

Why are welfare states in the US and Europe so different? What do we learn?¹

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Summary

Over the past century, Europeans have built large welfare states, while the US has maintained a much less generous system. While America spends about 11 percent of its national income on social programs, France spends almost double that amount; Nordic countries spend even more. Labor market regulations also differ significantly on the two sides of the Atlantic. This paper explores the reasons for this difference which has to do with the direct and indirect effects of the history of political institutions and race relations in the US. In the second part we compare the degree of efficiency of alternative models of welfare and we analyze the pros and cons of different types of regulations and redistributive policies.

Key words

welfare state – Europe versus America – labor market regulations

¹ Much of the content of this article draws from our book *Fighting Poverty in the US and Europe: A World of Difference*, Oxford University Press 2004, French translation by Flammarion 2005. The reader may also find useful to consult A. Alesina, E. Glaeser and B. Sacerdote (2005), "Work and Leisure in the US and Europe: Why so different?", *NBER Macroeconomic Annual* MIT Press Cambridge Mass. And A. Alesina and F. Giavazzi, 2006, *The Future of Europe: Reform or Decline*, MIT Press Cambridge Mass.

Cross-Atlantic animosity goes well beyond the specific disagreements about the war in Iraq and the Middle East strategy and different international sympathies of the United States and Continental Western Europe (Europe in short from now on). These disputes stem from profound and broad differences in attitudes, government policies and worldview that separate the United States and Europe, especially France.

Over the past century, Europeans have built large welfare states, while the US has maintained a much less generous system. While America spends about 11 percent of its national income on social programs, France spends almost double that amount; Nordic countries spend even more. Relative to GDP, Europeans spend more than five times what Americans do on unemployment insurance and other labor market programs. Not only Europeans spend more on social programs they also regulate more in attempt more or less successful to protect workers against business interests. Labor market regulations are especially intrusive with rules like prohibition or high cost for firing, mandate long paid vacation, short work hours in a normal work week, generous sick and maternity leaves, etc. For instance, most European national governments mandate more than 25 vacation days per year, while in the US the federal government does not officially mandate a single day free from work. The amount of vacation is a private contractual issue between workers and employers. Taxes are not only higher but also more progressive in Europe than in the US adding another redistributive mechanism on the revenue side of the government balance in addition to the spending side. In Europe pension laws allow early retirement, traditionally with special privileges for public employees and women. It is not unusual for men and women to retire in their late fifties in Europe with full pensions. Some countries are slowly trying to change these laws but they find extremely strong opposition from labor unions controlled by older workers and pensioners. More than one European government has fallen over pension reforms or had to endure long periods of social unrest even for relatively minor attempted reforms.

The differences in spending and regulation significantly impact the ways that Americans and Europeans spend their lives. To begin, the Americans work much longer hours in the market place than the average European worker. In addition, labor force participation in the US is higher than in most European countries and it is especially low in Italy. Unemployment is also lower in the US. Eighty-eight percent of Americans drive to work in a public car; in European welfare states, higher gas taxes and better public transportation make driving more common. There is more home production in Europe, that is more goods and services are produced at home rather than being bought in the market; think for instance of home cooked meals versus restaurant meals. Life in the US and Europe is indeed quite different.

Some of the most striking differences between the US and Europe and in particular those concerning social protection and welfare derive from different ways of thinking, different ideologies in the broadest sense of the term. Consider this: According to the well respected *World Value Survey* 29 percent of Americans think that the poor are trapped in poverty; 60 percent of Europeans believe the same. 60 percent of Americans believe that the poor are lazy; 26 percent of Europeans share that view. But differences of opinions go well beyond the economy. Several surveys find that about 60 percent of Americans say that religion is very important; 11 percent of Frenchmen share that view.

Why is America and especially American government so different? In our book: *Fighting Poverty and Inequality in the US and Europe: A World of Difference*, we try to understand why the US doesn't have a European-style welfare state. After reviewing a number of unsatisfying economic explanations, we find that the weight of the empirical evidence supports two sets of causes: political institutions and the direct and indirect effects of ethnic heterogeneity including those on attitudes and ideology. The US have a cluster of institutions—including a majoritarian electoral system, extensive checks and balances including the common phenomenon of divided government, a situation in which Congress

is controlled by the party which is out of the White House², and a Constitution that stresses the defense of property rights—that have served to limit the role of the state. This is the result of the history of the 20th century when, in the wake of labor uprisings and wars, the European left rewrote constitutions and installed new ones, much friendlier to social democrats, the labor movement and therefore the welfare state. The second major factor that explains American exceptionalism is ethnic heterogeneity. Governments redistribute less when their people nations are ethnically diverse, and the US is far more diverse than any European nation. In this essay, we review some of the arguments, and also suggest how the same factors that explain the lack of an American welfare state can also explain some of the other striking differences between the US and Europe. We then discuss the differences in welfare states within Continental Europe and we draw some policy implications on how think about welfare reforms.

1. US versus Europe: Failed Explanations

To economists, the most natural explanations (for everything perhaps) but certainly for fiscal policy and the welfare state are naturally those relating to the economy. Since we are economists when we sought to understand why the US does not have, like the Europeans, a system of social insurance and redistribution, we first turned to the economic differences between the US and Europe.

First of all, redistributive schemes and social insurance schemes become more extensive in richer countries, but both the US and Europe are amongst the richest countries in the world. Thus this argument may explain why Europe redistributes more than developing countries but it does not apply to a US versus Europe comparison. Second, a standard economic view of redistribution and social insurance is that more unequal societies with more economic volatility should have more redistribution and more social insurance. If the US were somehow a much less inherently unequal society with much less economic volatility then we could perhaps understand the lack of an American welfare state as a rational response to those economic conditions. The problem with this view is that the US economy, before taxes and transfers, is much more unequal than its European counterparts, and the volatility of the American economy is much higher than most European economies. In other words, more pre tax inequality may result in more pressure for redistribution in a democracy, but that does not seem to be at work: in the US there is more pre tax and transfer inequality and less redistribution than in Europe. In fact in the US pre tax inequality has been on the rise in the last decade but we see no sign in an increasing pressure for more social insurance.

A related argument posits that America has less redistribution because there is more social mobility in the US. According to this theory, America may look more unequal but because Americans are regularly moving up and down the social ladder, American society is in a sense more equal because none is “stuck” in a certain position of the social ladder. One implication is that today’s poor may not demand large redistribution because they feel that because of the social mobility they may be rich tomorrow.

This theory also is at odds with the available evidence. Americans are slightly more likely to rise from the middle of the income distribution to the top, but they are less likely to move from the bottom of the income distribution to its middle. There is no evidence that shows America to be much a significantly more mobile society than Europe. Nevertheless Americans are deeply convinced that their society is very mobile, as we discussed above while the Europeans are just as convinced of society’s immobility. So either Americans overestimate social mobility or Europeans underestimate it. This observation suggests that differences of views are more based upon ideology than facts; we return to this issue below.

A third theory that is grounded in basic economics suggests that the larger European welfare state could be explained if the Europeans run much more efficient governments or if Europeans are much more effective at raising taxes without distorting the economy. There is no evidence to support either claim. The US government has its flaws, but most surveys suggest that it is as competent as most

² France also has the possibility of cohabitation, but the American President and administration have much more extensive powers in domestic legislation than the French President.

European countries. Evidence on tax cheating suggests that American tax authorities are much more efficient than their European contemporaries. Economic explanations do not go very far.

Another set of arguments emphasizes ancient cultural heritages or World War II. The data on the size of the welfare state supports neither view. The gap between European and American social spending begins neither in the 19th century nor after World War II, but rather in the early years of the 20th century, especially after World War I. In the 19th century, America seemed far more liberal than its European counterparts. In the 19th century, American Republicans fought a war for the rights of their country's poorest citizens. It was a pioneering American labor uprising in 1886 that is celebrated today throughout Europe on May 1. What made Europe and the US move in different political directions has been the growth starting at the end of the 19th century but much more so after the First World War and the growth of the Communist movement. While Communist and Socialist parties have been critical in the design and construction of current European political institutions and at times have ruled or heavily influenced European governments, these parties have never been successful in the US.

Finally let's also eliminate another cultural explanation based upon the idea that Europeans are simply more generous than Americans. As it turns out private charity is much larger in the US than in Europe; private charitable donations are around 600 dollars a year in the US more than six times as much the average donation in Europe. This cannot be explained by different tax codes, since most Americans do not even claim charity donations for tax exemptions and in some European countries charity donations are as tax exempt ads in the US. One possible interpretation of this fact is that Americans prefer private charity to public welfare because with private charity one can choose how to direct the flow of money, with public charity (welfare) the government decides. If you feel that some people are more deserving than others, then you prefer private to public charity. The issue of "choice" on how to spend welfare money becomes more relevant in a more heterogeneous society like the US relative to more homogeneous European countries.

Related to this is another stereotype that Americans are individualists while Europeans believe more in social activities. This is simply not true. Ample evidence suggests that Americans participate more in social activities like parent teachers' associations, sport clubs, various kinds of associations than Europeans do. Some observers and in particular Robert Putnam (2001) argue that this kind of "social capital" is declining in the US, but while the claim is disputed, it is probably declining in Europe as well for the same reasons why it is happening in America.

2. Us versus Europe: Political Institutions

If economics offers little ability to explain the differences between the US and European welfare states, political institutions offer us more hope. A number of studies have found strong cross-national evidence linking political institutions with the size of the welfare state. In particular in OECD countries proportional representation is a strong predictor of the size of social spending. Majoritarianism predicts less social spending. This should be no surprise, for a century or more, leftists have advocated an increase in proportional representation. The French leftists who created the Fourth Republic installed proportional representation; majoritarianism returned with De Gaulle's fifth republic. Proportional representation empowers organized minorities, and allows even extreme leftist groups to be represented. Relatively small Communist parties gained representation through proportional representation and even when not in government could influence the policy formation process. Also proportional representation often implies coalition governments that have an especially hard time resisting demands for favors and public spending in the direction of various sectors of society.

Contrary to Europe America has hardly any type of proportional representation, aside from very few (usually left wing) cities and towns. If we multiply the difference in proportionalism between the US and Europe times the cross-national estimates of the impact of proportionalism representation on social spending, we find that one-half of the difference between the US and Europe can be explained by this variable alone. We don't interpret this as actually meaning the proportional representation alone is so critical, but rather than proportional representation is one of a set of institutions, that usually go together, that have tended to empower the left. Also we do not mean to imply that

proportional representations “causes” the welfare state, but that societies that were more favorable to the welfare state ended up with more proportional representation because the latter was better at delivering what society as a whole wished for.

Indeed, the US has a cluster of institutions that were created in the 18th century American constitution with the explicit goal of limiting political extremism and expropriation of private property by the state. The separate election of the president and Congress often has led to divided government, namely one party holding the presidency the other one controlling Congress. A pro redistribution President could be kept in check by Congress. Franklin Delano Roosevelt for example was regularly stymied in the late 1930s by conservative Democrats and Republicans in the Senate. In some cases, these checks and balances do not reflect a one person one vote rule. The Senate for example represents land area almost as well as it represents population. The Supreme Court is an added check and the court historically served to limit progressive moves, like the income tax. In 1864 the Supreme Court vetoed a law that would have introduced a federal income tax on the ground that it violated property rights. It took 20 years and an amendment to the Constitution to have it approved.

European constitutions instead typically have fewer checks and balances and more attention to social rights and less attention to the defense of property rights. This is not surprising since most European constitutions were passed with substantial influence from Communist/Socialist parties in the 20th century. In fact only the American and the unwritten British constitution have any claims for age. European constitutions are almost all modern and they are outcomes of political events as well as causes of modern political outcomes. In the 19th century, European countries still had monarchs and empowered aristocracies. The US had a wider franchise than almost any European nation. A look at the world in 1870 would suggest that it is the US, not Europe, which seems more likely to adopt progressive reforms. This perspective pushes us to the real puzzle: why did America preserve its 19th century institutions while Europe changed so radically?

The history of proportional representation is instructive in this respect. Proportional representation was tried in US first in some cities and towns for instance in Ohio; it is not a European innovation. However, it was adopted as a cause by the European left and at the time when it was a minority. Labor movements were confident (and correctly so) that it would empower them and they made proportional representation one of their causes. As a result, when labor leaders have the ability to influence constitution-making, proportional representation began to appear.

Belgium came first. In the 1890s, national strikes crippled this former employer's paradise with one of the most restrictive franchises in Europe, and caused electoral reform. To mollify the strikers, the franchise was widened and proportional representation was included. Before World War I, leftist uprisings caused change in Finland and Portugal. During the war, Switzerland also succumbed to a national strike and adopted proportional representation.

World War I, however, was the great watershed. Before the war, the armies in the larger countries - Germany, Austria, Russia and Italy - were sufficiently strong to repress labor unrest. An uncharitable view of the Austro-Hungarian army is that this is all that they were good at. In the chaos of 1918 and 1919, left wing uprisings struck all of these countries and there was no coherent army to fight back. As a result, Russia got a full fledged communist dictatorship, and Germany, Austria and Italy got not only proportional representation, but a number of institutions that labor leaders thought would support the left. France repeated this process after 1945, when the right was discredited by Vichy, and leftist constitution writers installed proportional representation.

The United States is different, then, not because it lacked labor uprisings. The New York City Draft Riot of 1863, the Haymarket Riot of 1886 and the Homestead Strike of 1893 were full-fledged revolts. But the country's vast size always meant that outside armies were available to come in and suppress the uprising. The vast distances in the US ensure that an uprising in the Coal Country is unlikely to be able to force change in Washington. The same thing was true in Wilhelmina Germany, but unlike the Germans, the US has never experienced the chaos of a complete military defeat. The US has preserved its 18th century institutions because of its size and because it has not lost a war on its own soil. Those 18th century institutions explain one-half of the difference in social spending between the US and Europe.

In addition a wide open West allowed for some of the working class of the East to migrate in search of fortune to the West, diluting the unrest in eastern cities. This possibility was not available to the European working class.

3. US versus Europe: Racial Heterogeneity

The other half of the difference between the US and Europe is due to American racial heterogeneity including both its direct and indirect effects. There is abundant evidence showing that people are less likely to support redistribution to people who differ from them ethnically. For example, race predicts support for welfare far better than income or any other variable. Even after controlling for income Whites oppose redistribution and African-Americans do not. In other words a relatively poor White would not be so supportive of redistribution relatively to a relatively well-off Black. Whites are less likely to be hostile to redistribution in the US when they live around poor people who are also White, but more likely to be hostile to redistribution when they live around poor people who are Black.

Across states within the US, there is a striking correlation between welfare generosity and the proportion of Blanc population. In all states, Blacks are a minority, but when they are a larger share of the population, welfare payments are far less generous. Homogeneous American states, like Minnesota, are far more kind to their poor than heterogeneous American states, like Mississippi. This result holds even taking into account the different level of income of different states, that may affect their ability to provide welfare for the poor. The effect of racial heterogeneity of redistributive policies is not only an American phenomenon, one finds the same results comparing countries around the globe.

We don't believe that the tendency to be less generous in ethnically diverse places reflects hardwired prejudice. Certainly people tend to be more suspicious and less willing to mix and "share" with people of different races. This has been proven in experimental evidence. It does not have to reflect racism but simply a tendency for people to look for what is more familiar. Like it or not it is a fact of life. In addition ethnic differences create cleavages which can be exploited by politicians who are trying to discredit their opponents' policies. Anti-welfare politicians discredit their opponents by simultaneously emphasizing the tendency of welfare policies to help poor minorities and by building hatred towards those minorities.

This process was described by C. Vann Woodward (1971) in his classic account of the rise of racial segregation in the American south. In the 1880s, the first national pro-redistribution party—the Populists—rose in America. This group sought support from African-Americans who would particularly benefit from its policies. In response, conservative Whites spread stories emphasizing Black crimes and stoked the fires of racial hatred. Eventually, the populists would join in Jim Crow policies that ensured that Blacks would receive none of the benefits from any government redistribution, but as a result they lost the large potential Black vote. Race provided a wedge to fight redistribution.

This process has been repeated both in the US and in Europe. Many Europeans on both the left and the right have historically used anti-Semitic hatred to further their own objectives. The rise in immigration has made Europe more diverse, and we have seen a predictable rise in politicians, mostly on the right like J. Haider and J.-M. Le Pen, using ethnic hatred to discredit redistribution. The difference between the US and Europe is certainly not that American politicians are more unscrupulous, that is a regular feature of the occupation, but rather that American heterogeneity gave American politicians more to work with. This is a critical point for Europe which will become more and more diverse in next decade.

The importance of racial heterogeneity is particularly clear in the rise of the modern Republican Party. No Republican President, since Eisenhower, would have been elected without support from southern states. The South's switch from being a Democratic stronghold to being a Republican Region is clearly associated with Lyndon Johnson's support for Civil Rights for African-Americans and the consequent shift of the South to Republicans, whose support for states' right made them more attractive to southern Whites. Today race is a less important part of the American political landscape,

although there are glimmers of American politicians again turning to anti-immigrant rhetoric. But the absence of racial debate is partially a result of the very limited amount of American redistribution.

The association between race and redistribution also helps explaining different attitude about poverty. In more homogeneous societies it is easier for the relatively well-off to see the poor as themselves (in other words for a middle class person it is easier to put himself into the shoes of a poor person). It is less easy in a society with racial cleavages. Incidentally survey evidence always shows that Whites underestimate in the US the amount of welfare spending that goes to Whites and overestimate the amount that goes to racial minorities.

Finally note that racial fragmentation and political institutions are related. One of the reasons why an American Communist party never materialized is the fact that ethnic diversity interfered with class solidarity in the labor movement, a point already well recognized by Marx and especially Engels and later by Sombart (1905). Earlier waves of immigrants viewed the following waves with suspicion. The history of proportional representation is another example. An additional reason to avoid it in US cities was precisely the fear of electing representatives of racial minorities (Blacks). In fact much of the evolution of electoral laws in US cities with the associated laws suites and Supreme Court ruling has to do with the White majorities' attempts (especially in the South) at manipulating electoral laws to minimize the influence of Black minorities.

4. Other Explanations: Self Selection and Religion

One can think of at least two other factors which may explain US versus Europe difference even though it is quite difficult to quantify their magnitude. The first one is the self selection of European immigrants. Perhaps those who left Europe in the final part of the 19th century and the first half of the 20th were different from those who stayed and transmitted different values to their children. Those who left were prone to search for individual fortunes taking a long perilous and uncertain trip. Perhaps they were less risk averse than those who stayed. The latter were more likely to demand social changes in Europe (through the Socialist Communist parties) while the former searched for an individualistic market solution to their poverty. These different values can certainly travel from one generation to the next, at least up to a point.

The second argument has to do with the Protestant ethic, namely, the idea that Protestants and Calvinists view success almost as a religious sign of being chosen, and therefore economic success is viewed as something that everybody should strive for and that if you fail there is something "wrong" with you. Survey evidence does not show difference in the perception of poverty and economic success amongst American Protestants versus American Catholics or American Jews or any other religion. However, there could be something more subtle than that: even if you are a Catholic and you live in a country that is historically dominated by the Protestant ethic you change your attitude. There might be a dominant Protestant ethic even amongst those Americans who subscribe to different religions.

5. Different welfare states in Europe

Thus far we have compared the US versus Europe welfare state as if a single type of European welfare system existed. This is a simplification which was useful for the broad analysis of above, but clearly there are vast differences across European welfare states. There is no question that whatever the system Europeans want a more generous welfare state than the American one. This does not mean that no reforms are needed in many European countries and that everything is fine. Reforms are needed and are talked about in many countries. Certainly any kind of welfare reform in Europe will maintain significant differences with the US system, but often those who do not want any reform wave the spectrum of the so called "Anglo Saxon ultra liberalism" the (in)famous term invented by Jacques Chirac to prevent any serious discussion about changes.

Different welfare systems in Europe work more or less well, but many of them are close to being fiscally broken and ineffective in achieving their goals of redistribution and social insurance. A few

observations about their differences coupled with the previous discussion about the origins of welfare states are useful for a discussion about reforms.

There is a standard classification in the literature between four types of welfare systems – the Nordic system, the Anglo-Saxon system, the Continental system and the Mediterranean system. The Nordic system is the one of Scandinavian countries, the Anglo-Saxon the one of the US, UK, Australia, and New Zealand, the Continental one is the French, Belgian, German, Austrian ones and the Mediterranean one is that of Italy, Greece, Portugal and Spain. Obviously like any other classification this one is far from perfect and significant differences inside each groups remain as well as similarities across groups.

The Nordic system is the most generous and it has the highest level of social protection; these countries allow for universal welfare provision; and have extensive fiscal intervention in the labor market. The Nordic countries, especially recently, have done what economists think is the right thing, namely, they have eliminated much of the existing firing costs and regulation in the labor and product markets that impede the smooth functioning of the markets. They have maintained generous unemployment compensation. Obviously the generosity of the system comes at the cost of high taxation. Marginal tax rates are very high in Nordic countries even though they have come down from the peak of the late eighties. High taxes discourage work even though some of the welfare provisions sponsored by the tax itself promote growth: think for instance of an income tax that supports free child care.

The Anglo-Saxon systems that we already discussed with reference to the US case are much less generous; social protection is the last resort. They have lower unemployment subsidies, lower transfers, and lower pensions. However, tax rates are much lower.

The Mediterranean systems often concentrate (too much) on pensions and they have heavy intervention in the labor market with much regulation, such as very high firing costs. These systems are considered to be the least efficient of the four. In fact the Mediterranean welfare systems are still relatively expensive in terms of taxation, much more than the Anglo-Saxon one and they are not very efficient at redistribution income from the rich to the poor. Italy for instance sends more than any other country on pensions but well functioning unemployment compensations do not exist. Data from the OECD suggest that there is just enough risk of poverty before and after government intervention tax and transfer programs.

The Continental systems share some of the same problems of the Mediterranean one but they work a bit better, in the sense that they are more successful at moving income from the top to the bottom of the distribution. One problem that they share with Mediterranean systems is excessive regulation of the job and product markets.

As an example of the inefficiency of this type of regulation let's consider firing costs. If a firm knows that it cannot fire even non-productive employees, it will be very careful in hiring and it will hire less. Also, it may switch to labor-saving technologies, a phenomenon which has indeed happened in Europe and that has implied the disappearance of many manual and low skilled jobs, contrary to the US. Obviously, if you already have a job, you would favor retaining the firing costs, but all of those who are out of a job lose from firing costs. So why are the unions so adamant in defending firing costs? Remember that despite their rhetoric against unemployment, unions' policies are geared towards the needs of elderly union members who have a job already.

A particularly pernicious type of firing cost is judicial intervention. In fact, not only does the law impose severe restrictions on firing; but, even when employers follow the law, often judges step in, typically ruling in favor of the workers. This is typical in France and Italy. In France, for instance, judges rule routinely against any firing justified by the need to improve profitability of the firm. That is, increasing efficiency is not considered an acceptable justification to reduce employment in a firm. In Italy a notoriously slow justice system is very fast and efficient when it comes to protecting employees against firing, and many of them are promptly reinstated in their jobs. Recently an Italian employer had to reinstate a worker who while at home in sick leave won a soccer tournament ³.

³ See *Corriere della Sera*, August 26 2006.

Above and beyond these extreme examples, hiring and firing should be part of the normal “tool kit” of every firm. In fact, there are two types of firing: those of individuals or small groups of workers, and the closing down of plants or even entire companies. The latter receive a lot of media attention (and union reaction) but as a fraction of total job flows the first, more “normal” occurrences constitute the lion’s share. Both types are difficult for European employers. Stories of absentee or even dishonest employees that cannot be dismissed are common - and for every absentee and dishonest worker that cannot be fired, a young and productive worker goes unemployed. In the other case, threats of closure of plants immediately generate a flow of subsidies and favors from the government to employers to bribe them into not firing. The result is of course that unproductive firms are kept alive instead of releasing workers to be reemployed in more productive sectors or enterprises.

This does not mean that the unemployed should go unprotected and that the labor market should function as the market for any other good. Unemployment causes loss of income for families, distress and a variety of social problems. There is no doubt that the unemployed should receive insurance and that since it is difficult for the private sector to insure them adequately, there is a role for the government to step-in. Unemployment subsidies, however, should not discourage job search, as they currently often do, but, on the contrary they should encourage job search. For instance, they should be ended if an unemployed person refuses a job offered to him/her or makes no effort to search for a job. Also, unemployment compensation should not become permanent and/or be so generous and long-lasting that it becomes preferable to a job: it should only serve as an insurance scheme against temporary spells of unemployment. It should not become a permanent transfer.

The question is, of course, how to finance unemployment insurance. One option is, of course, from general government revenues, and this is the option most often followed. Two French economists, Olivier Blanchard of MIT and Jean Tirole of the University of Toulouse, have suggested an ingenious alternative (Blanchard and Tirole, 2003). They proposed a “firing tax”: firms could fire anyone they wanted to, but they would be taxed a certain amount and this tax revenue would cover part (or all) of the government expenditure on unemployment subsidies. The reasoning is the following: if society bears the costs of unemployment, those who contribute to create it should properly “internalize” its costs and pay a tax for it. In other words, if the costs of unemployment are only borne by society, any firm may “overfire” since its employees will be compensated at no cost to the firm. Obviously, the firing tax should be fixed at a level that is far less than prohibitive; otherwise we are back to the problem of excessive rigidity! This system would also totally eliminate the highly inefficient involvement of judges in the hiring and firing process and would eliminate all (or most) regulation about firing.

This discussion underscores an important point: it is better to allow market to work relatively freely and protect the “losers”: with transfers rather than by preventing the market from working properly with regulations. This is indeed, the road that Nordic countries seem to be adopting. Generous social protection with free markets without intrusive regulation in both the labor and the goods markets is the preferable road. This seems to be quite successful since they seem to have been able to provide generous social insurance retaining decent rate of growth of the economy.

The Nordic countries are becoming the “heroes” of the European left because in the last few years they seem to have had very decent and quite sustained growth and a very generous welfare state. But enthusiasm should be moderated. Certainly it is true that at least to a point : the Nordic system is so successful then the question is : can it be easily exported to other countries in Western Europe or perhaps new democracies all over the world? Unfortunately, the answer is probably no. First we should not forget that the Nordic countries are on the rebound from fairly deep recessions in the nineties. Therefore the good growth performance of the last several years can be considered at least in part as a recovery. For instance starting from the mid seventies when the welfare state in Sweden truly “exploded” this country has lost several positions in the ranking of per capita income. The same holds for Finland. Denmark had to endure a major slowdown in the late eighties early nineties before adopting market liberalizations. Second the Nordic countries have the highest level of social capital, social cohesion and generally good social behavior in the OECD group. Even tax compliance is high considering how high the tax rates are. Nevertheless as Assar Lindbeck (1997) has often reminded us the welfare system in Sweden has generated long lasting distortions in social norms of behavior. Swedish workers tend to be at home sick a lot, even though looking around Stockholm you see a very healthy looking population.

A very generous welfare state Nordic style cannot function where cheating, abuses and mismanagement are common as they would be in many other countries. Recent discussions in Germany have highlighted extensive cheating in that country; Italy is notorious for tax evasion and false claim of social insurance programs. Third the increasing racial fractionalization of Europe due to immigration as we discussed above will create additional pressure toward trimming rather than extending social insurance and redistribution. Fourth budget problems in many EU countries will make it quite difficult to expand rather than cut public spending and further increases in tax rates may be impossible.

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Conclusions: which welfare?

There are a few lessons that the comparison of welfare systems teach us. One is that the excessive regulation is counterproductive and if one wants to be generous with social protection should do it in a way that preserves market incentives and market allocations, while providing insurance for the “losers”. Regulations, for instance in the labor market create pocket of privileges (older unionized workers, public employees, pensioners) that are not necessarily the most deserving of social protection. Regulation of good market prevents entry and allows the formation of various overprotected lobbies (shopkeepers, notaries, taxi drivers, etc) who end up opposing liberalizations. Their screams against liberalizations are simply a way of protecting privileges. Thus social protection should be provided with the minimum possible distortions in economic incentives, prices and markets.

The second lesson is that the same level of tax revenues can display very different levels of effectiveness at reducing inequality and providing social insurance. To put it differently there is much room for improving social protection without increasing government spending, especially in Continental and Mediterranean systems of social welfare. It is not merely a matter of waste in public spending, but a much more serious issue is the capture of the welfare systems of over privileged group, the best example being often public employees.

The third lesson, related to the second, is that it is perfectly possible to reduce even significantly public spending as a percentage of GDP without reducing the amount of social protection for the really needy and the really poor. A reduction in government spending would allow for tax reduction that would spur growth, which in turn would alleviate poverty. However any talk of serious cuts in government spending in Europe is immediately cast as a non starter. Why?

Two reasons. One is the (mistaken) view that any cut in the 45 to 50 percent of GDP of current government spending in Western Europe would mean to turn Europe into a sort of American style capitalism, the quintessential enemy of the European social democrats. This is a fantasy which is in the interest of various lobbies to keep alive. Public employees will tell you that any reduction in their number would imply a collapse of public services and create unemployment. Old workers will tell you that working above the age of 60 is cruelty even though they have a life expectancy at 60 which is well into the late eighties. Rich students will tell you that it is unfair that they should cover their university education with higher school fees, and so on. A lot of what is defined as social spending has nothing social at all. Often goes to privileged groups (rich university students, public servants with job security, etc) and there is a lot of tax churning. That is the government taxes with one hand and provides services to the same people with the other hand, introducing waste and distortions in the process. Thus one reason for why it is so difficult in Europe to cut public spending and reduce the burden of taxation is the mistaken impression that any cut implies a severe loss of welfare for the poor.

The second one is the overemphasis of the recessionary effect of public spending cuts. Often Keynesian economists are excessively worried about the recessionary effect of spending cuts. Evidence instead suggests that reducing public spending and taxation increases growth even in the short run. Even spending cuts that simply reduce deficit without reduction in taxes may not cause downturns for several reasons: reduction in interest rates, improvement in expectations and profit opportunities. Private investment often immediately pick up the slack left by reduction in public spending as the evidence of many recent fiscal adjustments in OECD economies suggests⁴. Thus the combination of the strategic interest of lobbies that live off public programs and the excessive worry about the cyclical effects of spending cuts often interfere with plans for reforms that could at the same time reduce the burden of taxation without reducing effective social protection for the disadvantaged.

In summary, labor, goods and service market liberalizations and deregulation coupled with social protection for the truly poor and temporary assistance for the unemployed, elimination of social programs that support the middle class in exchange for tax cuts to them and elimination of the privileges of insiders, is a combination of policies that would preserve the European sensitivity for social protection but at the same time preserve growth enhancing market incentives.

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⁴ See Alesina and Gavazzi (2006) on this issue.