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European Journal of Political Economy
Vol. 20 (2004) 743–754
European Journal of POLITICAL ECONOMY
www.elsevier.com/locate/econbase

Challenges to the Scandinavian welfare model ☆

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Received 25 February 2004; accepted 25 February 2004
Available online 15 July 2004

Abstract

Policy debates with increasing frequency question whether the Scandinavian welfare model is robust to the challenges of international integration, demographic change, and changing socioeconomic conditions. The welfare model relies on a large public sector and strives for egalitarian outcomes. Beginning with an interpretation of the Scandinavian welfare model in terms of social insurance, I here consider the major challenges faced and some of the policy options. A particularly interesting question is whether the Scandinavian welfare model is more vulnerable to some challenges than other welfare models.

JEL classification: H11; F15
Keywords: Social insurance; Taxation; International integration; Demographics; Norms

1. Introduction

The public sector faces challenges in most countries. Some of the challenges are country specific while others are universal and relate to common factors such as demographic changes and globalization. An important policy issue is how to cope with these problems. However, the role and organisational setup of the public sector differs

☆ Invited lecture, European Public Choice Society, Aarhus, April 2003.
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0176-2680/$ - see front matter
doi:10.1016/j.ejpoleco.2004.02.007

across countries which implies that the consequences of even the common challenges may differ, as may the available policy options.

Policy debates with increasing frequency question whether the Scandinavian model is robust to challenges such as international integration, demographic changes, and changing socioeconomic conditions. The debate spans a wide spectrum of views ranging from the "retrenchment view" claiming that a "rolling back" of the welfare state is necessary to the "robustness view" asserting that only small changes are needed and that it may even be that other countries would converge to the Scandinavian welfare model (or at least to essential parts of it).

The Scandinavian countries are known for having relative high-income levels as well as being egalitarian. The public sectors are a cornerstone of the welfare states that have been developed, and accordingly, the relative size of the public sector and the tax burden (relative to GDP) are among the highest in the world. Other noteworthy stylized facts are that the employment frequency is high, not least because labour force participation for women is high. Institutionally, labour markets have historically been among the most centralized and have strived for solidarity-based wage settlements.

A key issue in the debate is thus whether a retrenchment of the public sector is necessary or whether it is possible to adopt the Scandinavian welfare model to the challenges. In the economics literature, the size and structure of the public sector has traditionally been seen in the perspective of the outcome of political choice between equity and efficiency, which to various degrees may have been affected by rent-seeking behaviour. While capturing essential issues, this approach may be an oversimplification because it disregards the (social) insurance implications implied by various welfare arrangements. This is important because there may be beneficial efficiency effects of some welfare arrangements via the insurance provided. These aspects have to be considered carefully to identify precisely the problems faced by the Scandinavian welfare model and the available policy options.

In the political science literature, there is a strong tradition of focussing on the institutional arrangements and the structures around which welfare arrangements are organized. In a seminal contribution, Esping-Andersen (1990) proposed a simple but useful classification of various welfare arrangements namely the liberal, the corporatist, and the universal model. The different models are distinguished by the weight given to the market, civil society (family, church, friends, private organisations, etc.), and the state in providing social services and insurance.

In the liberal welfare model, the state plays a limited and a well-defined role in the sense of providing the ultimate floor in cases where the market and civil society do not suffice. State-provided benefits are targeted, and concern about work incentives plays a dominant role. The corporatist or continental European model relies on the family and the employers as the backbone of society, and therefore as providers of social services. In its modern form, private insurance schemes play a crucial role, and they are mostly tied to labour market participation. The activities of the state tend to be directed towards families rather than individuals. Finally, the universal or Scandinavian model has the state in a crucial role as supplier of social services. Benefits tend to be defined at the individual level but with differences depending on the individual's labour market history. The main financial sources are various forms of taxes.

While obviously a simple classification in which it may be difficult precisely to fit a specific country, it is useful in pointing to the role of different institutional setups in achieving risk diversification and social objectives. With the outset in this observation and the recent economics literature on welfare arrangements, I here consider the major challenges faced by the Scandinavian welfare model as well as some of the policy options. A particularly interesting question in this context is whether the Scandinavian welfare model is more vulnerable than other welfare models to some of the above-mentioned challenges. While the literature uses the classification "the Scandinavian welfare model" to capture important aggregate similarities across the Scandinavian countries, it is a fact that specific institutions and policies differ substantially. To make the following as precise as possible within the space available, the presentation concentrates on one country, Denmark.[1]

The paper is organized as follows. Section 2 starts by providing a brief introduction to the principles of the Scandinavian welfare model with special focus on the social insurance aspects. The challenges are then considered under three broad headings, international integration in Section 3, demographic changes in Section 4, and socioeconomic changes in Section 5. Section 6 concludes by presenting some of the key policy choices that have to be made.

2. The Scandinavian welfare model

The hallmark of the Scandinavian welfare model is, as noted, its universal character in the sense that basic welfare arrangements are a citizen's right defined for the individual and the financing is collective via taxation. An implication of this basic principle is that there should be no direct relationship between entitlements and financing for the individual. Although this principle is not applied without exceptions, there are strong universal elements in basic arrangements such as education, hospital care, social benefits, care of the elderly, and basic pensions.

A particular noteworthy fact is that, because social policy is not primarily based on the family or tied to labour market participation, it follows that the model in a comparative perspective leaves relatively high support for low-wage groups or groups marginalised on the labour market (see for example Hansen, 2001). This aspect shows the focus of the model on poverty reduction, or to use a Rawlsian perspective, the concern for the least well-off citizens (Sandmo, 1998).

This welfare model has been developed to an extended form in the Scandinavian countries, implying that these countries have the highest average tax burdens and relative shares of the public sector among OECD countries (some 50% of GDP). This is a model that has a long history but which, in particular, was developed during the 1960s and 1970s, and it holds fairly wide support both among political parties and the population. It is important to point out that, despite the large public sector and therefore public involvement, fairly liberal policies have been maintained vis-à-vis business, private property, etc. The Scandinavian welfare model is thus tightly integrated with a liberal market economy.

[1] For a presentation focussing more on Sweden, see for example, Andersen and Molander (2003). For Norway, see example, Norges Offentlige Utredninger (2000).

There are many political, ethical, religious, and other perspectives for interpreting and understanding egalitarian objectives. However, if the choice of welfare arrangement was simply a question of where the political system would place society on a well-defined trade-off between equity and efficiency, it would be hard to explain why countries like the Scandinavian have been able to attain relatively low-income inequality and yet belong to the richest countries in the world.

A key to explaining this fact may be found in the observation that modern economics teach us that it is very difficult to distinguish between insurance and redistribution. The reason is that, what ex-post appears as redistribution (from the "lucky" to the "unlucky"), often, ex-ante can be considered as an implicit form of (social) insurance. If the welfare arrangements make transfers from those who, for example, turn out not to become sick to those who become sick, individuals know ex-ante that there is some insurance or risk diversification, with respect to the risk of becoming sick.[2] Accordingly, an extended welfare state with universal elements is essentially an extended implicit or social insurance contract. Provision of insurance may both have direct welfare consequences but also have positive incentive effects. The latter arises because market imperfections related to capital and insurance markets leave a rationale for public interventions on efficiency terms. These effects have to be taken into account alongside the distortions arising from taxation. The social or implicit insurance function of the welfare arrangements arises from the fact that the public sector offers services and transfers if various contingencies are realised through life. Obviously, this insurance function applies to public services and transfers, but also, more generally, to income taxation (Atkinson, 1999; Varian, 1980; Barr, 1992, 2001; Sinn, 1995). Moreover, institutions in the labour market such as solidarity-based wage settlements may be interpreted from this perspective (Agell, 2002).

3. International integration

The Scandinavian countries have historically been very open to trade and have routinely been classified as small and open economies. Accordingly, the need to make the welfare model and the public sector developments compatible with international integration is not a new constraint. The interesting question is whether the ongoing international process raises some new challenges.

3.1. Tax base mobility

An issue that is often discussed is that mobility of factors of production (or more generally tax bases) sets some limits on the scope for taxation. The basic mechanism is that

[2] An important example is education financed via general taxation. This has potential beneficial efficiency effects from exploiting the human capital base of the population as much as possible (reducing the barriers arising from social inheritance) and by the implicit insurance provided via a tax financed education system (Eaton and Rosen (1980)). Moreover, it is in accordance with the ethical or political objective of providing equal opportunities. Potential adverse effects may arise via distorted educational choices and labour supply decisions of educated persons.

the more mobile a given tax base, the more difficult it is to tax at a rate (significantly) above that of your close trading partners. To avoid loss of tax revenue due to further integration, the response has to be lower tax rates, which in turn will erode tax revenue. A more aggressive response would be to undercut the tax rates of trading partners (tax competition as an example of a race-to-the-bottom mechanism), in the hope of attracting more economic activity. Another response would be to change the tax structure lowering taxes on mobile tax bases and increasing them on less mobile tax bases.

The Scandinavian countries have gradually adopted their tax structure to cope with some of these changes, in particular, via the so-called dual income taxation system that allows a proportional taxation of capital income to be combined with progressive taxation of other forms of income. Therefore, it has been possible to adjust taxation of capital income and corporations to lower levels to match rates observed in competing countries while maintaining relative high rates (and progressive elements) of taxation of labour income. Tax adjustments have also been made in specific areas like excise taxes on, for example, alcohol, to cope with problems from increased cross-border trade.

However, the key question is whether the ability to tax labour is affected. If this is not affected, the above-mentioned changes are important from a tax policy perspective but of second order importance for the overall structure and size of the public sector and thus the welfare state. The reason is that the taxes most directly affected by mobility-like corporate taxation and capital taxation matter relatively little for the overall financing of the welfare states in the Scandinavian countries (see below on migration). This is supported by a quantitative assessment made by Sørensen (2000) of the implications of tax base mobility and tax competition for capital income taxation and corporate taxation. He finds, in accordance with theory, that such taxes become inefficiently low, but compared to the initial situation, the consequences are very small in terms of production, employment, etc. The important question is thus the direct and indirect implications of international integration for the taxation of labour income.

3.2. Labour mobility

Increased labour mobility may be a particularly important problem for the universal or Scandinavian model. The reason lies in the fact that the welfare model is comparable to an encompassing implicit (social) insurance contract, and like any insurance market, it becomes problematic if adverse or self-selection implies that the "good" risks leave and "bad" risks enter. The key determinant here is the labour market status of the potential emigrants and immigrants because this is an important determinant for whether the person in financial terms is a net contributor to or net beneficiary to the welfare state. Hence, there is a problem if immigrants have a below average attachment to the labour market because they would then be net beneficiaries of the welfare system, and there, among emigrants, overrepresentation of the highly educated because they tend to be net contributors to public finances. This can affect public finances significantly, in the sense that expenditures grow and tax revenue shrink. In Denmark, emigration flows are smaller than immigration flows, and the average labour force participation for immigrants from less-developed countries is only 50% compared to the 80% for the incumbent population.

This creates some crucial dilemmas in economic policy. Consider first education and emigration. The public sector offers free education to provide equal opportunities and to reduce the risk in educational decisions. Expenditures to education are financed via general taxation with some progressive elements implying that those turning out to have the highest incomes after education will also pay the most. This provides both a capital market function (no credit constraint in relation to educational investment) and some risk sharing (diversification of the risk associated with respect to wage and employment prospects). Clearly, this model is vulnerable to mobility because the migration decision can be taken when education has been financed by the public sector and the veil of ignorance in relation to labour market prospects has been lifted. Moreover, by moving to countries relying more on private financing of education and therefore less taxes and more wage dispersion, the individual gains from mobility can be high, and the cost to society large.

Likewise, immigration may pose problems if labour market integration of immigrants fails. This can happen either due to insufficient qualifications, incentive problems, or discrimination in the labour market. Because the level of social assistance is relative high and universal, it follows that the financial burden of immigration can be substantial. This has raised a delicate political problem in relation to immigration policy, namely, whether immigration rules or principles of the welfare state should give in. Both have happened in Denmark. The social assistance structure has been changed such that the entitlements have become dependent on the period in which one has lived in Denmark. This is considered politically problematic because it implies some discrimination and violates the universal principle. The alternative in the form of more strict immigration rules has also been implemented recently, but this obviously also has problems.

The public finance consequences of immigration by persons having a below-average labour market participation are of course more severe in welfare states with strong universal elements.[3] The reason is straightforward because the balance between use and financing in the implicit social contract is affected.

3.3. Job mobility

Although emigration of labour so far has been very modest, labour markets may still be affected through some indirect routes. This may affect both the need and scope for welfare policies. The indirect effects can be summarized in increased job mobility across countries and thus labour markets. Increased integration of financial, and in particular, product markets in combination with technological changes implies that it is becoming easier to relocate production, and thus, employment, across different geographic areas. This may work through mechanisms affecting market shares of domestic and foreign producers and relocation of firms via foreign direct investment, outsourcing, and the like. While it is beyond the scope of the present paper to discuss all the implications of these changes, two general effects stand out.

[3] Similar issues have come up in respect to EU enlargement and the free mobility of labour. A concern in the policy debate has been whether social policies will be put under strain.

The changes in product and employment determination may imply both that labour market risk increases and that it becomes more difficult to sustain egalitarian labour market outcomes. The former effect arises via the larger exposure to international developments (see for example Andersen, 2002) and the implied relocation possibilities. The latter arises because integration, in general, entails both opportunities and threats, and although the former tends to dominate in the aggregate, this does not necessarily hold for the individual or particular groups (Andersen, 2004). The opportunities arise from the option to access foreign markets (via for example exports), which in turn may improve wage or employment prospects, while imports following foreign penetration into domestic market may do the opposite. Because exports presume competitiveness, this opportunity would, in general, tend to arise for high-productive groups and thus highly paid, while the import threat would materialize for low-productive groups and thus relatively low paid. Moreover, groups previously earning high wages because they were protected from international competition (nontradable sectors) would also be affected. All of this is likely to increase wage inequality.

The effects on wage dispersion discussed above do not mean that international integration makes it impossible to maintain an egalitarian wage/income structure but that it is only possible provided that the qualification structure is sufficiently egalitarian. This leaves an important and fundamental policy challenge, namely, to enhance both the general level of education, research, and development to maintain competitiveness in the "global economy" and to ensure that the qualification structure does not become too "unequal".

3.4. Tax distortions

With a high tax burden and therefore also high taxation of labour, the question of the effects of tax distortions for the labour market is highly relevant. The Scandinavian countries have both high average levels for taxation and also high marginal tax rates due to progressive elements in taxation. To understand why this has no very detrimental effects on the labour market, it is important to note that the distortions from labour income taxation cannot be evaluated independently of labour market structures (see for example Summers et al., 1993; Andersen, 2003).[4] The reason is that the interrelationship between wages and taxes involves a common pool problem. Taxes levied on labour income finance expenditures that are also to the benefit of the workers. Accordingly, if wage formation takes place at a centralized level, negotiators will perceive that taxes finance expenditures to the benefit of workers, and therefore, the tax to wage spillover will be small. Oppositely, decentralized wage-setting negotiators will not perceive that their own tax payments have a significant influence on aggregate tax revenue, and therefore, the spill-over from taxes to wages will be stronger. This effect is therefore stronger the more decentralized the wage formation process is. Historically, labour markets in the Scandinavian have been very centralized.

[4] Note also that the income effect in labour supply cause labour supply to increase when taxes are raised.

There are two reasons why tax distortions from given tax levels and structures may increase in the future. First, the increased job mobility following from further international integration (cf. above) implies that employment becomes more sensitive to local conditions including wages. If a larger fraction of jobs due to international integration is created in sectors with a more elastic labour demand, it follows unambiguously that the distortionary consequences of taxes levied on labour are nondecreasing (see Andersen, 2003). Accordingly, the tax distortions increase alongside international integration, or to put it differently, to the costs of raising tax revenue via taxation of labour increase. Secondly, and possibly even more importantly, there is a tendency to move towards more decentralized wage-setting systems (see Boeri et al., 2001). As noted above, with centralized wage setting, taxes levied on wages would be less distortionary because the public budget constraint is internalized. In a process where labour markets become more decentralized, either due to international integration or due to other forces, it follows that tax distortions are on the increase.

As a specific example of this point, recent negotiations in the Danish labour market have for some areas allowed workers to choose between (i) a wage increase, (ii) less working time, or (iii) a larger pension contribution. This reflects decentralization in the sense of allowing the individual a larger individual freedom of choice. While this may be desirable in its own right, the choices have different implications for the society at large. The reason is the tax distortion that is involved because the choice is between, for example, less working time (nontaxed leisure) and higher wage income (taxed). As should be expected, experience with such options has shown that the "leisure option" is very popular and this is an example of how decentralization can increase tax distortions.

4. Demographics

Ageing of the population will also affect the Scandinavian countries (see, for example, Andersen and Molander, 2003). The burden on public finances varies substantially due to different arrangements of the pension system and different progress with respect to reforms. Although demographic changes are not more severe in the Scandinavian countries than in many other countries, the public finance implications can be substantial.[5] The reason is that public finances are very sensitive to the fraction of the population active on the labour market because more employment implies both more tax revenue and less expenditures to income maintaining transfers.

Recent calculations for Denmark suggest that to maintain existing welfare arrangements and to ensure sustainable public finances, in the sense that the present value of future revenue equals the present value of expenditures at the initial debt level, it is necessary to permanently increase taxes. The order of magnitude is a permanent revenue requirement amounting to 2–3% of GDP annually. While there are various estimates of the financial

[5] In Denmark, the more widespread adoption of labour market pension schemes during the 1990s has been instrumental in reducing the consequences of the demographic changes for public finances.

consequences and there is of course some uncertainty associated with such calculations, this is a nontrivial change. To the extent that there is a widespread demand for shorter working hours and earlier retirement (partly reflecting improvements in living standards), the needed adjustment is larger.

Early retirement is a particularly controversial policy issue. In the late 1970s and early 1980s, an early retirement scheme was introduced as a labour market policy response to a severe youth unemployment problem. The idea was to allow old workers (above the age of 60, official pension age at the time was 67) to withdraw from the labour market with public transfers roughly identical to the unemployment benefit paid to the unemployed young person expected to take over the job of the retiring old. If successful, this scheme would allow a better allocation of work at very small costs to the public sector. However, the job substitution rate turned out to be significantly below one and therefore, the scheme became more costly than perceived. At the same time, the scheme quickly became popular (currently about 5% of the labour force is in the programme) and was perceived as part of the welfare package offered by the welfare society. Despite recurring debates about this scheme, it remains in place, although a very unpopular reform in the late 1990s made it less favourable and introduced some incentives to remain on the labour market beyond the age of 60.

Politicians in Denmark have realized the problems arising from an ageing population and have issued a plan—known as the 2010 plan—which in the years up to 2010 should pave the way for the public finance consequences of the demographic changes. The plan has three main elements, namely, a reduction of the public debt level, maintenance of public consumption growth significantly below the growth rate of GDP (and private consumption), and a substantial increase in the labour force and employment. It is at present unclear to what extent the objectives of the plan will be met but the plan is interesting because it reflects an awareness of the need for reform. In general, ageing problems are difficult to handle because the problems unfold gradually over time, and it may therefore be difficult to convince current voters on the need for reforms that will tend to have short-run costs but long-run gains.

5. Norms and individualization

The defining aspect of the universal welfare model is the fact that access to welfare arrangements is an individual right. Because financing is collective, it follows that there is no direct linkage between entitlements and financing at the individual level, and no such linkage is supposed to be presented to ensure maximal social insurance. Underlying this principle has been the viewpoint that receiving social assistance should not be stigmatizing but rather be considered as a right. While this raises many issues, it also raises fundamental incentives or moral hazard problems. Any insurance contract has moral hazard problems if the insurance is against contingencies that can be affected by the insured. This also applies to social insurance.

In this respect, the attitudes and norms associated with receiving social assistance play a key role. If the norm is that this is the "last option", it follows that misuse of the system would be minimal, but this may also imply that there is a strong stigmatization associated with receiving social assistance. A basic idea underlying the universal model is to make access to social assistance an individual right, with the purpose of making receipt less stigmatizing. While this is preferable in relation to those "who rightly deserve", it also changes norms and makes misuse of the system more likely (via various forms of moral hazard, cf. below).

Norms may, moreover, change over time, not least because behaviour may depend on other people's behaviour. It is thus quite common to choose a particular form of behaviour if sufficient, many do likewise, and as a consequence, there may be multiple social equilibria (Schelling, 1975). Changes in norms can lead to rapid changes in the scope for welfare policies by leading to unsustainable combinations of transfer levels and taxes (see for example Lindbeck, 1997; Lindbeck et al., 1999). Interestingly, some of these changes in norms may be an inherent consequence of the way in which the welfare system is organised. In particular, in smaller communities, social pressure may be a sufficient enforcement mechanism, whereas in large urban and individualised societies, this may be less so. This is especially so if entitlements are given as an individual right. This may be reinforced if use of social assistance is considered justified by having paid taxes in the past.

These problems may show up in different contexts but the most important examples are found in relation to the labour market. One key aspect is the reservation requirements unemployed people have with respect to the type or location of jobs one is willing to search for and accept. The more restrictive these reservation requirements, the larger the financial burden arising from unemployment.[6]

An interesting question is whether the moral hazard problems associated with social insurance can be mitigated without changing fundamental principles in the welfare model. An interesting example of this is the changes in labour market and social policies in Denmark in the second half of the 1990s. Up to these changes, access to the unemployment benefit system was very lax, compensation generous, and the entitlement period long. The main policy objective was income maintenance. The policy question was whether incentives could be sharpened without resorting to cuts in the compensation level for recipients of unemployment benefits and social assistance.

An essential ingredient of the labour market policy has been so-called activation measures. Whereas such measures have been part of the labour market policy since 1978, the main purpose has effectively been, in the past, to provide a scheme to make it possible to regain the right to unemployment benefits. With the labour market reforms in the mid-1990s, the activation schemes became an integral part of the "right and obligation" principle: the society offers income compensation and the individual has the obligation to participate in activation schemes—passive collection of, for example, unemployment benefits should thus be more difficult. An important part of the reform was that participation in an activation activity would not qualify for a new spell on unemployment benefits.

[6] Similarly, there is an issue in evaluating whether or how much a person with, for example, physical problems is able to work. Evidence from both Denmark and Sweden shows that the number of persons unable to work has been on the rise.

In principle, one can think of various effects of activation. There is an incentive effect because the value of unemployment benefits decreases when time-consuming obligations are part of the package. This may induce some to search more actively for regular work (or give up work in the shadow economy) or leave the labour force if they value leisure highly. This is a sorting effect implying that unemployment benefits become more targeted to those in real need. In principle, this incentive or sorting effect could be achieved with any mandatory time consuming activity.[7] However, if the job prospects of unemployed can be improved by participation in activation, this is a potential important additional effect. This could work via both a motivation effect (participating in activities motivating people to return to regular work or giving them the habit of regular activities and the self-confidence needed) or a qualification effect (providing skills needed to improve employment chances). However, participation in activation could also have a negative effect on job search because people may search less actively while participating in such activities, and this may create lock-in effects. Moreover, participation in such schemes may affect the reservation requirements, for example, by narrowing job search to jobs very narrowly linked to the type of training received during activation. These reforms are thus an example of how to avoid retrenchment of benefit levels and thus social insurance, while at the same time, strengthening incentives.

6. Concluding remarks

The interesting policy question is whether the challenges faced can be addressed without violating some of the main principles of the Scandinavian welfare model. This is so because a simple retrenchment has no political support and is therefore not a realistic policy option. The policy problem is in simple terms that demands are increasing but financing becomes more problematic. Squaring these challenges obviously does not have a simple answer.

The reform initiatives already taken show some interesting steps to address some of the problems while maintaining basic social insurance functions, as exemplified by the "workfare" elements introduced in labour market and social policies. Another question is whether it would be feasible to make the public sector more efficient and flexible in order to make it more cost effective and at the same time, be able to meet the demands it faces.

While important, this is unlikely to be sufficient, and therefore, two key issues are whether it would be possible to target social policies and would be how to increase the employment share. Related to the former are issues like user payments and means testing, and to the latter, both work incentives (over the year and life) and the qualifications needed to be employable. The need for carefully considered reforms is thus great if the welfare state is not to end up with severe financial problems.

[7] It could be argued that the incentive effect could be strengthened by making the "activation activities" demanding, but meaningless. However, this would not be possible given the political constraint of decency in the treatment of people.

Acknowledgements

Comments from participants at the European Public Choice Society where this talk was presented are gratefully acknowledged.

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