the corresponding averages in the EU-15, which were 47.2 and 16.0 per cent respectively). Moreover, there have been changes in the provision (but not the funding) of social services.

Despite these difficulties, we learn from this chapter what constitute the features of a successful welfare state: those that have not changed (or which have been reinforced) since the 1980s and have accompanied the good growth performance recorded in this decade. These features are a universalistic system of entitlements to insurance programmes (with means-tested benefits limited to residual social assistance programmes); the active promotion of female participation; a combination of employment protection legislation, generous unemployment benefits, and active policies in the labour market; close involvement of the state in the education of young children; the provision of social services and work incentives to families and individuals. *These results, together with those reported in other chapters, lead us to our sixth conclusion, namely that social policies in Europe should incorporate measures able to conjugate the objectives of equity and efficiency through a universal system of social insurance accompanied by social assistance for persons experiencing difficulties at entry-points; a combination of labour-market policies which both protect worker, and produce a positive attitude towards technical and structural change*; *a system of incentives – including through the tax system – and the provision of care and other social services – that encourages labour market participation and promotes gender equity*.

2.2 The social dimension of Europe is influenced crucially by the allocation of prerogatives at different levels of government, with the European Union and the Member States being the two main actors involved. As Atkinson's institutional and historical analysis in chapter 1 clarifies, the potential 'division of labour' between these two levels of government initially generated a tension that had to be resolved, and it was so through recognition that action in the domain of social policy is the responsibility of Member States but within a framework of common objectives. The definition of these common objectives is the prerogative of the EU, and the method involved (the open method of coordination) coordinates national policies towards achievement of the *desired ends*, rather than dictating the implementation of common *methodologies*. As has been argued, '*how* we achieve something is undeniably important, but thinking ahead about *what* we want to achieve is obviously what matters most' in the field of EU social policies (Vandenbroucke, 2002, p. xxii).[2] Thus, in the institutional architecture envisaged by the Treaty, the EU is an active actor in charge of defining *what* Europe wants to achieve: namely the common objectives of Europe in the social field.

However, this allocation of prerogatives has been challenged in the name of 'normative criteria' in the spirit of fiscal federalism (Alesina and Wacziarg, 1999). On this view, the 'federal government' (in the case under discussion, the EU) should restrict its action to those fields where gains in economic efficiency can be obtained via centralisation, internalisation of externalities, and scale economies. By contrast, national states (or sub-national government levels) should be assigned responsibility in all those policy domains, including social policies, where the costs of centralisation would be greater than the benefits (so the argument goes) because of the 'heterogeneity' of preferences across national communities. Consequently, according to this point of view, each Member State should freely set its preferred distributive objectives.

One problem with this position is that the motives for choosing the nation (or lower geopolitical compartments) as the appropriate level for preference aggregation are far from self-evident in the conditions of non-zero mobility costs *de facto* prevailing in Europe. With zero mobility costs, states (or their subsets) would be transformed into homogeneous 'clubs' defined by their citizens' shared preferences for equality, social protection and tax rates, thereby establishing the ideal conditions for the normative criteria of fiscal federalism to be implemented. These aggregations would take place because European citizens endowed with a degree of inequality-aversion not reflected in the actual inequality indexes of their own countries would move to communities with similar preferences. For example, if people from Calabria (a southern Italian region with very low per capita income, where poverty is geographically concentrated) were willing, but unable, to obtain effective redistributive policies in the national context, they would move *en masse* to, say, Sweden if mobility costs were zero. Correspondingly, people with a greater taste for inequality would move to Italy.

As this argument suggests, *in conditions of cultural diversity and non-zero mobility costs, the laissez-faire normative implications of fiscal federalism (called 'Smithian fiscalism' by D'Antoni and Pagano), are inadequate to promote efficiency, in the economic sense of establishing a correspondence between socioeconomic outcomes and individuals' preferences. In conjunction with the other reasons summarised above, this leads us to our seventh conclusion, namely that economic arguments counsel in favour of an active role for the EU in the definition of Europe's common social ambitions.*

2.3 The social dimension of a country is influenced by its position in the international economy. A large body of literature has studied, for instance, the new constraints imposed on social policies by 'globalisation' (see, for instance, Bardhan *et al.* 2006). Costabile and Scazzieri in chapter 5 call attention to a different aspect, namely Europe's new role in the international economy after monetary unification, and the possible implications for its social dimension.[3] The authors interpret the EMU as the final result of Europe's initial decision to avoid the undesired economic *and social* consequences of a model of 'growth-with-external imbalances' typically associated with an international monetary system centred on one 'key currency'. To be sure, monetary unification had economic and social costs: in order to promote credibility and compliance with the rules, strict discipline had to be imposed on European macroeconomic policies. This happened precisely when the US economy – facilitated by its role in the international system of payments – was enjoying the benefits of more relaxed monetary (and sometimes fiscal) policies, low interest rates associated with large saving inflows from emerging economies and, consequently, a favourable environment for investment even in the presence of low domestic savings rates.

But monetary unification has enabled Europe to adopt a model of 'growth-without-the external-imbalances,[4] *meaning that Europe as a whole, thanks to economic integration and the common currency, can basically afford to live in external equilibrium. The social advantages of this model can be reaped through a combination of policies promoting the productive abilities of citizens and their well-being. The new opportunities thus produced include a 'high road' to competitiveness via better abilities in production rather than compressed domestic demand, and the opening up of a 'welfare scenario' centred on social well-being.* The optimism engendered by this last conclusion gives us a good opportunity to close this book.

Notes

1. The positive relation between employment and welfare state expenditures considered here works through supply-side channels, not through the effective demand for goods, as in standard Keynesian models. Demand and supply effects may be complementary.
2. As this author (the Belgian Minister for Social Affairs and Pensions) recalled during the Belgian Presidency of the EU, 'a political agreement on common quantitative indicators' was reached 'to monitor the Member States' performance with regard to social inclusion' (p. viii).
3. The promoters of European economic integration were well aware of the importance of social objectives, as Atkinson explains in chapter 1. With more specific reference to monetary unification, see, for instance Eichengreen and Frieden (2001, p. 2): 'Politically, monetary unification has been seen as a practical and symbolic step towards a capacity to develop social and foreign policies at the European level'.
4. Even the 'effective ban on autonomous exchange rate policies' imposed by monetary unifications (referred to by Offe in the sentence quoted above, p. 223) may be considered a stimulus for countries to pursue a 'high road' to international competition via product quality, innovation, etc., rather than intra-European 'beggar-thy-neighbour'-type policies (Costabile, 2006).

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