

The Welfare State, Taxation and Economic Performance


Torben M Andersen
Department of Economics
Aarhus University

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- How does the welfare state affect economic performance?
- What accounts for the position of the Nordic countries?
 - High income level
 - Relatively equal income distribution
 - Extended welfare state/large public sector
- How to maintain this position?

What is the welfare state/society?

- Individual entitlements;
collective financing

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- Social safety net
 - Welfare services
(education, health,
care....)

- Large public sector;
high tax burden

Some important add-ons:

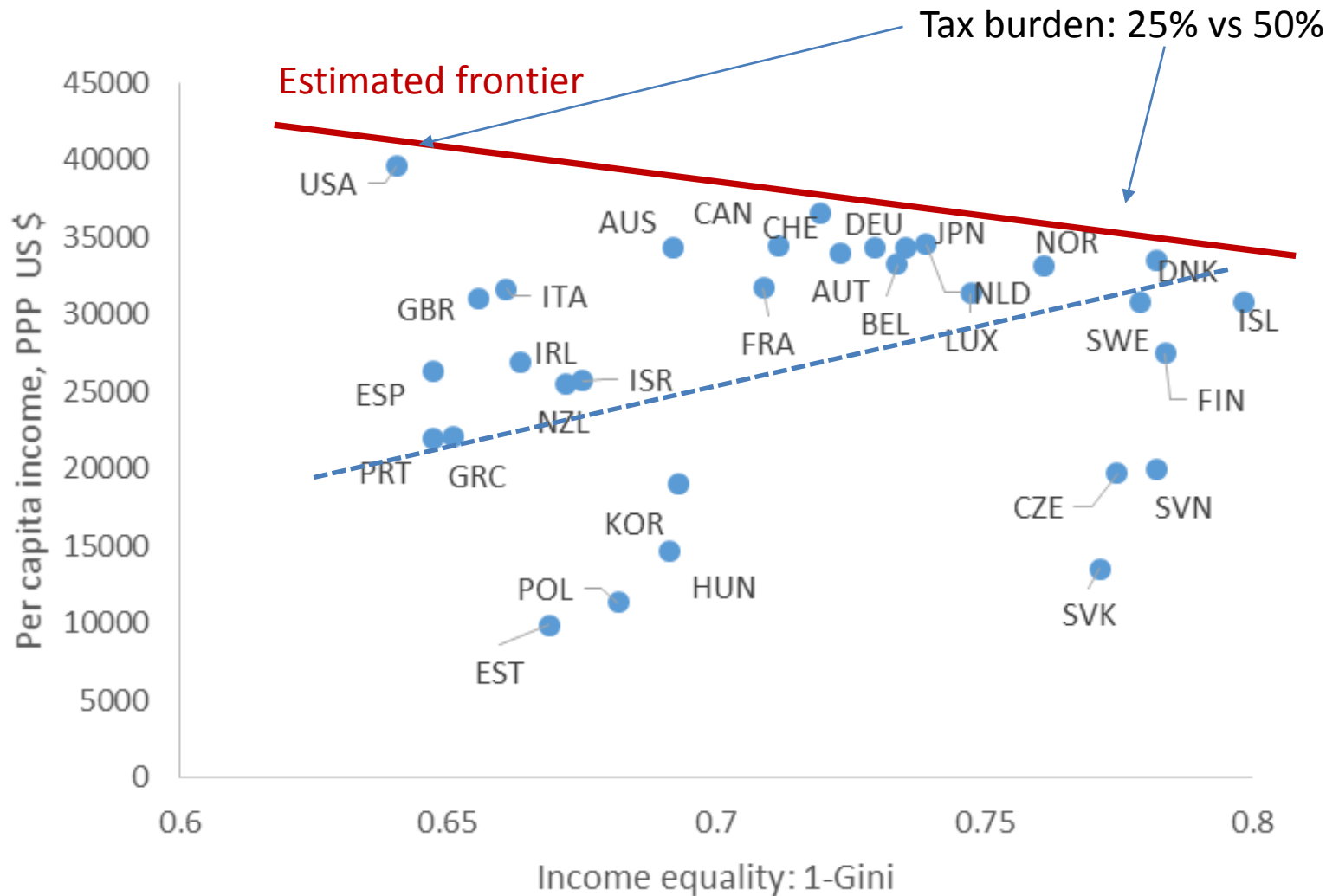
- An employment model
 - Public finances very sensitive to the employment level (double budget effect via benefits and taxes)
- Institutions/trust/social capital
- Liberal privat sector

What defines the Nordic model?

Similar, and yet so different

- Huge differences in specific policy areas
 - Tax structure
 - Pension systems
 - Unemployment insurance
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 -
- Package/overall objectives matter – ingredients can be combined in different ways
- Not a static model – recurrent reforms adapting to challenges and changes in society

The BIG trade-off



Two separate questions on the role of taxes

Tax distortion:

- Taxes/transfers: Private return is lower than the social return
 - Social return includes what the taxes are financing, private returns do not!
- Level of activity is socially too low
 - Labour supply
 - Investments
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Tax effect:

- How does a change in the tax rate affect e.g. labour supply?
- No general answer can be given - depends on what the tax is financing!

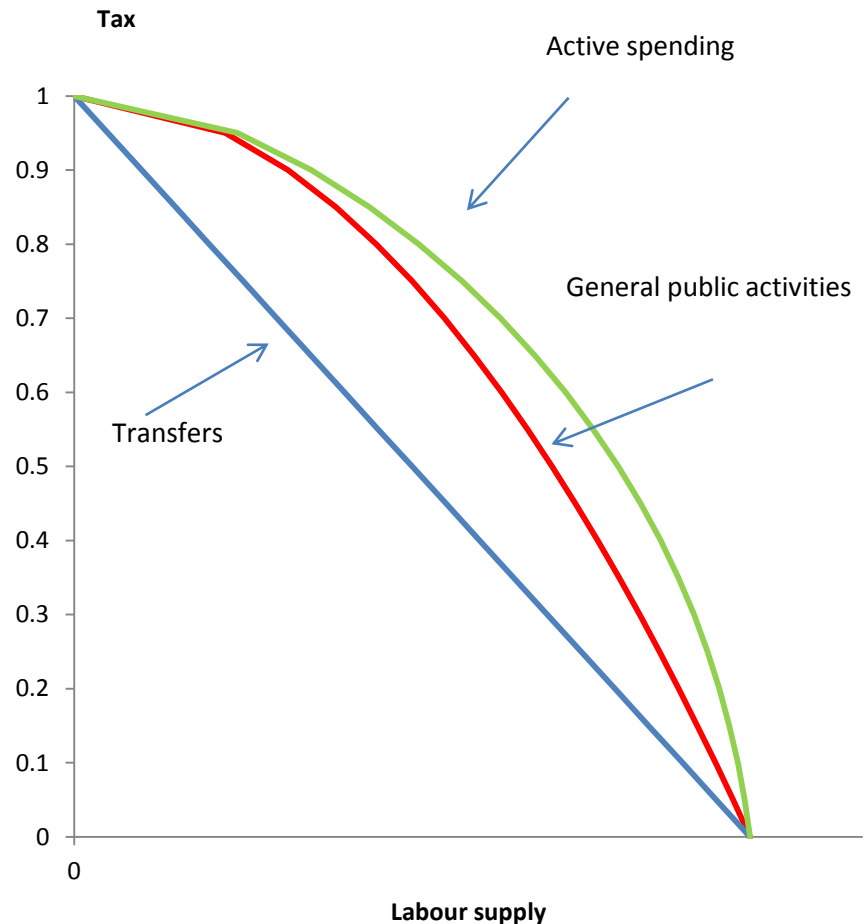
Standard theory – what is relevant?

Two different questions:

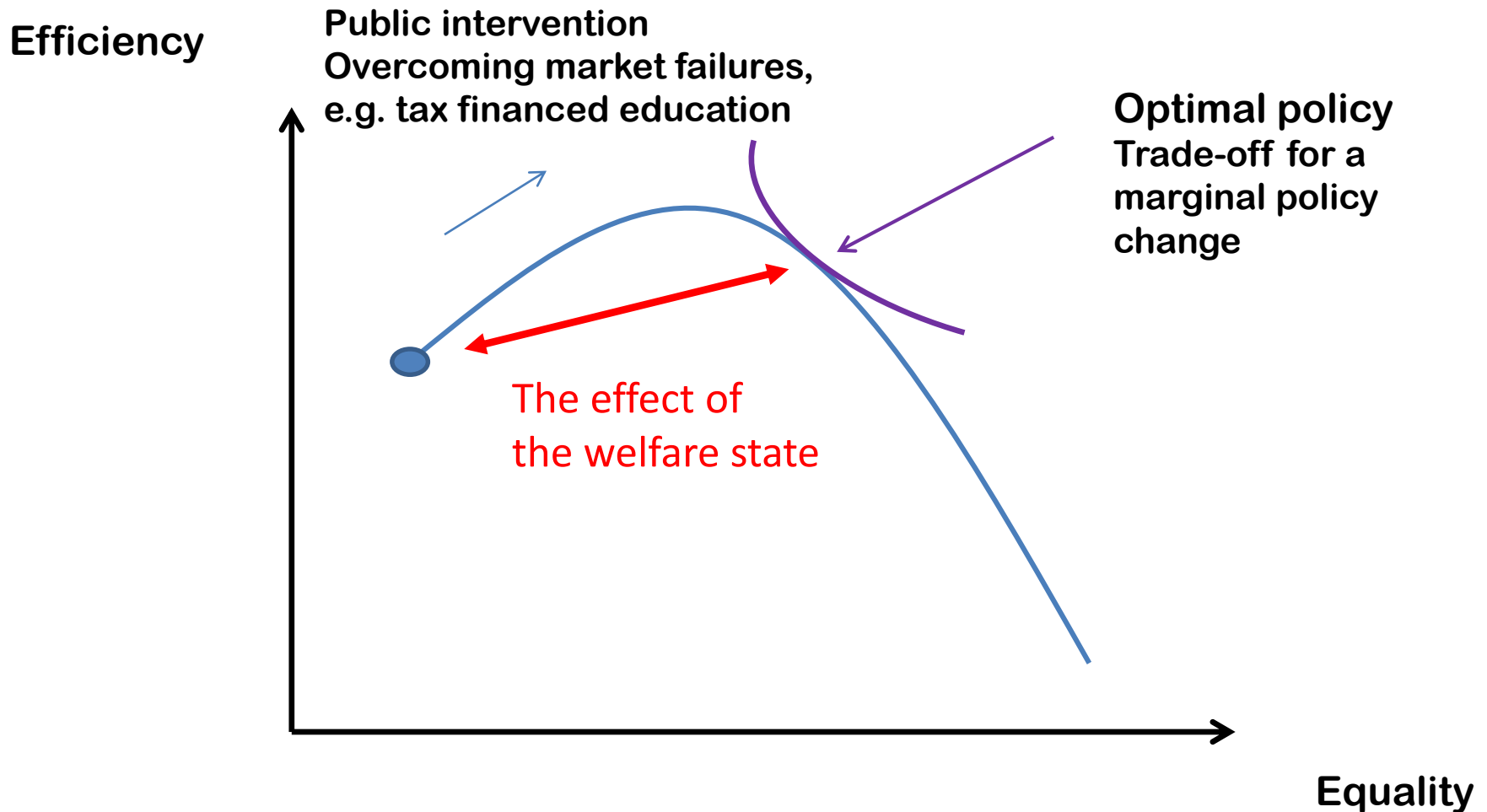
- What is the effect of a marginal change in the tax structure (fully financed)?
- A change in the size of the public sector (taxes, expenditures, composition)?
- Most tax-theory:
 - income taxes finance a demo-grant
 - ”...overall all transfers taken together are fairly close to a demogrant...” Piketty and Saez (2013)
- Not a good approximation of the Nordic model!

Taxation and distortions

- Some expenditures can strengthen labour supply (active spending)
 - Day care
 - Education
- Some weaken labour supply:
 - Early retirement
- Others have no direct effect

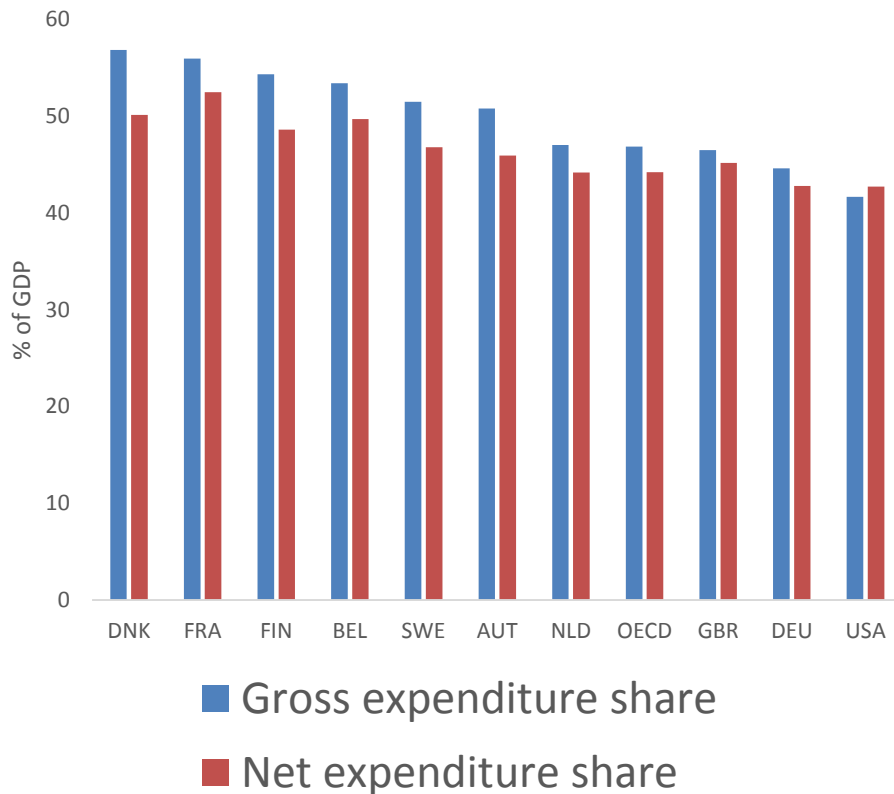


The efficiency-equity trade-off

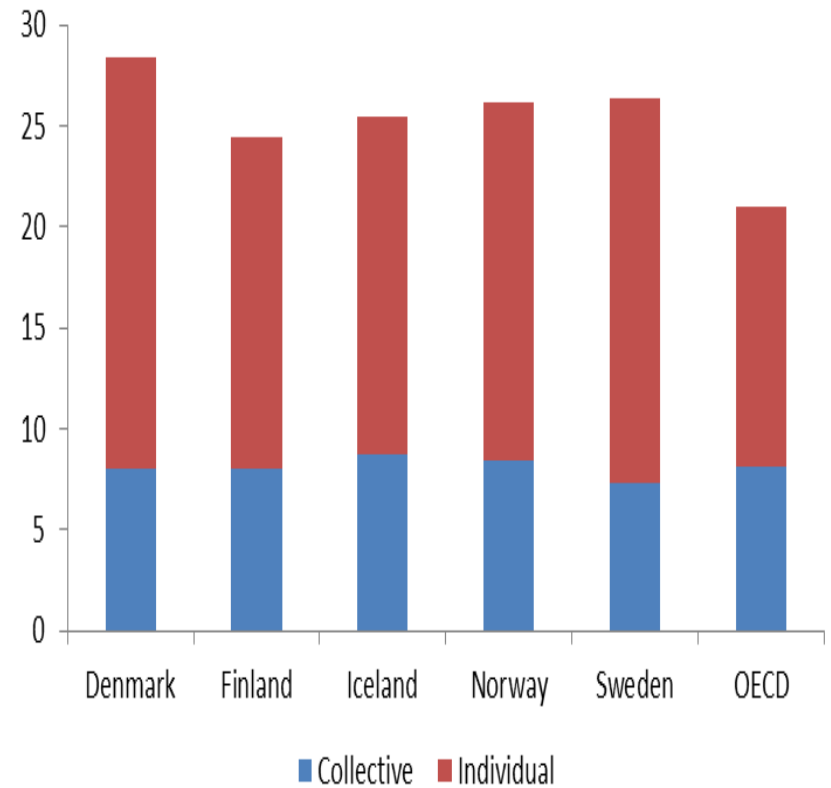


Public sector: size and structure

Size



Structure



Empirical evidence – how does the public sector affect economic performance?

- Data/measurement
- Reverse causality
- Estimation methods

Mark I – Literature:

- Cross-section
- Ambiguous conclusions

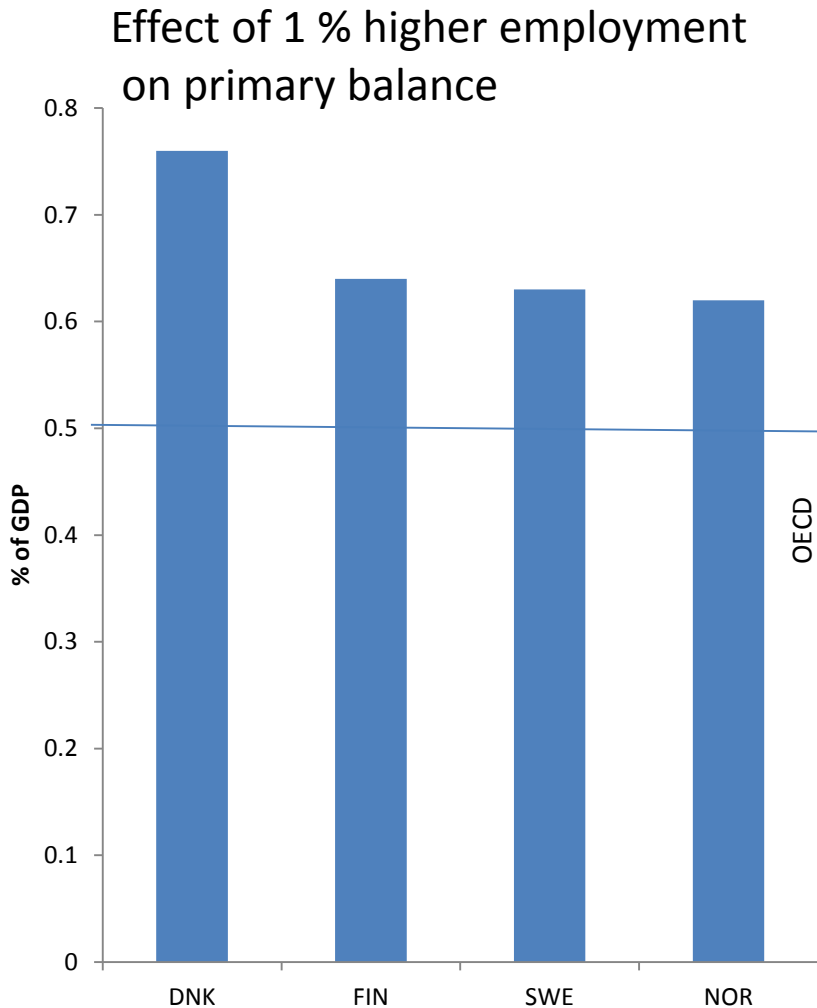
Mark II –literature:

- More sophisticated estimation methods (panels)
- Explicit distinction between active/passive spending; distortionary/non-distortionary taxation
- Explicit account of the budget constraint

Empirical findings

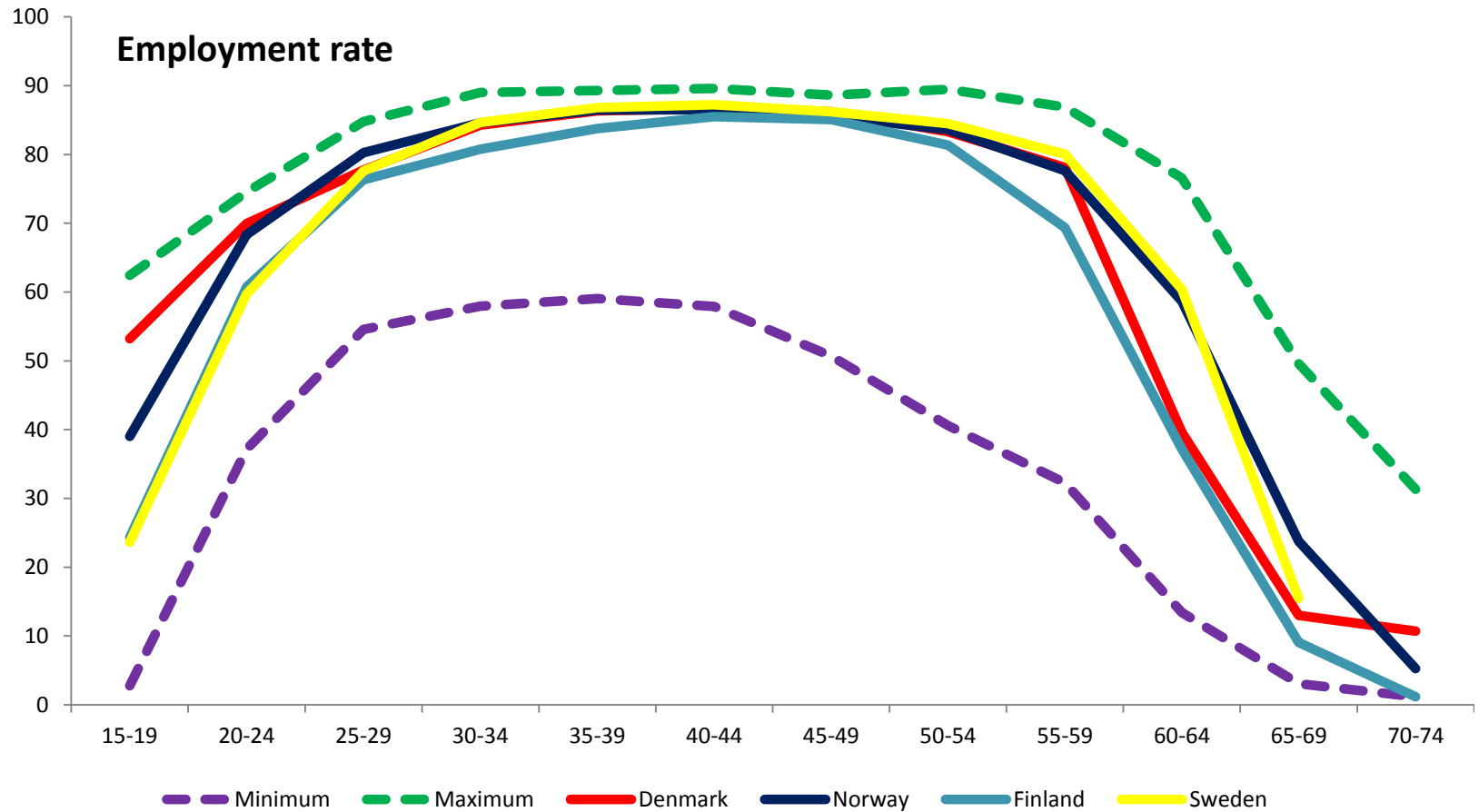
		Expenditures	
		Active/productive	Passive/non-productive
Taxation	Distortionary	Ambiguous – possible non-linear (Growth hill)	Reduces growth
	Less-distortionary	Growth enhancing	No effect on growth

The model is dependent on a high employment rate

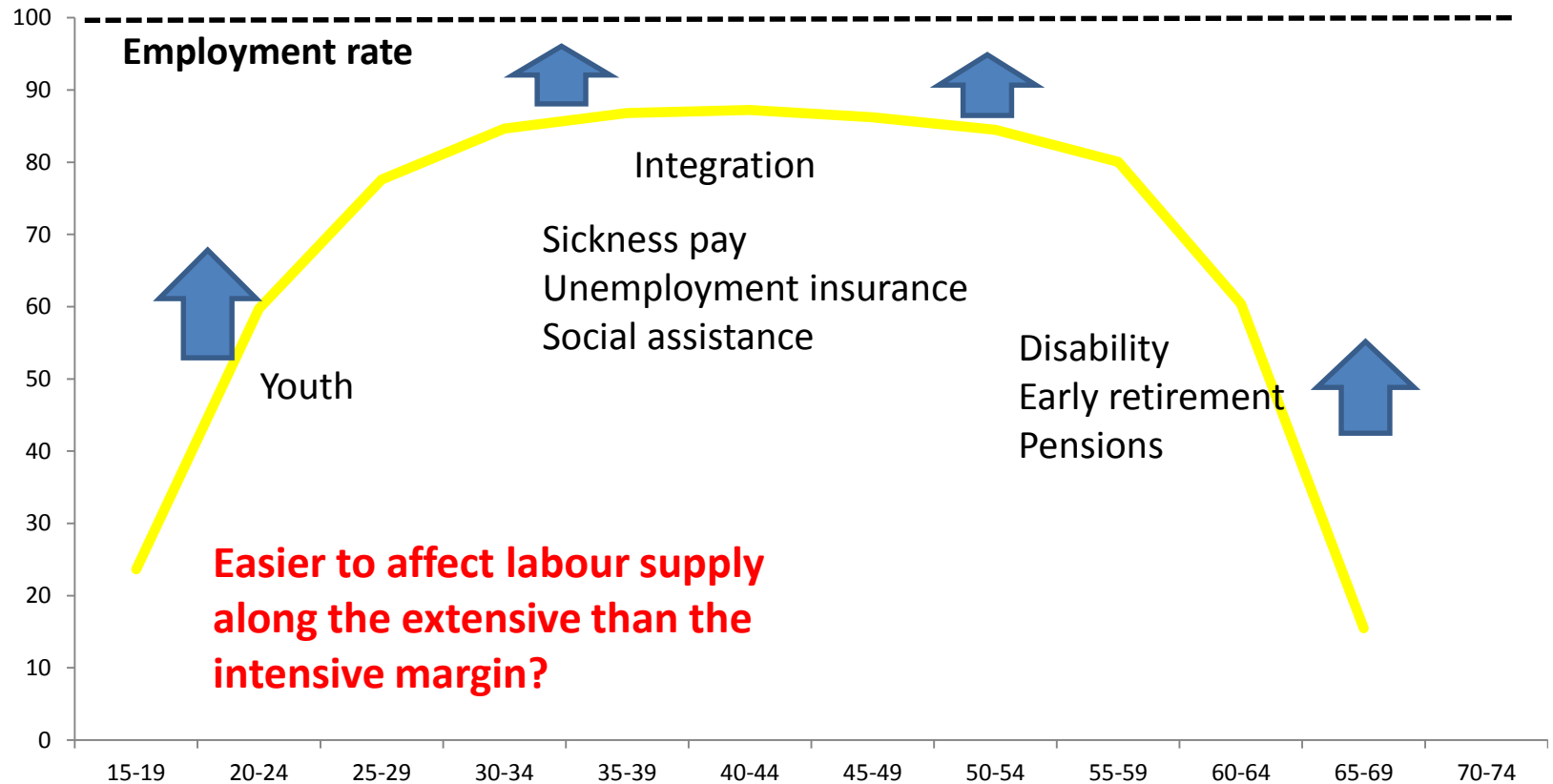


- High budget sensitivity
- Cycle: Large budget variations
- Medium-run: High employment rate needed to ensure financial viability

Employment over the life cycle



Employment over the life cycle



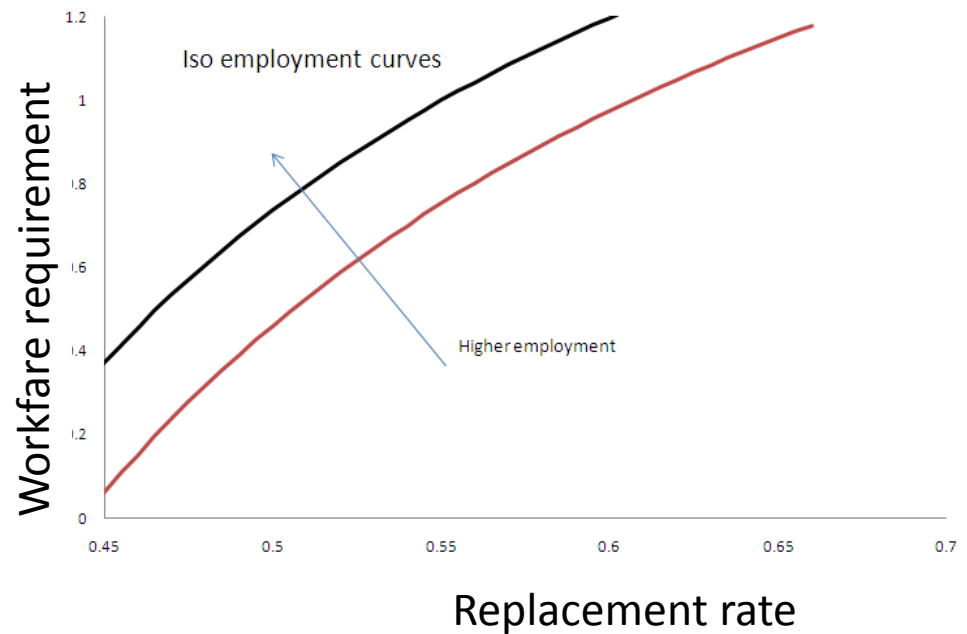
Entitlements to welfare benefits (Unemployment benefits, social assistance)

- Conditionalities with a strong employment focus
 - Availability/job search test
 - Enhance job finding possibilities
 - Overcome qualification barriers
- Aim to provide income support/insurance, not to subsidize leisure
- Active labour market policies. Continuous change in requirements and contents
 - Business cycle situation
 - Evidence

Incentives vs distribution

Standard search model:

- Unemployment benefits distort job search
- Activation strengthens job search
- Improve incentives:
 - Lower benefits
 - Workfare requirements (programme participation)



A high employment level can be supported despite a generous social safety net

High taxes and a generous social safety net

Individual:

- Non-work to work

Work: Wage - tax

Non-work: Transfer

Gain from work: Wage - METR

Marginal effective tax rate:

METR = tax + transfer

- High METR = incentive problem

Economy-wide:

- Change in employment: ΔE

More tax revenue

Less expenditures on transfers

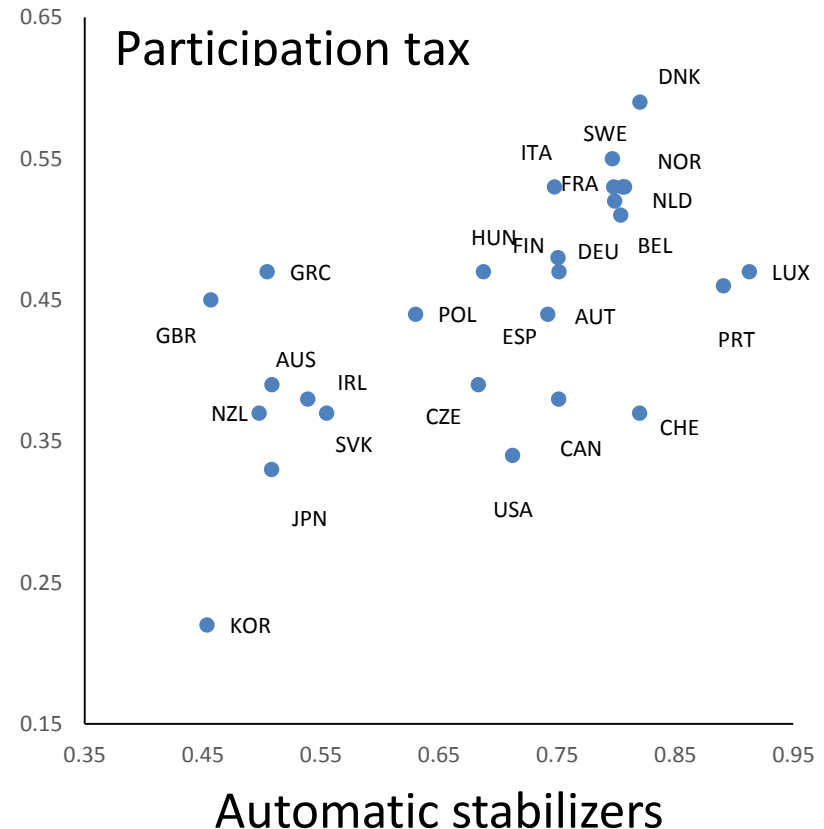
Net effect = $\Delta E \times \text{METR}$

- Short-run: Strong automatic stabilizers

- Medium-run: Financing requires a high employment level

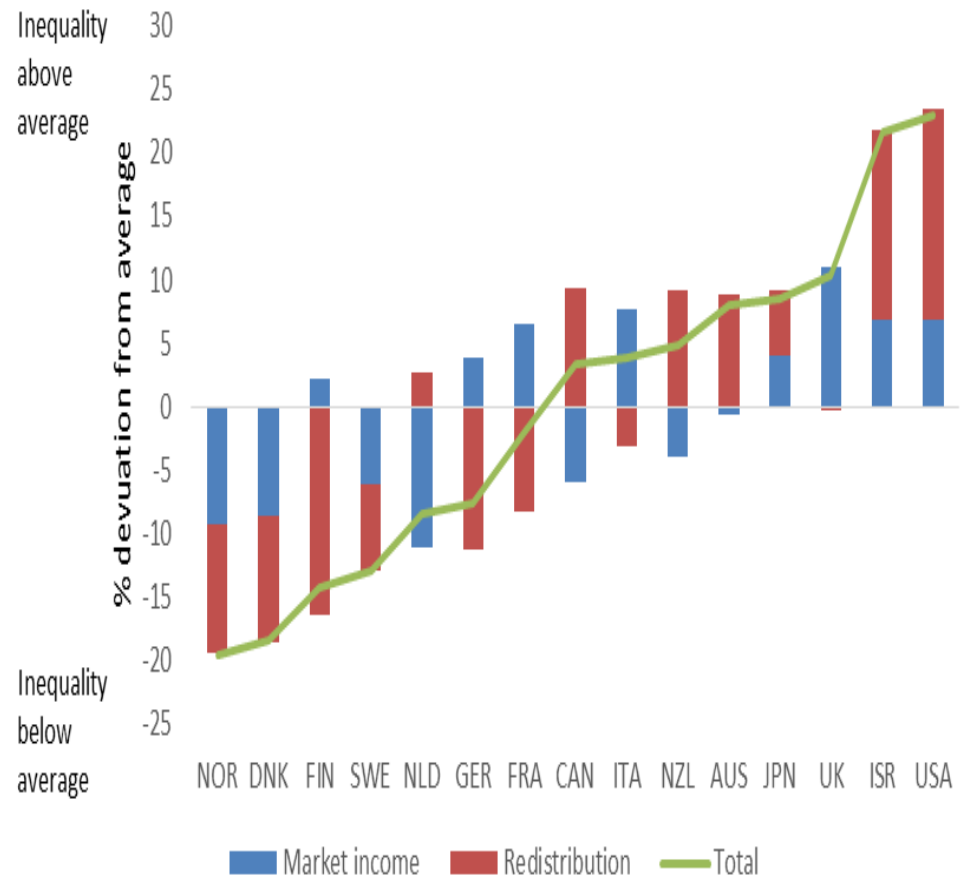
Empirical evidence on automatic stabilizers/insurance

- Cushion individual disposable income - Private alternatives for this type of insurance are highly imperfect and incomplete;
- Contribute to stabilization of the aggregate economy via their stabilizing effect on disposable income and hence private consumption and aggregate demand;
- Mute the consequences of economic crises on income inequality;
- Rule-based inducing an automatic response to a change in the business cycle situation.

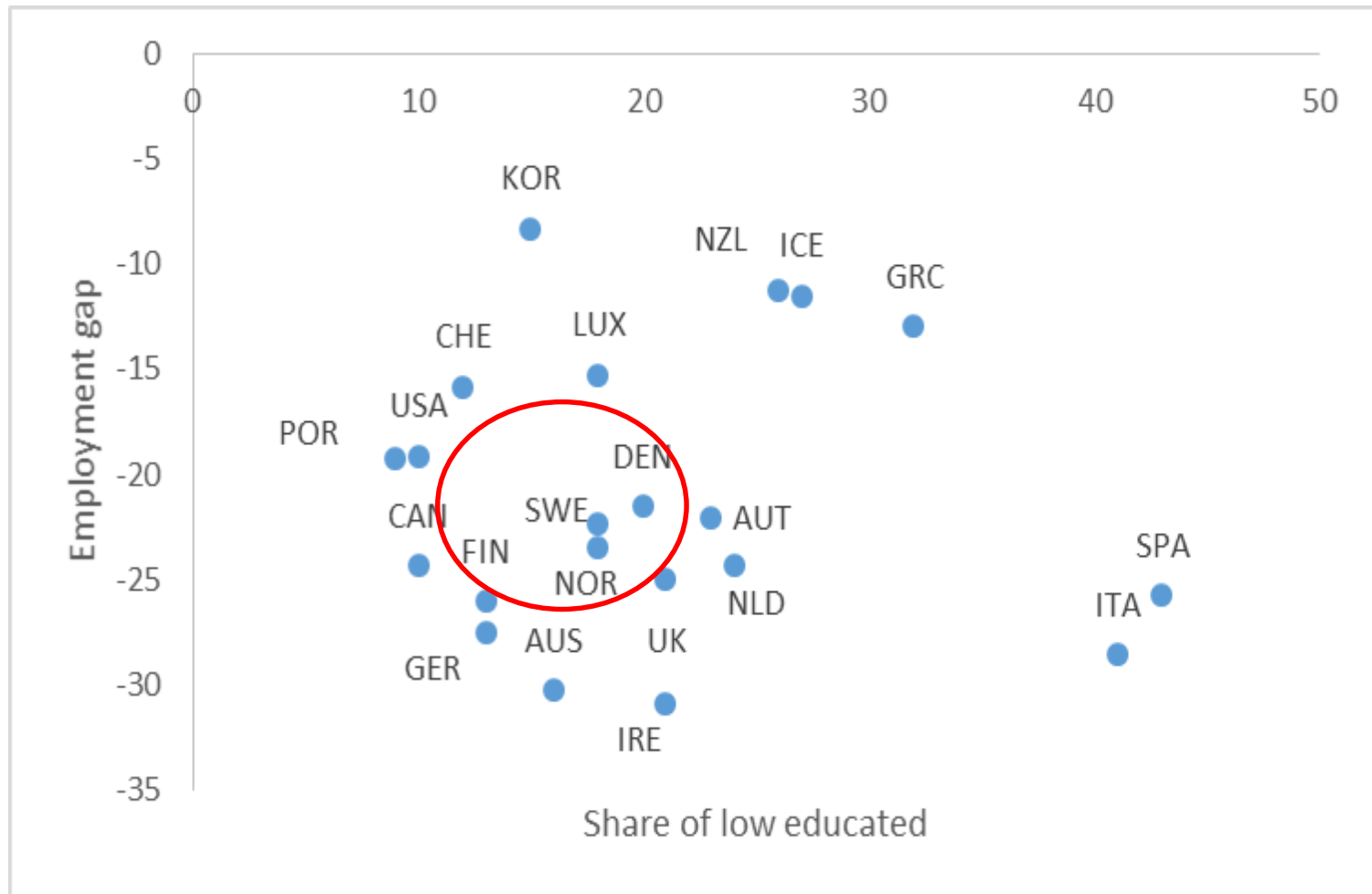


What accounts for low inequality?

- Passive redistribution
 - Taxes/transfers
- Active redistribution
 - High level of qualifications
 - Equal distribution of qualifications
 - High employment rates – also for low skilled (few working poor)



The challenge - Educational gap



Conclusions

- The structure of the public sector is as (or more) important, as the size
- Active vs passive spending/redistribution
 - Possible to make improvements both in the efficiency and equity dimension
 - The Nordic countries have a strong "active focus"
- Future challenges
 - Not all changes are threatening the principles of the model
 - New solutions (e.g. pensions)
 - Not a static model
 - Reform capacity
- Mobility/migration – may induce selection and "race-to-the-bottom" mechanisms