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Comunidad de Madrid

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“Human Resources and Labour Market in Madrid Region”

July, 8th 2008

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CONFERENCE: PROFESSOR JAMES J. HECKMAN

Thank you very much, governor. I appreciate the opportunity to speak tonight. I’ll try to be short. I’ll try to focus on the main discussion. I am very pleased to meet our prominent official and I am very pleased to be invited here in this city as a guest of the province, the community of Madrid.

I would like to talk about the role of incentives in labor market policies. It is part of a body of research that I have been conducting for years. My particular application tonight is in reference to the welfare state in Europe. I have a larger question in mind, though, even though that is a big enough question. The question I want to discuss is a way of thinking about how to evaluate policies to understand the way the world operates and to understand what a good policy might be and what they are not. So I want to try to illustrate a certain approach to understanding how economies work and to understand how to think about the welfare state. So let me just start and give you some idea.

First of all, there has been a lot written about the welfare state and we know there are reasons for the welfare state to exist. The welfare state is a fairly recent creation. The welfare state came into existence as we understand it in the late 19th century and has subsequently been perfected and has been subject to constant experimentation and expansion. In most modern societies today are some form of a welfare state and so the demand for the welfare state which started off as a desire to protect people against some of the uncertainties which are a feature of the modern economy have become even more heightened in the last 20 or 30 years. Globalization and the inability of the individual states and provinces and cities to tax the mobility of capital has made the welfare state come under pressure. Globalization is a central force in the world. And in fact, the desire to protect people against the vagaries of economic life, that demand has increased if anything in the last 20 years because there has been some people who said the world is more flat, there is a lot more trade, we are a lot more interconnected. That carries with it a lot of opportunity but also carries with it some risk. The opportunity is, of course, that we can find new trading partners, we can essentially take new opportunities that didn’t exist a hundred years ago, but at the same time, the upside of these possibilities has the downside of some risk. And so there is some notion about trying to provide the insurance for individuals living in these societies, again, some of the greater risks that they face. So, as economies become more open, it becomes much more difficult to shelter workers, even though the very openness of the economy creates a demand for some sheltering. And we know, for a fact, that less sheltered economies, sheltered economies like the US and the UK which have been quite opened historically, not perfectly open, but certainly more open than many economies, many of the welfare states in Europe, have shown an increase in wage inequality and social inequality. This is due in part to the way that the structure of the world trade and technology has become a lot less predictable. We also know from a lot of research in modern economics that a premium has emerged in the economy and the global economy for those societies that are flexible and responsive. The more flexible a society is, the more it can take opportunities. And we know what determines flexibility. High levels of workforce skill, regulatory environments that support change allow societies to benefit from new opportunities. And we have also known that an economic welfare state that was set up in Europe, in many countries in Europe after the II World War that was well adapted to that environment some 40 or 50 years ago has become a lot less functional (maybe some people would even say dysfunctional) in the early 21st century because the categories and the predictable quality of those earlier times has left us, maybe forever. Now, the case against introducing the welfare state and those people who attack it has been that it blunts incentives and reduces productivity. It would seem, from looking at the data, that that is true. And in fact, the economic performance of many welfare states has been quite poor, at least over the last 20 or 30 years.

I will show you some statistics, but it is well-known that if we look at the recent economy in Europe, Western Europe, in the last 20 or 30 years, there has been a rapid run-up in unemployment, and what we actually find is that the unemployment statistics that are in the public domain are actually understating the true level of unemployment in Western Europe. A lot of incentives have been created by the welfare state, and there are many different versions of the welfare state—to withdraw from work, to go underground, to retire early and not to produce. Also, as is true here in Spain, certainly true in Holland, Germany and other Western, France, the immigration issues which there are serious, substantial high levels of immigration, and in many European countries the immigration problems have become more serious, in part because of the welfare state policies. So, what’s happened in many modern welfare states is that there has been a low growth in the formation of human capital, which is a vital ingredient for modern economies—slow rates of entrepreneurship, slow rates of research and development, which are the result of high taxes. So, the general discussion, everything I have just said is pretty well known, is pretty much in the public domain. But recently, many people, in particular OECD, think-tanks around Europe have become fascinated with the Nordic welfare states, in particular Denmark, to an extent Holland, but certainly Denmark, Sweden, Finland, have been viewed as very successful states and maybe even models from which we can draw many important lessons. I want to examine the success of the Nordic system, but I want to go beyond just examining the merits and the demerits of a particular system and to try to establish some general properties of what is going on.

What I want to argue today is that the key to a successful welfare state is in devising proper incentives. I want to move beyond the normal discussion about looking at incentives and looking at any particular body of facts to try to extract some very general lessons across many different societies, not to sanction or to condemn any particular set of policies or any particular set of political or social organizations but to try to take from this a conception of what is the most important, which features lead to success. In principle, and I think this must be said at the beginning, the welfare state can provide proper incentives and can at the same time afford a measure of security and dignity for its citizens, but it has to respect incentives. It has to understand that when incentives are ignored, when the basic operations of incentives are ignored, things can become quite perverse.

So, today I want to talk briefly about 5 broad things. First is the one that I just stated, which is that people respond to incentives. And I think it is a mistake, it is a mistake that we have all come to understand in modern discussions, in government, in political economy, in politics, have come to understand that agents, that human agents, that actors in the social system are extremely ingenious people. They can evade, they can get around, they can circumvent regulation. Unless we account for this we have a substantial limitation on understanding how to device proper policies.

Secondly, I want to make a very important point. That is that in this discussion about the welfare state the way the issue is typically cast is as a comparison between North America or just the United States or North American and the Anglo-Saxon bloc against the European welfare states. I think that’s a false choice. It frames the issue in a way that it is a false dichotomy. That is not really the issue. It is not a question of whether or not the US is a good system or a bad system or whether or not the Anglo-Saxon bloc is a good or bad system. It frames the choice which I think is misleading. We know, for example, that the so-called Anglo-Saxon bloc of countries, the US, Canada, UK, Ireland, Australia, New Zealand are welfare states. They are welfare states with various features, and anybody who studies the economies in these states has to understand that there are important mistakes that have been made and we should learn from them in order to avoid them. So the relevant issue is not whether Europe should adopt the Anglo-Saxon model or whether Anglo-Saxons should adopt the European model. Rather, it is about trying to understand what lessons we can learn from this entire experience we had in the last 130 years with the welfare state.

A third point I want to make, and I think it is very important, is that the term welfare state is far too broad. There is a categorization due to André Sapir at the Bruegel Institute in Brussels. I will draw on his categorization. Many people would claim this is far too crude already and should be refined, but generally we can talk about four categories of welfare states. The one that has received the most attention is the so-called Nordic corporatist model, that includes Scandinavia, Finland and Netherlands. These are states that have high levels of security for workers, or so it seems, a heavy reliance in active labor-market policies, job training programs and a whole set of legislations, all of which is adopted here in Spain, low inequality in the larger society, high levels of taxation of labor income, relatively low levels of taxation of capital, very high levels of education and high levels of government activity. In terms of the union sector there are concentrated unions and union wage-setting, so that we find a highly centralized bargaining system. That is one model.

A second model is the so-called continental model. This includes France, Germany, Belgium. And that has a different feature. First of all, the unionism, while it is expansive and substantial, it is not as highly coordinated. There is a heavy reliance in insurance based in unemployment benefits and old-age pensions. The unions are not centralized and there is some competition among the unions. There is lots of regulation in the labor market and in the product market, inflexibility, but again, like in the Nordic countries it compresses wage distributions. But what is striking while comparing the continental model and the Nordic model that many people have noted is that in the labor market especially, but in other markets as well, there is a marked inability to respond to change because of labor market regulations, the cost of hiring and firing workers. That is the second model.

The third model is the so-called Mediterranean model. That is the model that includes Spain, Italy, Portugal and Greece. Here, generally speaking, except for the use of temporary contracts, there is a heavy reliance on unemployment protection, lifetime jobs, union-covered sector has compressed wages, a lot of spending and old-age pensions and a lot of segmentations of entitlement and status.

And the fourth model is the Anglo-Saxon which would include United Kingdom and Ireland here in Europe and then, of course, more generally, the English-speaking union, if you will. Social assistance only as a last resort, relatively low levels of job protection but not absent job protection and relatively low minimum wages but, at the same time, characterized by cross-section wage inequality. Some people would use the term that yes, they are more flexible, but this is sometimes characterized by the so-called savage capitalism with high levels of inequality.

Now, these categories are far too broad. You could, for example take Ireland, which is really a corporatist state which has been lumped in. Ireland speaks English it does have some features in common but it has highly centralized bargaining, it has a lot of wage coordination. The Irish are currently engaged in a round of negotiation. So I want to try to go across these categories and I want to try to extract lessons, not to condemn or praise any particular system but to understand what we can draw from it.

So, a fourth lesson I want to try to emphasize is that when we think about policies and we compare discussions, inevitable, and it has been a feature of public policy discussions for decades, there is typical desire to take a whole system to feature something, like for example to think right now that the Nordic model offers some success and that we should embrace that, but I think you have to understand that this is a very dangerous business. If we go back in time we will see the different base-line periods, different terminal periods can lead to very different ratings of any economy, so it is dangerous to seize on a success story. About ten years ago The Economist magazine was publishing an article about the Dutch model. How could Holland have such low rates of unemployment, such great success… and notice they haven’t been talking so much about that so recently since it has vanished. There was an earlier fascination with Japan. And for those of you that are old enough to remember this, there was even a fascination with the Soviet Union. So we should be warned from these histories that it is too easy to somehow draw lessons and extract lessons. But I would say that recently in Europe, and particularly the OECD has made a strong support of what they call the corporatist model, and in fact, the Nordic corporatist model as being co-equal in its efficiency and superior in its reduction of inequality to that of the Anglo-Saxon model. Sapir discusses that many people have adopted this, in fact, I kept a quote from Jeff Sachs who is at Columbia University, head of the Earth Institute, who basically makes this quotation. You can read it for yourself, but basically it says that 60 years ago Hayek was concerned about “The Road to Serfdom”, he thought that the welfare state, he was really talking about the British welfare state, circa 1944, and remember “The Road to Serfdom” was actually written even before the British welfare state was put in place; Churchill was prime minister, not Attlee, but what happened was the notion that Nordic states have thrived, that Hayek’s concerns and the concerns of many liberals about welfare states were misguided, that the welfare state can in fact offer strong, generous policies, it is not a road to serfdom but in fact does very well. I think the Sach’s quotation which I extracted as representative of a large body of thinking is typical of what a lot of people thought about the Nordic welfare states.

Now, I want to argue that in fact Sweden’s economic performance has been impressive. You cannot deny that. So is that of Finland. And Denmark, especially, has attracted a lot of attention. The so-called *flexicurity* system, where essentially the argument is that we can give security to workers but we can also flexibelize labor markets by giving workers who are unemployed incentives to return to work, so you have short spells of unemployment. So this *flexicurity* system has attracted a lot of attention. But I would argue that this kind of endorsement of the Scandinavian model or any other model is typical of a line of thinking, a way of thinking about these things which essentially is looking as some particular working model, rather than go beyond the working model and look at basic principles and the success or failure of any model. So, today I would like to try and look at these basic principles.

A fifth and basic methodological point is the following. There is a lot of reliance on bad data in this discussion. What is typical of OECD and many leading scholars in this area is to actually develop indexes of job market protection, indexes of things to try to capture the extent of unionism, the extent of access that people have to different markets. But they don’t get at the fundamental measures of what are the incentives that are facing the agents. They are highly aggregated and they don’t look at actually what are the costs of labor, what are the costs of doing business. What I would argue is that this whole body of work has been somewhat misleading in its quality. It is based in part on statistical mirage. There is a phrase in English, I am not sure what the Spanish counterpart is, but it is “garbage in and garbage out.” So, if you have very weak measures, you are not going to find that these are going to explain very much. And what I want to argue is in fact, and this will kind of bring the Latin American heritage of Spain back to Spain, but in fact, some scholars in the Latin American labor market have been a little more systematic. They have measured the costs of regulation much more systematically than any students have currently in the European welfare state. And what they find is that if you do things in the traditional way that is done in Europe, you will find very weak evidence on incentives, but if you actually go out and take the trouble and the pain to measure what the costs are of doing business in certain countries, the cost of hiring and firing labor, payroll taxes and a variety of other incentives, the better we measure these incentives, the more likely we find that they are important. So, let me just talk a little bit about the welfare state in Northern Europe. Just to make a point that some of the statistics that are put out in the public domain are not as glorious as they have been put forward. The OECD report I have mentioned already talks a lot about the fact that *flexicurity* and the Nordic welfare state is a great model for Europe to adopt. But if you look at the European unemployment rates, and I will not go into the details of this, but if you look at a phenomenon that has very well documented, that purple line and that figure is essentially the OECD Europe unemployment rate. In the bottom line, this dashed line here, the blue dashed line that is at the very lowest is actually the American unemployment rate, not always low but essentially somewhat lower than the European rates. What has also attracted a lot of attention is this blue line, this dashed blue line, with the arrows, which is the corporatist model, which in the last 5 or 6 years has had a fairly low level of unemployment, although in previous periods it was higher than the American rate. We also notice, if you look at productivity growth, productivity growth in the European area is particularly low, but if you look for example in the flexible market, Euro, the blue line here, very rapid productivity growth, which in some periods it has exceeded that of the American economy, so you see that there is a real performance delivered by the Nordic labor markets.

On the other hand, the GDP growth is lower. Let me consider Sweden. Sweden is one of the most studied welfare economies because there is a body of scholars working in Sweden, a lot of the economists, there is a lot of knowledge about Sweden. So let’s take a look at the economic history of Sweden, but to try to understand that yes, Sweden has improved a lot and recovered a lot from its depression or recession in the early 1990’s, nonetheless one has to understand that in terms of historical performance, the Swedish economy has not done all that well. So if you look at the end of the II World War, when Sweden entered the post-war economy it was in a relatively advantageous position. It had not participated in the war, it had probably made money by selling iron to the Germans, so there is no question that it was not too much skewed by the war, trading relationships were cut off. But if we are to look at the economic performance of Sweden, say between 1950 and 2000, this is essentially a measure of how the purchasing power parity adjusted GDP per capita in Sweden compared to that of the rest of the OECD, we can see that over the last 50 years, 55 years has been a decline. What we also see is that Sweden hit a rock bottom in its historical average against the rest of OECD in 1990 or so which lead to substantial reforms. This lead to an improved economy. Taxation was essentially caught of many reforms which were put in place and this lead to some improvement in the economy. If you look at this figure over there at the left, you’ll see some increase in GDP per capita. But if we look closely we see nowhere has Sweden recovered back anywhere near to its pre-eminence of 50 years. The Swedish economy relative to the rest of OECD is one of decline, not growth. If we look more closely at the Swedish experience, we will see that most of the employment that occurred in Sweden, most of the growth was that of government employment. So, for example, here is the total population of Sweden, it was increasing. But if we look for example at total growth it was government employment, total employment went up but it was only because of government employment. Only after the 1990 reforms when more incentives were put in place, taxation and capital was reduced, the total income tax was cut to the lowest level it had been even since the cuts in the depression in the 1930’s, they started to see some growth in civilian employment. And so what you have really seen is that Sweden is not a bad case but it is partly a triumph. And if you were to compare Sweden to other countries in Europe, for example Ireland, until recently, has done extremely well. And so if you look at all these Nordic miracle countries and ask how do they compare in their GDP per capita, if we go back 30 years we can see that Sweden and some of the Finish economies have done well recent periods but over the long haul not so well, and not all the tremendous growth of GDP per capita that countries such as Ireland have experienced. If we ask what are the features that have made Ireland so successful, partly it was the low taxation of capital, partly it was an opening of the economy, but don't forget, Ireland was a corporate state, it did have centralized bargaining, it wasn't that it completely embrace the North American model, but it did provide incentives and in particular incentives for firms that located into the Euro zone. So in job creation, if we look at total civilian unemployment, we can see that Ireland had tremendous growth in the previous 10 years, and the Swedish, the Nordic miracle states did not do much. Productivity per hour went up, it was tremendous growth. So put in context, the Swedish miracle is not miraculous.

So it is incentives that matter. We take these things, we look at many other reforms, for example in the United Kingdom, New Zealand, Australia, Chile, we see that essentially when the economy started to perform it was that social partners cooperated in a time of crisis. There was a crisis in virtually all of these economies that lead to the reform—another lesson to bear in mind. And one cannot underrate the value of crisis in producing reforms. The question, and one which I think should be of great concern here and everywhere is how can one make meaningful reforms and not have to go through the crisis. That is a question.

But let me make one remark which is more a statistical remark. It is on the statistics of the Nordic welfare states. They appear to show a health that in fact it is disguised by the larger way in which statistics are presented. The official statistics in the Nordic welfare states are very distorting. And let me show you an example of why that is true. Active labor market programs are widely regarded, even by the OECD and certainly many commentators in

Europe as being a very important source of success of the Nordic and other economies. There has been a major commitment in many European countries, including Spain, to these so-called active labor market programs and many people have endorsed these programs. To get an idea of how extensive the coverage is of expenditure on active labor market programs, if you look for example at this bar in Denmark, so this is Denmark over here, if you look here, close to 5% of GDP in Denmark is actually being spent on these active labor market programs, Netherlands is 4%, Spain is somewhat lower but nonetheless still at 2.5%, substantially larger than what you see in Canada, the US, Australia and the UK. So, there is an important emphasis here. Greece and Italy are, of course, lower. I am not sure those are appropriate bench marks. But what we have learnt from a large body of studies some of which we heard about a minute ago in the introduction, are essentially that the active labor market programs have had minimum long-term effects in wages and employment and most did not survive across benefit tax. So if we ask what are the long-term benefits for most of these active labor market programs, the fact is that they are really quite limited. Most programs are not taking [incomprehensible] out of poverty. And a recent paper by Alan Kruger co-authored showed that none of the recent recovery showed in the Swedish economy can be attributed to this. But it is worse than that. It is not just that societies are essentially wasting resources by spending 5% on programs that do not work. It is worse because these programs are concealing problems. Let me give you an idea. The way that the Swedes count people that participate in government training programs is that they count as government employees, so they employ people. You spend 5% of the GDP, you put these people on training programs, and they now are employed. If you realize that they are being employed in programs that do not have any long-run effect, this artificially accelerates growth, reduces unemployment. So, for example, let me show you how dramatic this effect is. In the Swedish case if we were to essentially… this is the corporatist case, not just the Swedish case, the whole set of corporatists this would be Finland, this would be Norway, this would be Sweden, this would also include Denmark. And we were to simply say how much of the unemployment, if we took those people who were brought out of the labor force and put in these training programs and counted them, as the properly should be, as unemployed people, then we get an increase in the unemployment rate in the Nordic miracle countries from a little less than 6% to a figure that over around 11% in the later periods. So what is happening is that the government statistics are essentially concealing the problem. This is true not just with unemployment, but if you see some countries around Europe, you see substantial differences between the open and the true unemployment rates that are concealed in part by hiring people in these training programs. So there is some deception going on not only in not producing better people but in not producing a program that has substantial benefits but at the same time you are actually leading to a reduction in the structure, you are kind of concealing a problem by making these programs appear successful. And this is true, for example, in other programs in the welfare state. In the Netherlands, at one time, one out of seven workers in the labor force or potential workers was in disability, 1 out of 7!, huge proportion, 14% of the potential workforce. You can see that at one time nearly 6% of GDP in Holland was actually spent on disability programs. This has been cut in recent reforms, but even now in Sweden we see 4-5% of GDP is being spent on these programs, huge expenditure. What is the effect of this? It disguises the statistics. If people are out of the labor force, they are not employed. It looks like the society is succeeding and consequently that leads to bad statistics.

So, more generally, these programs in the welfare state, if you had to give the beneficiaries as well as the people who are actively engaged in government employment leads to a very unhealthy political economy. It turns out that if you count dependency as not only direct receivers of transferred benefits, unemployment benefits, job training benefits, benefits that have to do with disability and you count government employees, then in Sweden you have over half of the entire workforce. It’s either a beneficiary of government or is actually working for the government, which makes it very difficult to change policy. They are benefiting from the system, why should they change it, even if they see it might lead to a problem. So, I will skip through some of these other statistics. But it leads them to a substantial problem. But it also leads them to an amount of perverse incentives because to finance a welfare state, what has been adopted in practice, although it is not an essential feature of the welfare state, are levels of taxation that are heavily distorting. For example, Lance Bolvenberg, a very important Dutch economist has estimated that for the median Dane essentially 75% of the taxes that a median Dane receives are repaid in benefits over the course of a lifetime. So, they pay money and they pay it out, but each time over the life cycle, whether they are transfer recipients early on, whether they pay heavier taxes later on, margins are distorted. So what happens is that the incentive to acquire education is reduced, the incentive to acquire skills is reduced, and people are distorted, Bolvenberg himself suggests that major reform for the welfare state which is social accounts which will not be distorted, people will not be taxed at each margin, but will essentially have a set of benefits which they can draw on in a way that is unrelated to their particular tax bracket at a particular age. So what has happened is that in the course of trying to finance some honorable motives they have had huge distortions of the statistics and huge distortions in the incentives.

So, let me just talk very briefly about the consequences of the current level in the welfare state which is the slow growth in levels of education in Europe. We know that education is a major determinant of long-run employment and unemployment, and that more educated workers help to make the economy more flexible, they adapt more easily. But we also know that educational expenditure in tertiary education, college, is much lower in the EU than it is in the US. In part, the incentives to acquire education are dull, partly is the high marginal tax rates on income, partly it is that there is so much reliance on the public sector to support education, especially at a time when government resources are scarce. We know, and this I think is a positive lesson from the American welfare state, Canada and the UK, that as we rely more on private resources inside the education sector, we can do two things—we can generate a source of revenue that helps support education, and at the same time we can screen students in with a high demand and help raise the level of support of education. So, what happens in welfare state policies is that some economies essentially try to offset the high distortion that comes from high levels of taxation with high subsidy for schooling, but this is kind of undoing one distortion with another and it is a delicate business. So we can see there has been a very slow growth and if we compare educational levels compared to what has been happening in other parts of the world, then we can also see that in terms of a measure of quality of educational expenditure, the US has had a much higher level of quality. They have been able to attract some of the best scholars from around the world, precisely because incentives are built into the educational system, especially the college system, which makes it really an attractive system, and which has attracted some fine academics from around the world, including many leading academics from Spain. But let me give one final note about the welfare state, which I think should be a source of concern. The continued operation of the welfare state has now been documented to change preferences. As people become adjusted to the welfare state they started to give in in a way that was not so common some 20 or 30 years ago.

I remember visiting some towns in Sweden some 20 years ago and I was amazed from looking at these disability rates that in Sweden, and certainly… I was in Gothenburg, some of them were programs just across the border in Norway, and what amazed me is how much the Swedes worked even though every incentive was very much against their working. There was actually a replacement rate on earnings for those who had disability of something like 110%, so you could actually make money by not showing up to work. The incentives were very strong. You get more money if you called in sick and said you were disabled than if you actually worked, and yet the Swedes, nonetheless, tended not to use this system. But what we have seen in recent cohorts, younger cohorts facing essentially the same incentives is an increase in welfare participation. These are Swedes, these are not immigrants, these are not people coming in to migrate and take advantage of the system. Every statistic I am about to show you is that of so-called native born Swedes whose generations go back, their families go back for generations in Sweden. So, let me show you how this is operated.

We can see three graphs here. This is the graph for men and this is the graph for women. What you can see is participation rate in disability programs. So if you look at the older cohorts of people, these are people in their 50's and 60's. So, if you look at what age they were in 1968, what we see is essentially that these are the younger people who go through the system, these are the older people. We can see much lower rates of participation at the same incentive rates in those programs that essentially are favoring…those programs that are essentially the same through these cohorts. What we see is a much greater take-up rate for men and women in benefits among the younger cohorts. And so, what has developed is a sense among the younger cohorts that the society will take care of themselves, that you do not have to work, that the kind of social compact, the kind of work ethic that was a central part of the welfare… of the foundation of the welfare system is slowly coming unglued. So, I think this is a serious long-run problem that is just beginning to be analyzed. That particular graph that I just showed you is from a PhD student of mine who is now at the Stockholm School of Economics. His name is Martin Lee Yong, and he, working with Kelly Reagan, has documented that there is a substantial… I guess this is the point here… discovered, maybe a little late, but better late than never… so here we see the participation rates, and this does suggest that essentially the modern cohorts are getting adjusted. If they are getting adjusted that means it is going to be harder. That means you are going to have greater dependency and less productivity. So I have already made some brief reference to this. I will just refer briefly to what the comparisons have been. But again, the effect of the structure of the welfare program, whether or not these programs have substantial disincentive effects is highly debated. There is a whole cottage industry of people who create indexes, whether it is OECD, whether at the European Commission in Brussels or in many other academic centers. These famous cross-country panels that have been analyzed by Blanchard and Woofers among others are suggesting that European unemployment rates are not much affected by incentives in these organizations. But what I want to argue is that these studies are almost guaranteed to produce weak findings because they do not measure incentives at the level at which they operate. So, what you see is essentially that the incentives do not matter, but because the incentives are not well measured, there is a template for a better way to go about this, and that is what has been done by students for the Latin American labor market. A series of studies about regulation and law in Latin America have essentially made the effort to quantify the costs of incentives to try to put into one common framework, the structure of the incentives in the Latin American labor market. Let me show you how dramatic the variation has been. Latin America is a very interesting area to study, partly because of the political instability, partly because of regime changes, partly because even within the same administrative structure you see wide variation in policies that let us use this crazy economic experiments to understand what real variation is like—variation you have never seen at this scale in Europe. So let me give you an example.

This is Fujimori’s Peru. This is a study we have in our analysis. Fujimori’s Peru, where there were substantial changes, where the effective costs in terms of the non-wage costs paid by employers fluctuated enormously over the period from ’87 to ’97 we see huge changes up and down, which give us a laboratory to try and investigate what happens as you increase the quantity, the costs of labor. And so we had huge changes, payroll taxes were increased, payroll taxes were cut, cut payroll taxes were re-instated, and so forth. We can examine these studies in building econometric models. And looking at this data in a consistent way and looking at these studies both in Peru, also in Colombia, Brazil, Mexico, Chile, Argentina, we have seen a consistent body of work, which is that these incentive effects are real, that if you measure the costs of labor correctly, you find that there are substantial costs and sometimes employment costs. But in fact, it is not quite so simple.

The basic finding is the labor demand curves it downward sloping, that means if you increase the price of labor, you make the employment of labor go down, that is not denied, this is found around the world, and the evidence from Latin America is entirely consistent with studies that have been done in Europe, and studies that have been done in North America, and studies that have been done in China and Japan. So what we have learnt is that there are substantial costs through the regulation, especially to taxes that do not have off-setting benefits to go with them. In reforms that were studied in Mexico, for example in this project we find that, of course, you could increase taxes, but if you give back worker’s benefits in the sense of higher performance, higher performance of pension systems and welfare systems, that essentially you can find that there are no disemployment effects, workers are actually willing to take lower wages adjusting to the higher taxes because they are getting back benefits in exchange for those taxes. But this is in contrast, these studies that would show a much sharper incentive effect are in contrast to the kind of standard literature which has dominated the European discussion—looking at indexes that do not truly measure costs. So, what I want to argue is that there is …that flexibility is important in terms of how flexible wages are. If we had a minimum wage we put a payroll tax, really whether or not that has substantial disemployment effects depends on how well you can pass along the costs and whether or not the government is actually providing a benefit for the tax that is actually paid. And so there is much more to this. It is not just saying you raise the costs of labor. You have to understand what the true cost of labor is, and surprisingly governments are very flexible. Workers are very flexible in understanding this. So, le me just make a few final remarks and then conclude. If we look at other evidence of reform around Europe and studies where we looked at decentralized, deregulated markets or we have looked at the incentive effects, we find a consistent story. So, let me give you an example. This would be the case study of the United Kingdom.

We know that in the 1980’s, in the late 1970’s United Kingdom suffered from a lot of industrial strife. There were large unions, it was not one centralized union. There were many unions. They were striking. They were actually forking across purposes with each other. And so the history of this is that the British society became initially very supporting of this union, efforts were finally very disenchanted. By looking at the reforms, what learned is that reforms essentially were of a particular character. They did not necessarily eliminate unions. It was not the case that unions were destroyed. Not at all. What it did do is it changed the locus of activity of the union from a larger political scale, larger national scale to the level of looking at individual incentives, organizations, where economic activity was actually produced. And so, what it did, was essentially, not necessarily get rid of unions, I think that is too crude an analysis, but to change the nature of the union-firm relationship to create incentives to enhance productivity locally, and so what was found in many studies by scholars of the English Trade Union Movement was that in fact the incentives in these arrangements, whether they were in union shops or non-union shops, that was not so important, but once the locus of activity got away for making headlines, bringing in the government to help, but instead they focused on the actual productivity of the workplace and to protect the rights of workers in that workplace productivity went up, and so it was actually a question of improving the incentives. We also know the uniform wage-setting, for example in Italy, where there is wage-setting in the North and in the South, it creates a lot of unemployment in the South. In Eastern Germany, where uniform wage scales or at least elevated wage scales were set after the transition, that created a lot of unemployment, and so is it true in Northern Sweden, where you actually find that where low productivity regions are given the high wages of Stockholm, that leads to unemployment. So, what we have learned is that this large body of regulation, there is strong, powerful microeconomic evidence that this evidence of regulations that will make it to slow down the process lead to sluggish employment responses and protection laws generally have an effect which is very negative.

Let me make a couple of observations about making a remark that labor market and product market, we are talking mostly about the labor market, but if we looked for example at the product market, what we see is that the labor market and product market regulation highly integrated together. For example, you look at Portugal, Spain, Italy, Greece, we see high levels of regulation in both levels. The other branch of countries—Ireland, Australia, so we ask what is it that made these countries perform relatively well, it tends to be... it is related to the lower level of transition, but you can also see that Denmark in the second circle is actually pretty close to the first circle of the Anglo-Saxon countries, having relatively low levels of regulation; Germany being very high. We also know that there are substantial barriers to entrepreneurship, and these barriers to entrepreneurship tend to reduce substantially internet usage and the like.

So let me make an argument about inequality because many people are always making a comparison between the welfare state as a guaranteer, preserver of equality and social dignity as opposed to some other aspects of the, say, the North American model, which is less protective. That is the main argument that many people make—the welfare state is actually helping reduce inequality. But if we study the welfare state, we have to really understand that there really is in most welfare states a creation of a two-track system—the insiders and the outsiders. The insiders are those who get most of the protection. They are the ones who essentially are protected from the larger vagaries. The outsiders are the ones who find it difficult to get jobs, who find it difficult to get included in the larger economy, and this is true in many countries around the world. In practice the welfare state often excludes groups, it creates inequality and also reduces competitiveness. A comparison was made once comparing Italy with the United States. And it said, "well, there is much more inequality in the United States." Cross-sectional inequality is much larger in the US than in Italy, but there is much less lifetime inequality is actually somewhat less in the US than in Italy. Why is that? Well, the very rigidity that gives people lifetime jobs in Italy and it essentially creates lifetime employment, that has become so dysfunctional in an economy in which flexibility is highly valued, that very rigidity locks people into a poor employment situation. We know that at a time of change we need to have substantial flexibility. So, if we would actually ask what happens when people can change and gain higher levels of opportunity, then we actually find than in response to higher levels of mobility, lifetime mobility, that inequality measured in a lifetime sense is much lower. In fact, what happens is the reversal of the measures, if we look at lifetime measures of inequality. And so what we have to understand is that the welfare state is essentially promoting lifetime inequality.

It is promoting the exclusion of certain groups. It is favoring some groups but at the expense of others. And so that is an aspect that means that, at least the Central, the Continental European welfare state and the Southern Mediterranean welfare state is essentially creating a form of inequality that makes it hard for people to get protected. So let me just conclude my remarks today and let me try to summarize by saying that today I have tried to elevate the discussion of the welfare state beyond the level of endorsing one system over another. I want to try to look at the essential features of these welfare states, and it is all about incentives. If we look at the Nordic countries, we should recognize that even though they have been moderately successful, the success is overly stated by the statistics, the way the statistics are reported. And I think that is important. We also know, and we have seen a growing sense of dependency, a greater fraction of the whole economy dependent on the government, either as a transfer recipient, or as a direct employee, people taking from the welfare state, that the welfare state in certain extreme forms that does not promote social inclusion, that does not promote a larger sense of a corporate whole can actually erode the dynamism of a society. And that is a very serious long-term problem which is not fully recognized—it is juts beginning to be recognized. So this, it can build a culture of dependency, and there I think is where the Danes have been successful, that is in trying to build a greater sense of inclusion in a society. Yes, to give unemployment insurance benefits, but also to spank individuals who have spent too long finding new jobs, and reward them to get back to work. So what you really want to understand is that there are some negative features built in to some welfare states and positive incentive features built into others. But there is a serious issue here. If we do not understand these incentives, we are going to have to think very creatively when we design these incentives. So, *flexicurity*, yes, it has its features, but as has been remarked recently, the Danish *flexicurity* system, the flexible, the ones who are bearing the flexibility in this society are not those who are very secure, and the secure are not very flexible. So, in fact, you have a two-tier system even in Denmark, although it is a moderated version. So, what we need to think about in devising incentives for the welfare state is not to create negative incentives but to essentially try to bring in incentives that foster inclusion, not incentives like in Holland, where people who are migrants of the welfare state are subsidized to go on welfare, and for generations will stay excluded from the larger society, but to try to bring them in in the sense of assimilating them into the larger society, giving them incentives to work and making them participate in the larger society, not withdraw. The American welfare experience has exactly the same experience. So we want to use insurance accounts that insure but that retain flexibility and do not distort. And the most important thing is… one of the more important lessons is what we have learnt from this whole history of welfare state and welfare state reforms is that crisis is the mother of all welfare state reforms. Sometimes the crises are dramatic like in Chile, but even less dramatic we see in New Zealand, we see in the United Kingdom, we see in many, many countries from around the world—even in Sweden when the tax system was reformed so dramatically in the early 90’s, precisely in response to adverse economic circumstances. And so we know, as a fact, that most reforms that have been put in place have come in the wake of economic crisis. We know that there is very little internal capacity for democratic societies to reform themselves, and that is trouble. So what we need to do is try to understand how complicated the social system is, understand that it is easy to create perverse incentives, but we have 100 years of experience and we can learn from this experience, but we need to learn from this experience in a much more creative way than endorsing one system over another, say North America versus Europe. We need to understand that there have been some very successful aspects of the welfare state. The welfare state is very much something being perfected. It is fairly new. It is only 130 years old, really. The industrial revolution itself was only 250 years old. So we are really still experimenting and as we experiment and evaluate we are in a much stronger position to understand what the good is with the bad. But if we are to avoid crisis, if we are to actually try to understand this and to try to devise welfare states that are efficient but do so less in a statement of crisis and do so more in a considered way, we have to take stock from these lessons, we have to evaluate policies, we have to understand that some features, like active labor market programs, however political popular, are wasting 5% of the GDP; in some countries 3-4%. That money can be used in much more efficient ways. We can use a number of … but we need to improve the level of education, we need to improve the level of awareness, and we need to think of this not as an ideological matter but as an empirical matter. And to build a tradition of evaluation, to build the matter of data collection to build models, where we can create a deeper understanding that will inform public policy and move it away from a kind of left-right distinctions to a statement about saying which policies work, which ones are efficient, which ones do not work. And if we can show, as has now been shown for Sweden and many countries, that certain active labor market programs are not that effective, we can use the money to reform and transfer elsewhere…5% of GDP is not a small amount of resources. We can use these resources in different ways, but we have to think about this whole discussion of the welfare state in a more constructive analytical way that is more empirically oriented.

Thank you very much for your attention.

QUESTIONS AND ANSWERS

Any questions or comments? Yes, please.

- Thank you very much for your great exposition. First I wonder why you did not use the sample of Finland to compare. You know that Finland, for instance, in the World Economic Forum reports ranks equally in competitiveness to US for several years. And second, and then you focus more on Sweden that is more strict than Finland. And second you avoid, when speaking of the inequality, you avoid, I do not why, I wonder why, to pull any inequality measures making the comparison between European welfare states and the US and Ireland, even. How has inequality increased in the US, for instance in the last years and how inequality has been reduced, and Spain is a good example of how unequal they were for a state and in figures they have dramatically and I think there is no challenge to this opinion, in my view, that has made an increase in a great contribution to reduce inequality thanks to, I guess, to the welfare state.

- As I said. I am not here to attack the welfare state. I am here to understand it. There are certain aspects… there is no deny that in terms of cross-section inequality, the European welfare states are essentially… Western European welfare states generally are showing much lower levels of inequality, certainly in Spain, certainly in some Nordic countries and the like. What I tried to indicate, though, in the comparison of Italy and the US was that you have to be careful. In some of the Southern European countries, the measure of inequality that you make really has to be more comprehensive. It has to be more than just a snapshot of a point in time. It has to be a lifetime measure of inequality. How much can somebody who has been splattered into one level move away from that and escape. So in one sense, the opportunity to escape being trapped into one way of life, I think that is one of the advantages of some of the so-called North American models. And if you see some of these lifetime measures, the inequality gap measures… but it does not go away, it is not fully eliminated. There are some studies made, for example in the German Social Economic

Panel studies, but it is somewhat attenuated. But it is certainly true, though, for example in the case of Finland. Sweden and Finland are interesting countries. As you know, I am sure, that both Finland and Sweden are dominated by the success of particular sectors that have done very, very well—Nokia in Finland and Erickson in Sweden. And what you actually see there is that in other sectors of the economy…there is a new report that was put out by the national bureau and the Swedish National Statistical Service just coming out this year, actually. It is on the National Bureau of Economics Research website. And a comprehensive study was done, and so, yes, Sweden and Finland, as a matter of fact I do discuss the Finish case, do have real increases in productivity, especially in those sectors that I just mentioned. But on the other hand there are some serious sectors where there are strong disincentive effects, and in other sectors the economy really struggles. So what I am trying to do is entirely consistent with what you are asking me to do, which is "let's take the pieces that are successful". But then also let's look at the long-run trends. It is not so obvious, for example if you look at what is going on in Finland, and for that matter in Sweden. There has been a lot of outsourcing going on, and a lot of outsourcing going on in the US, and a lot of outsourcing going on in countries going on in countries like Romania, Latvia, Lithuania, and so again, what you are starting to see is opening up of some aspects of inequality, where the education premium is not as high, and now we are starting to see the wage growth, some growth in inequality. But it is certainly true that in some aspects of inequality, the Nordic states are further ahead of those in the United States. For example if you look at the persistence—how important is the father's income in determining the income of the son, ok? We can look at correlations. So if we look at the long-term correlation over a number of years—how predicting is the father's income on how the son's income is going to be. Well, in the Nordic countries you get a correlation of about 0.2—a moderate correlation. Not particularly high. In the United States it is closely to 0.65, and again it is clearly related to some Nordic welfare state policies. It is no doubt related to the fact that certain policies that favor investing in children, that favor high quality schools, that favor protecting women who are going to work do seem to have some beneficial effects in terms of raising quality of the children. So, that is the kind of dialogue that I want to open up. It is not saying that some other welfare state is evil or not. But on the other hand, if we look, for example you were mentioning productivity, well, yes, productivity has been high in Finland, but if we look for example…I do not know if I can find Finland on this graph, I will try to, I kind of brushed over it. No, it is not here. But the Finnish case is very similar to the Swedish case. What you see in the last 10 years is that there was a downturn in the Finnish economy, in the 1980's and early 1990's. So what you get is a regression to the mean. You get a rebound. And so, some of the productivity growth you see in Nordic countries was just a recovery from some very adverse bounds. Here is the bounds for Sweden. So, Sweden hit rock bottom in the early 1990's. It had the largest single tax reform in its history in the 1990's. Taxes were cut, capital… a lot of reforms were made, and that did lead to some substantial improvements. We saw private sector grow for the first time in terms of employment. So the Swedes and the Finns also did experience similar conditions. But we have to understand that part of this is going back to my very…you are falling into the trap I was trying to make you avoid, which is that if you can take short segments of time, some economies can do very well. So if economies have done particularly badly and now it is bouncing back…well—reversion to the mean. How much will this persist? And if you look at the secular forces. If you look, for example, at the long-term trends that essentially are creating a welfare dependency that are cutting down the costs that are making earning high income very expensive, you know, there was a comparison made about what the top CEO incomes were in Sweden compared to that of North America, and for that matter the UK, and so, not surprisingly, there has been a large migration of top executives from those regions to other countries. So, I am not saying you cannot have a system of taxation, but you have to respect incentives. There are probably better ways to redistribute income. I think that the way in which these countries have redistributes income towards the younger years has been very effective. No question. The way in which they built a culture of welfare dependency, that would worry me a little bit, if I were a Swede realizing that my children were much more likely to gain the welfare state than I was or my parents were. That has been a trend that is something that I think one should be concerned about. So, that is the part that we have to learn from. I do not know if I have answered your question, but I have tried. But I definitely want this disagreement. I do not want to make the statement saying that America… America is a whole new set of problems. If you look at what is going on now, like in France, we have a large growing group of people who are young people who are neither working nor going to school. So, I am finding a lot more high school drop-out rates, less participation in secondary education. That is a very unhealthy trend for any society. Some of it has to do with crime. A lot of it has to do just with withdraw from the general population. And so, you are getting kind of inequality. I do worry about the kind of inequality that is being produced here in Spain. It has a peculiar property. You are kind of building an unskilled labor force as a demand for tourism and so forth, but that kind of skilled structure is favoring unskilled labor, but will that persist? And will the Spanish economy be able to stand out and be able to be competitive in the world economy 50 years from now if it continues to adopt that strategy. I would argue that what we have learned is that in the long-run Spain will not be able to compete with China or Vietnam or less developed countries. What it is going to have to do is build a skilled workforce. That is going to mean creating the right incentives. It will probably mean an increase in inequality, providing the incentives for people to get education, maybe revitalizing the educational sector. So, you want to think not just in the short-run, not just what happened in the last 5 years, like The Economist does, but think about what has happened in the last 50 years, and this, I think, will give you a slightly different picture.

- Professor Heckman, I will speak in Spanish. I would like to know what you think about the relationship between the welfare state and the homogeneity of society. The welfare state system is an insurance system, so to speak, and one wants to co-share risks with people that are similar to us. But when societies has become very heterogeneous in their composition, for instance due to immigration, there may be a certain risk that people do not want to share those risks with those with those that they understand as different. That perhaps may explain why most welfare states in European societies are more homogenous than American ones, that are more heterogeneous. Can you explain why

somehow in Europe and in some countries there is a certain crisis of the welfare state. What is your opinion?

- Well, the issue of homogeneity, that is a very standard and important argument. And that was originally the argument of why Sweden could support a state of welfare and why the United States could not—there were many competing interests. On the other hand, take the case of Holland. The welfare state is actually operated in certain ways to essentially create the very heterogeneity that you are talking about. But what has happened is, for example, in Holland the Malaccans who settled there in the 1950’s after supporting the Dutch in Indonesia (unsuccessfully, of course), they were given large benefits, they were given essentially entitlements, and what has happened is that this group of people, heavily subsidized, with an intention to try to restore and give them dignity and equality has been isolated from the larger state, creating this very kind of heterogeneity. So, here what you have done is you have taken immigrants, you have subsidized them not to participate in society, they have not assimilated, they have suffered discrimination, they have suffered ostracism, they suffered a substantial number of deficits in the larger society. That is a good example of what I was talking about that the welfare state actually can work both ways. It can essentially help to bring people in. Incentives that include are very productive. Incentives that start excluding are not. For example in Chile, there was a study that the welfare state that was set up and re-established after 1990 was essentially one that was protecting a certain enclave of workers but excluding others. That is creating inequality of a social kind. So, that is a point that has to be emphasized, that welfare states can operate either way. Now, in Switzerland you have a somewhat different operation of the welfare state. In Switzerland individuals become citizens and are entitled to benefits from the welfare state only after they have settled and worked in various cantons, and have actually shown their participation and willingness to work in the larger society. Then they can get the benefits from the larger society. In other countries such as Holland, where somebody who walks in immediately can gain welfare benefits, or at least used to be able to get benefits, what you get is a two-tier creation. A lot of the Arab populations were segregated.

What you see is a lot of the main cities in Holland, now, you see populations that are segregated, second and third Arab populations still not speaking Dutch, still not integrating to larger society. That is where the welfare state is working in a perverse way, to perpetuate. And that is actually what we are doing in the United States with welfare in the 1960’s. The welfare state we saw and the war on poverty acted to essentially create a formation of ghettos, remove black Americans from participation in the larger society, stigmatized them, isolated them. And the reforms that we are doing now and trying to move towards would be those trying to include people and saying yes, everybody is a larger member of society, but they should participate in it. So you work, we pay, we can subsidize partly, we can try to reduce some of the inequality, but that is one of the major lessons we learned from the welfare state. It can work either way. It can work as a blessing or a curse. You can either integrate people in society or you can isolate them and cause factions. I think we have definitely learned is that in devising future welfare states we have to think about inclusion, we have to think about bringing in different elements of society. So the traditional argument that was made in Holland is the one you made. Yes, how the Dutch people were very homogeneous and then suddenly they became much more heterogeneous, and then we saw in the next 10 years the violence that ensued in Holland, the feeling of isolation and now the deep feelings of dislike, even hatred against immigrants and certain immigrant groups. That has partly become because those immigrant groups were in part subsidized not to participate in the larger state, not to sort of feel that they are members of this larger state. So, that is why, again, I would say, you know, it is what we make of it, the welfare state. We can essentially make it inclusive, or we can design features to try to isolate and segregate. And those, I think, lead to social and political inequality of a very deep kind.

- Thank you very much. I am going to speak in Spanish. You suggested that in crises that is when reforms are more feasible and timely, if I understood you correctly, but in certain contexts the implementation of measures in crises, during a crisis, are not easy for the politicians that are in the government. For instance, in an economic area such as the European Union, where some countries individually wish to implement reforms of the

labor market to change regulations, for instance, they know that they face unavoidably a sort of worsening of labor conditions, and that, very often, given they cannot be countered with fiscal or monetary policies, this puts a break in the maneuvering capacity of governments and therefore they introduce, at least for certain observers, they introduce a sort of, so to speak, little hope that those reforms may be carried out. What do you think about this?

- What I meant to say was that if we look at the historical record when most of the reforms have been put in place, like the reform in New Zealand, the reforms in Britain, some of the reforms that occurred in parts of Europe, and also in other countries, we have seen that people have been more open, institutions have been more open to accept change. I completely agree that at certain times of crisis, the flexibility of government can meet particular wage demands or to respond to taxation to raise revenue may be in peril, but for example, if we look at Thatcher's England and the kind of crisis that was going on in the English labor relations in the early 1980's, most people agree that the model was not working. The same is true in the reforms in New Zealand, and so, at that point people became convinced that they had to try something else, they had to try something better. And so, it was not that they had the greater fiscal capacity, it was that they were willing at that point to bear the cost to essentially take the sacrifice. The same is true in Sweden. When Sweden had this downturn in the 1990's, they recognized that they had this low level of taxation, this low level of incentives, very inefficient government programs, and they actually took upon themselves the hard costs of reforming because they realized that the path that they were following was not that successful, was not that effective. And so, that is what I mean by saying that in the past crisis has been the mother of most major innovations in the welfare state. It is a source of concern because I think we do not want crisis, and in fact we have to build into our thinking how to design the welfare state and reforms, we have to think about ways to build an internal logic of the welfare state to avoid the crisis. But I fully agree that in time of crisis, the grease of flexibility, that is one of the big complaints, of course, about the European monetary union, the fiscal pact, that at a time of crisis, when you go past the 3% expenditure levels, the European Union tacks on additional costs to countries in crisis. Of course that has never happened yet, and I doubt that it ever will, but the point is that aspect of the monetary union is certainly crazy. The fiscal pact is an aspect which only adds to crisis.

But I think more generally that in times of crisis, at least historically, people have been willing to rethink institutions. Now, the Chilean case was a particularly dramatic case. And that was a case that was brought up by violence. I do not think that many people in Western Europe want to emulate the way that reform was brought about in the case of Chile—certainly not the violence and the death. But it is an example that the Chilean state did change many major policies. The same is true in other economies, in same cases in Latin America, where severe crisis forced people to rethink about existing policies. In fact, causing to rethink in both directions. To move away from liberalization of the market and maybe towards—lurching, maybe in each direction. But I think that the broader point is that in a time when a system has been shown to fail, mainly at a time of crisis, many parts of society will pull together and will act for a social interest in a way they do not act in traditional ways. For example, in Ireland in the 1980's, the trade unions, the different groups which had traditionally been in conflict with each other realized that the way the Irish economy was going was going down the drain, and that it was necessary to put aside their narrow interests. That is the sense in which a time of crisis can bring out the best in some societies. But you are right. There would be a physical strain.