

What Is Happening to the Welfare State?

Peter H. Lindert
University of California - Davis
18 March 2004 draft

ABSTRACT

What has happened to Europe's welfare states since they were so broadly attacked in the 1980s, and why? This paper interprets recent movements in social transfer spending, by country and by type of transfer. The overall OECD experience with social transfers up through 1998 shows no overall decline in the welfare state. That experience does suggest that the inexorable rise of the elderly share of the population will depress the relative disposable income of the elderly. It will not, however, lower their absolute real income, nor will it lower any category of social transfers as a share of GDP. Thus the burden on taxpayers will not abate.

In addition to these OECD-wide findings, I interpret the recent adjustments in pensions and other social transfers in the Second and Third Worlds. The more prosperous of the formerly communist countries will continue to be welfare states. In the Third World, countries will drift toward generous and egalitarian transfers as their populations age.

It has been a quarter century since the election of Margaret Thatcher ushered in an era of conservative assault on big government and the welfare state. This quarter century has seen a wave of enthusiasm for cutting taxes and transfers, privatizing state industry, and trimming union power. It produced at least fifteen English-language books with *crisis of the welfare state* or *welfare state in crisis* or *waning of the welfare state* in their titles. Up to 1995 the Anglo-American press repeatedly wrote off Sweden's welfare state as a clear failure, one that the Swedes have abandoned.¹

Hence the title of this paper. Is the welfare state really in retreat, or is it claiming ever higher shares of GDP? How would we explain, and project into the future, the trends we see? The tentative findings are:

- (1) The welfare state is not an endangered species among the industrialized OECD countries. While its growth clearly slackened after 1980, social transfers continue to take a slowly rising share of GDP. Ireland and the Netherlands are the main exceptions that have cut social transfers as a share of GDP.
- (2) We can use pre-1995 experience to judge how population aging and the pension crisis will affect government budgets. Already before 1995, countries with the very oldest populations had begun to cut the relative generosity of their transfers to the elderly *per elderly person*. They did not, however, cut the average shares of public pensions or other transfers in GDP. Cautiously projecting the same behavior up to the point where each country has 20 percent of its population over 65, and noting current retirement policies, suggests which OECD countries are in the most trouble in the looming pensions crisis.
- (3) There are a few welfare states in the Second and Third Worlds, and more of them will probably emerge as their populations age and prosper. Some, but not all, of the Second-World transition countries have elderly populations and are clinging to relatively generous pensions. In the Third World, Christian and Muslim countries are developing even higher social transfers than the OECD countries developed at similar stages of development.
- (4) Some of the Third World countries have regressive pension systems subsidizing public elites. These may (hopefully) erode as more egalitarian pensions and transfers rise.

The boundaries of this paper are set by my definitions of social transfers and the welfare state. Social transfers consist of these kinds of tax-based government spending:

- basic assistance to poor families, alias poor relief (before 1930), family assistance, welfare (in America), or supplemental income;
- unemployment compensation, alias the dole;
- public non-contributory pensions, in which the funds come from persons other than the recipient and his or her employer;²
- public health expenditures; and
- housing subsidies.

Such tax-based transfers tend to redistribute income somewhat progressively. Their progressivity is not uniform or easily measured, however. I shall define a welfare state as a country that resembles those European countries that the media often call welfare states. These countries tend to devote 15 percent of GDP or more to social transfers as defined here, and that threshold will define a welfare state for present purposes. My definition of the welfare state ignores such other government interventions as government regulation or ownership of industry, worker protection laws, wage and price controls.

Who Has Retreated and Reformed in the OEC D Core since the 1980s?

To judge whether the welfare state is an endangered species, we can begin with a straightforward survival analysis, of the type pioneered by George Stigler in the field of industrial organization. In our complicated world the sustainability of a type of firm, or institution or policy, often depends on more influences than a model can summarize and measure. Distrustful of our ability

to judge economies of scale from production functions and other model-dependent constructs, Stigler proposed a straightforward Darwinian test: What sizes of firms tended to survive, and what sizes tended to disappear? While many economists might discount such a test as merely descriptive, it is a useful starting point.³ We ask: Did social transfers tend to retreat as shares of GDP, or in their generosity to targeted recipients? Did they retreat especially rapidly for the top-spending countries, suggesting that large welfare states are proving unsustainable?

The OECD experience since 1980 is surveyed in Table 1, where Panel (A.) maps the changes between 1980 and 1998 (the latest OECD estimates), and Panel (B.) maps those between 1988 and 1998, two years that were both in the middle of business cycle upswings.⁴ The top row in each panel gives the main survival result confirming Stiglerian survival of large social transfers: On the average, the 21 core OECD countries slightly *raised* the share of social transfers in GDP, both across the Thatcher-Reagan 1980s and across the 1990s. Total social transfers rose by 3.8 percent of GDP for the whole 1980-1998 era, and 1.9 percent after 1988. Pensions and disability payments accounted for over half of the overall increase, though all programs rose as a share of GDP in either period. Across all countries, even the support ratios of pensions per old person and unemployment compensation per unemployed person, failed to decline significantly on the average, as shown in the last two columns.

Was there convergence or divergence in different countries' commitments to social transfers? The standard deviations in the second row of each panel paint a mixed picture. Expenditure shares for public health and unemployment compensation converged slightly, while those for welfare and pensions diverged. Overall, total social transfers converged slightly, suggesting that countries tended to trade off health and unemployment expenditures against welfare and pensions.

Despite the slight overall rise of social transfers as a share of GDP, there were some exceptions worth noting. As for countries, the two leading reformers were Ireland from about 1983 on, and the Netherlands from 1993 on. After 1988 both countries cut all categories of social transfers.

What kind of social transfers got cut most? Unemployment compensation stagnated, both as a share of GDP and as a support ratio comparing benefits per unemployed person to the average wage rate. The average stagnation, however, hides an important divergence in national experiences. As shown in the last column of Table 1 about half the countries cut the generosity of unemployment compensation, led by the Netherlands, Britain, New Zealand, and Austria. Many of these countries tightened up eligibility rules for compensation, as one would expect in an era adopting free-market reforms. How do we reconcile the cuts in relative support for the unemployed in about a dozen countries with the lack of any overall drop in the share of unemployment compensation in GDP? Part of the reconciliation is that the countries cutting the support ratio for the unemployed had rising unemployment on the average, so that the support could stay about the same as an average share of either labor earnings or GDP. The rest of the reconciliation lies in the fact that a nearly equal number of countries -- especially Greece, Italy, and Portugal -- raised the generosity of their support for the average unemployed person.⁵ Welfare spending was not severely cut, except in Austria, the Netherlands, and Sweden.

The most important changes, both recent and future, are those in the public pensions. As the media constantly remind us, something has to give when a pay-as-you-go (PAYGO) pension system combines with an ever-aging population. The choices are

- (1) raise the tax rate on current workers' earnings and property,
- (2) cut non-pension transfers per young person,
- (3) cut pension benefits per pensioner, or

(4) raise the official ages at which benefits are granted.

All four options are being hotly debated in every industrialized country.

The movements of the 1980s and 1990s have already begun to reveal how aging democracies are likely to dole out the medicine of pension reform. The industrialized countries have not returned to a fully funded or a private pension system, with the partial exception of Britain under Margaret Thatcher.⁶ The main reason seems to be that switching back to these relatively sound systems would impose a double burden on the transitional generation that has to pay for the retirements of both a previous generation and itself. In addition private pension systems are themselves showing a lot of strain in the face of population aging and volatile asset markets.

Stuck with PAYGO, the OECD democracies have shown some tendencies in the 1980s and 1990s that are likely to continue. Table 1 illustrates these tendencies, which are borne out by multivariate analysis. Most countries have not cut the share of GDP spent in taxes on social transfers, nor have they cut social transfers to the young. The share of GDP going to the elderly in the form of pensions and medical aid have also been stable on the average.

What has already been cut in some countries in the 1980s and 1990s is the support ratio per elderly person, as shown in the next to last column of Table 1 and in the four panels of Figure 1's portrait of some countries' pension support ratios.

The three countries that have cut the relative generosity of support for the elderly are those featured in the first panel of Figure 1, namely the Netherlands, New Zealand, and Ireland. The Netherlands in the 1990s slashed its average support for the elderly, as evident in the next to last column. The share of pension payments in GDP hardly fell at all, however, because of the rise in the share of the population over 65. The magnitude of the cuts would be hidden if one looked only at the literature on pension reforms as such. Support for the

elderly was not cut by pension reforms, but rather by a retreat from the excessive disability payments and other subsidies to early retirement. Back in 1990 less than 40 percent of men in the 55-64 age bracket worked. Over 33 percent were on disability pay, and the remaining 27 percent were collecting other payments, especially the special early retirement (VUT) payments. Sharp reforms of this system in the mid-1990s explain the decline in the support ratio for the elderly, since disability payments were counted as support for the elderly in Table 1. New Zealand achieved a significant but gentler pension reform by raising the normal retirement age to 65 from 1989 to 2001, and by indexing benefits to prices rather than to wages after 1993.⁷

The pension support levels of other countries differed in both level and trend. Five countries have kept their level of old-age support below the OECD average. In addition to Australia, Japan and the United States, all pictured in the second panel of Figure 1, Canada and Portugal have also kept their spending down since 1980 and earlier. By contrast, at least three countries -- Austria, Greece, and Italy, have been scaling up their benefits for the elderly faster than the average OECD country. Finally, the Scandinavian countries, including Iceland, have maintained high levels of support.

While the exceptional cases of transfer-cutting reforms make important topics in their own right, the main conclusion is clear enough. Since 1980 social transfers did not decline as a share of GDP. The welfare state have not yet flunked Stigler's (or Darwin's) survival test, either among all 21 countries or among the group of initial high spenders.

Extrapolating the Pension Crisis into the Twenty-first Century

The welfare states that have survived the 1980s and 1990s may still be done in, however, by the aging and pension crisis. The fact remains that

populations continue to get older, and that something has to give in the pay-as-you-go pension systems that now dominate. Whose pension crises will be the worst? Will the high-spending welfare states fare worse than others? We can indeed identify which countries are most in trouble, given their rates of aging and their current policies.

As it turns out, though, the countries most in trouble are not exactly the welfare states. The budget pressures that can crush social programs can come from any source. In a PAYGO world, whatever raises the deficit and national debt relative to annual GDP can force a country to cut back on any kind of spending, including social transfers. The countries under the greatest pressure right now are not the welfare states. Rather, it is Japan that has the highest deficits in the OECD, and the United States has suddenly vaulted into second place in the deficit/GDP ranks since 2002.

To get more specific about which countries probably face the gravest crises calls for courageous conjectures. Forecasting has its usual pitfalls here, though we are helped a bit by the relative predictability of population movements. The forecasts emerge from a consideration of four issues: Who is aging fastest, what aging meant for public budgets in the pre-1995 experience, what budget pressure this combination implies, and finally which countries have added to their problems with early retirement subsidies and soaring overall budget deficits.⁸

Some of us are aging faster each year than others -- as national aggregates, not as individuals. In the 1980s the oldest countries tended to be Scandinavian. Over the first quarter of the twenty first century, it will be a race between Italy and Japan. Italy will win by mid-century, and be saddled with the oldest population in the OECD, according to the United Nations projections. Yet the aging phenomenon is common to all OECD countries, not just to these leaders.

What the aging implies for budgets cannot be determined mechanically by applying the current pension rates to a rising elderly share, as many authors of

scare stories have done. Rather, the budgetary effect depends on how the political system reacts to the population aging. Here our best guide is pre-1995 experience, when the Scandinavian governments had already confronted a large elderly population share, while Japan and North America and other countries still had young populations.

Statistically controlling for other determinants of social budgets in the 1978-1995 sample period yields the likely age effects shown in Figure 2.⁹ Let us follow the curves to the right of the point where the elderly (over-65) share of the population was a middling 14 percent. In this right-hand zone, the three curves projecting transfers as shares of GDP are all steady or slightly rising. Public pensions do not seem to be *over the hill* as a share of GDP or as a tax burden. They are, however, *over the hill* in terms of pension support per elderly person. Figure 2 suggests that after other variables have been controlled for, as the elderly share rises toward 18 percent of the population, the elderly will see the fruits of their gray power erode in per-person terms.

What the pre-1995 patterns imply for individual countries early in this century is suggested by Table 2, which pushes the age-effects beyond the sample limit of 18 percent over age 65 to conjecture about a world in which 20 percent have passed that 65th birthday. Country by country, the age trends yield specific numbers shaped by the curves of Figure 2. Again, the aging effect taken alone implies that none of these 21 countries will cut the share of GDP it spends share on transfers. Taxpayers will apparently get no relief and non-pension transfers will not be cut. Rather the burden in most countries is likely to fall on pensions per elderly person.¹⁰ Australia, Ireland, the United States, and Norway will have the lightest burdens, because they are relatively young and still not aging fast, thanks in part to immigration.

Among the countries that are aging fast, fewer need to see a crisis looming than the set of countries with minus signs for the pension support ratio in Table 2. The reason is that some of them have already been doing their homework by

taking the logical approach to longer life expectancy. The logical approach, for public pensions as well as for private pensions, is to extend the retirement age. An increasingly healthy and productive senior population can stay at work longer. Two countries that have faced this issue already are not welfare states: Japan and the United States tend to keep their workers employed to more advanced ages than most OECD countries. The other leading countries with wisely extended work ages, however, are the welfare state of Scandinavia, particularly Norway and Sweden. As best we can project, population aging looks less ominous in these cases.

Rather the OECD countries in the biggest pension trouble are those whose political balance yielded to pressures to buy out seniors by subsidizing early retirement. Starting in the 1960s, several European countries invited their workers in the 50-64 age range, and especially those over 60, to retire early. The implicit tax on staying at work peaked at the start of the 1990s. The incentives to quit work varied. Most European countries formalized an early retirement age, the 55th birthday for Italians and the 60th for others. Belgium and France gave the 55-64 age group extra unemployment and layoff benefits. The Germans up to 1982, the Italians before 1984, and the Dutch before 1995 offered especially generous disability benefits, making it easy for workers to claim that they had a job-related disability.

Such golden handshakes may be a main reason why men have been retiring earlier and earlier. Table 3 shows this trend for twenty countries. In 1980, when the data series begin, Belgium and Finland stood out as countries where men retired earlier. Between 1980 and 1999 men in the 55-64 age group cut back on work in all countries. French men were world leaders in quitting work earlier than their predecessors back in 1980, catching up to Belgium in the level of early retirement. Men in Spain, Italy, Canada, Germany, and the Netherlands also cut back heavily on work, though the Netherlands has since reversed this trend. This shift away from older men's work, which was only

partly offset by the rise in older women's work, further strained budgets in these countries.

So far, the combination of aging trends and early retirements suggests that Italy may be the country whose pension system is in the most trouble, followed by France and Belgium. The Italians seem to have realized as much in the 1990s. For Italy, public pension coverage for private employees had won great victories back in the late 1960s. It was around 1969, in response to the financial distress of postwar funded schemes, that the government gave cost-of-living protection to all pensions, tied pensions to employees' high final salaries, and set up the means-tested *pensione sociale* as a safety net for all elderly.¹¹ At that time, Italy's age distribution was not unusual among the more developed countries. By the early 1990s, even politicians recognized the implications of Italy's having one of the world's lowest birth rates, excellent life expectancy, and not much immigration. Small reforms designed to improve the social security budget were passed in 1992 and 1995. Yet these limited reductions take effect only in this century, and the basic math of Italian pensions remains problematic. Beyond Italy, the group of countries with the greatest danger might be Austria, Belgium, Finland, France, Germany, Greece, Netherlands, and Spain.¹²

Two broader points about the locus of the crisis need emphasis here. First, a pension crisis does not need to be caused by aging. As already noted, it can come from any source of huge deficits in the overall government budget. Even if pension were ostensibly protected in a special lock-box fund, a desperate government can always raid the lock box. Second, the pension crisis might have a zero cost in terms of GDP even if it imposes a heavy burden on a particular group. This lesson emerges from twentieth-century experience. The net GDP cost of major changes in pensions or other social transfers looks like zero. Whatever happens to pension policy appears to involve offsetting gains and burdens that net out to zero. There is indeed a pension crisis in the sense that

some major changes will take from one generation and give to another. Yet these inter-generational effects net out to a virtually zero cost in terms of GDP.¹³

What Should We Expect in the Second World?

The transition countries of Eastern Europe and Central Asia face a social policy crisis that should continue to be more severe than the pension crisis in the OECD. History has exerted three pressures that are pushing the transition countries to cut their social transfers, including their pensions. First, in the 1990s, they were emerging from a communist legacy demanding high levels of social spending. Second, their populations were almost as old as those of the average OECD country. Having a large share of elderly, just like having a communist legacy, tilts a country's policies toward supplying more safety nets at government expense. Third, these countries fell into even greater relative poverty in the disruption of the early 1990s.

It would not have been surprising to see all of them slash their social budgets and fall back to the historical path followed by OECD countries of similar income levels and elderly shares, such as Greece. Yet nothing was simple in Eastern Europe and Central Asia in the 1990s, and a counter-pressure made some of them *raise* the shares of GDP spent on the elderly and the poor. The new post-communist governments desperately needed political support, or at least acquiescence, from the general public. Since the elderly tend to be politically vocal, their demands for safety nets were not so easily suppressed. What emerged was a variety of social policy responses in different countries.

The best starting point for surveying the turbulence in social policy in the 1990s is the Soviet prototype as it had evolved by the 1980s. Soviet social policy famously provided comprehensive social programs, with greater spending of resources on child care, schooling, public health, public housing, and pensions

than one would have predicted of a non-socialist country with the same income level and age distribution. In addition, jobs were so secure and so marginally productive that many received what might be called unemployment compensation on the job, as in the familiar Soviet expression they pretend to pay us, and we pretend to work.

Pension spending may have crept slowly upward as a share of GDP in the Soviet bloc in the 1960s, around the time it was rising in the OECD countries. In the Soviet Union, collective farmers were belatedly added to the national pension scheme in 1961. With the retirement age set as low as 55 for women and 60 for men, the number of recipients of old-age support and privileges greatly exceeded the over-65 population. In the 1970s and 1980s, budgetary pressures started to thin out this support per elderly person, even though pension spending remained a high share of national product.¹⁴ With similar pension developments throughout the bloc, by the late 1980s cash pensions amounted to about 6-9 percent of GDP in all republics, except in the young populations of Romania and Muslim Central Asia.¹⁵ In addition, the elderly were given housing and other aid in kind.

The collapse of the Soviet Union and the communist regimes of East Central Europe in 1989-1991 caused political turmoil and an economic slump. The new regimes reacted differently on the social transfer front. Some cut back, as one might expect in hard times and in the collapse of the whole system of taxation. So it was for pension spending in Belarus, Estonia, Kazakhstan, Moldova, and Ukraine, and for non-pension cash transfers in Bulgaria, the Czech Republic, Romania, and again Estonia and Ukraine. Yet other countries moved in the opposite direction between the late 1980s and 1993-94, raising social entitlements to unprecedented levels even as their economies slumped. Poland and Hungary stood out, raising the shares of GDP spent on both pensions and other cash transfers. Pensions also jumped as a share of GDP in Bulgaria, Romania, Slovenia, and Uzbekistan, and non-pension transfers rose in Russia.

Such upward ratcheting of transfers was probably the result of both a need to buy support for new regimes and the continued rapid aging of the population.

The peculiarity of the situations in the transition countries is underlined by comparing their shares of transfers in GDP since the late 1980s with both a global view for 1990 and the longer sweep of history. Figures 3 and 4 set the larger regional differences into perspective. Each panel helps us focus on some national and regional oddities by projecting social transfers against either the old-age share or GDP per capita.

The transition economies of Eastern Europe and the former Soviet Union retain a stronger commitment to social transfers than other parts of the world, for any given age distribution and level of income. The same peculiarity emerges in most cases – whether one looks at pensions or at the total transfers shown here, whether one projects them against age shares or against GDP per capita, and whether one compares the transition economies to the long flow of OECD history or to Third World countries around the year 1990. To illustrate, let us turn first to Figure 3, comparing total transfers as a share of GDP with what one might expect given the elderly share of the total population. In the lower right, we see the flow of OECD history from 1880 through 1995, for the generous pensions of welfare state Sweden and for the lower-spending United States and Japan. Most countries of the former Soviet bloc clearly devote a greater share of GDP to public pensions than Sweden, or the United States, or Japan, or other OECD countries ever did. Their commitment to public transfers also exceeds that of East Asian countries (the triangles) or other Third World countries (the X s). What is most peculiar is the differential departure from the late-1980s norm of spending 6-9 percent on public pensions. Most of the transition economies (dark dots) kept their shares from rising, as mentioned. Yet the public pension shares in Hungary and Poland had jumped by 1993 to levels that rivaled the pension commitments of Western Europe's welfare states. Public pensions were also strikingly high in Azerbaijan and Uzbekistan in

the depths of the slump. Similar contrasts between these countries and others stand out in Figure 4.

Are these high commitments sustainable? The peak commitments of the early 1990s were partly an artificial byproduct of the deep slump in GDP per capita. The same stickiness that kept countries from slashing benefits as fast as GDP fell should also keep them from raising benefits as fast as GDP recovers. So the support should drop as a share of GDP. The pension support ratio should fall even faster, as the population continues to age. In fact, that tendency to retreat toward world standards of support was already in motion in Poland and Hungary by the turn of the century.¹⁶ To judge from skimpy data, it seems likely that the retreat toward the Swedish historical curve will continue in these countries.

What Should We Expect in the Third World?

The Third World as a whole spends more on social transfers, including pensions, than was spent in the earlier history of the advanced OECD countries at similar levels of purchasing power and at similar shares of elderly in the population. So say either the positions of dots and lines in Figures 3 and 4 or the underlying numbers.¹⁷ To illustrate, let us compare Sweden in 1930, just before the Social Democrats first came to power, with some developing countries around 1990. Back in 1930, Sweden spent only 2.6 percent of GDP on social transfers, at a time when it had a relatively aging population (2 percent were over the age of 65). Compared to the Sweden of 1930, the following developing countries were poorer and had younger populations around 1990, yet paid a *greater* share of GDP in taxes for social transfers than Sweden's earlier 2.6 percent: Costa Rica (10.9 percent), Panama (9.8 percent), Tunisia (7.0 percent), Sri Lanka (5.3 percent), Egypt (4.4 percent), and Bolivia (3.3 percent, by the central

government only). The same was true for some other developing countries as well.

Within the Third World, two large regions seem to spend more than two others. Latin American and the Middle East generally spend more on the elderly, the disabled, the unemployed, and the poor than either Africa or South and East Asia. The lower social spending of Africa and the Indian subcontinent can be explained in large part by differences in income levels and age distribution. Yet one particular contrast stands out even after we have controlled for income and age. East Asia – that is, Asia east of India and Bangladesh – taxes and spends less than Latin America or the Middle East, the two regions that dominate the set of Third World dots in Figures 3 and 4. The contrast is blurred in the age perspective of Figure 3, since the East Asian countries tend to have young populations. Yet in the income perspective of the other two figures, the contrast comes back to us: Why should East Asia, which is more prosperous, pay a lower average tax rate for social transfers?

Many observers of the regional differences have imagined a contrast between a tougher and more virtuous East Asia and a more welfare-dependent Euro-American community. Is there a separate anti-welfare East Asian culture? How old is it? Will it last?

The imagined separate Asian culture was trumpeted in the literature on Japan as Number One, which was peaking in popularity just before Japan's asset markets crashed so resoundingly between 1989 and 1991, leading to Japan's lost decade of stagnation and policy stalemate in the 1990s. In the 1970s and 1980s many Japanese and foreigners thought that Japan had achieved the world's Number One Welfare State without government, by having families take care of themselves out of savings and mutual aid. The premise of high private savings is correct, of course, though Japan's data have never revealed any peculiar mutual aid or co-residence between the generations since World War II. Returning to Figures 3 and 4, we see that Japan's historical time-path of pensions

and other social transfers was indeed near the bottom of the range of OECD paths, well below that followed by Sweden. Yet it was not far below that of the low-spending United States and Switzerland, complicating the task of distilling a historical lesson about Asian culture.

Louder and more sustained than the drumbeat on behalf of Japanese values has been the emphasis on anti-welfare Confucian values in the predominately Chinese countries. In these countries twentieth-century leaders often preached the Confucian traditional emphasis on the family as the main source of support in times of need. That was even true of the government of Mao Zedong, at most times, despite the obvious tension between elevating the family and elevating the state and the wisdom of its leader. In Singapore, former President Lee Kuan Yew and the ruling People's Action Party (PAP) seldom passes up the opportunity to re-assert the superiority of his Asian values over the Western disease of welfarism. His successor, President Ong Teng Cheong repeated the PAP sermon thus, when opening Singapore's Parliament in 1994:

Developed countries in Europe, Australia, New Zealand, and Canada once proudly called themselves welfare states. Now they have to revamp their welfare systems in order to remedy the disastrous side effects of state welfare: weakened family bonds, diminished incentives to work, and impoverishment of the country's finances Their problems confirm that we have chosen the right path. ¹⁸

To chart the social program trajectories of Third World countries requires a statistical look at their recent history. We need data from countries that have followed consistent definitions for several years. For most developing countries the international agencies supply insufficient data, both because they report social transfers only for one or two benchmark years and because those few data are not sufficiently explained in the publications of the ILO or the IMF. In the

working-paper version of this chapter, I have assembled relatively reliable data for 21 developing countries in the years 1975, 1980, 1985, 1990, and 1995.¹⁹ To allow for possible simultaneous feedbacks between GDP per capita and the social transfer behavior, I used a two-stage simultaneous equation GLS framework. As it happens, the feedbacks proved negligible in this case: GDP per capita did not greatly affect the social transfer shares, and social transfers had no effects on the level or growth of GDP per capita. Social transfer shares were strongly raised by population aging, and strongly reduced by ethnic fractionalization. Democracy made no clear difference in this sample. These results are broadly consistent with past studies, though the jury is still out on the effects of democracy and autocracy.²⁰

The effects of population aging among Third World countries have been very different from those revealed by the recent history of the OECD countries. Figure 5 shows this other side of the hill as a contrast to the OECD downside shown back in Figure 2. Among developing countries, where the over-65 population share never exceeded 12.3 percent, a more elderly population strongly raises both pension and non-pension transfers as a share of GDP. Among the youngest populations, up to an elderly share of about 10 percent, aging even slightly raises the support ratio *per elderly person*, perhaps as a reflection of the early stirrings of gray power. The strong positive effect of aging on social transfers suggests that we can once again forecast transfer trends up to the year 2020, this time for younger Third World countries. To interpret the predicted trends, however, we should first note how countries' starting points differed back in, say, 1990.

In fact, there is a significant difference between regions in their 1990s behavior toward social transfers, even when other variables are held equal. South and East Asia does indeed spend significantly less on all kinds of social transfers than Latin America.²¹ Does that mean that Asia has a separate anti-transfer culture, as Singaporean officials insist? Or is it Latin America (and

perhaps the Middle East) that has the truly separate culture, in this case a positive political tendency toward social transfers? Let us re-cast this question into the forecasting question that motivates it: As both Asia and Latin America age, would we expect Asia to spend less than the welfare states had spent earlier, or would we expect them to spend just and much while Latin America spends more?

Some courageous guesses are offered in Table 4, on the basis of different countries starting points in 1990, their aging trends, and the non-linear age effects fitted to the whole sample of twenty-one countries for five benchmark years. The guesses, or projections, for each country extend out to one of two horizons. If the country reaches the year 2020 with fewer elderly than 12.3 percent of the total population, then Table 4 reports its predicted behavior in 2020, based solely on its 1990 behavior plus an estimated age effect. The 12.3 percent share is used because this is the maximum elderly population share observed in the 1975-1995 sample. If the population over 65 reaches the 12.3 percent limit before 2020, then the forecast refers to that earlier year with 12.3 percent of the population over age 65. This choice is designed to avoid going beyond the observed sample of historical experiences. This earlier aging was observed in the cases of Uruguay, Israel, Singapore, Taiwan, and Korea (which is outside of the sample, but appears in Table 4 anyway). For the other countries the projections run to the year 2020.

The estimated age effects for developing countries imply that any aging country will experience rising shares of pensions and other social transfers, with little change in the pension support ratio. Pensioners will not fall behind, say the predictions, while their greater numbers will extract rising shares of GDP from taxpayers (or from non-social government spending). The projections imply that the downward pressure on pension support we witnessed in the OECD pattern will not have visited the developing countries by 2020.

Will any of these developing countries have become a welfare state by 2020, spending 15 percent of GDP or more on social transfers? Combining countries' starting points with their rates of aging yields the forecasts in the last column of Table 4. By 2020, there should be half a dozen welfare states, or near-welfare states, in this group. The clearest cases are two countries that had already crossed the 15 percent threshold in the early 1990s: Israel and Uruguay. What Table 4 adds in these two cases is the interpretation that their welfare state status has been, and will be, reinforced by population aging. Chile will also have become a welfare state by 2020. A caveat about the forecast for Chile is that the high level of government pensions may reflect conditions not usually associated with the egalitarian welfare state. As of 1990 Pinochet had bought out a whole cohort of pensioners with a generous state support to placate opposition to the eventual shift from PAYGO to funded pensions.

In East Asia, there should be at least three new welfare states by 2020, say the forecasts. These are Taiwan, South Korea, and even Singapore itself. All three countries will have neared, but not yet surpassed, the 15 percent mark when their elderly shares reached the sample-maximum 12.3 percent. By 2020, if we dare to extrapolate the age effect beyond the historical sample range, all three countries will have passed my admittedly arbitrary 15 percent mark. Taken at face value, the regression estimates and the forecasts deliver two conclusions about the distinctive anti-welfare culture of East Asia. On the one hand, yes, East Asia looked like a distinctively low spender in the 1975-1995 experience, even after controlling for other factors -- either that, or Latin America looked like a distinctively high spender. On the other hand, the strong age effect should propel Singapore, Taiwan, and South Korea toward welfare state status by 2020, even before they become as elderly or as rich as today's European welfare states. Whatever might be distinctively anti-transfer about their culture may well be outweighed by the pro-transfer era in which we live, an era in which governments tax and transfer more than did Japan, the United States, and even

Sweden before World War II. While these forecasts are as shaky as the average forecast, their implication seems plausible.

<A>

A Different Kind of Pension Problem

The Third World has had some severe pension crises, but not for the same reasons as the leading OECD countries. Most pension troubles in the Third World come from political sources like those that have put so much pressure on the budgets of formerly communist countries. Most crises have been byproducts of the general breakdown of government budgets, though some have been exacerbated by special inequities in pension finance. That is, instead of the usual causation running from population aging to pension crisis and general-budget crisis, as in the leading countries, pension crises in the Third World come as much from the larger political and budget breakdowns as they do from population aging.

The initial motivation for Third World public pensions also differs from earlier European history, even before any crisis has built up. The driving force is less often egalitarian help to the poor and more often schemes to transfer income from the general taxpayers to the well-connected elite, especially in Latin America. In Brazil, for example, the pension privileges for legislators, civil servants, and military daughters had become ruinously generous by the late 1990s. A Congressman or a career civil servant could retire in his late 30s, with lifelong pensions not far below his earlier rate of pay. In fact, he could even get a new job and still keep receiving the full pension the rest of his life. Subsequent governments have trimmed this leaky pension program, but it is still generous and low-income taxpayers have to pay a large part of the bill. Thus the immediate pension task of populist President Lula is not to launch a bold rise in

pension transfers, but to cut back on the existing pension transfers, which redistribute income from the general population to the public-sector elite.

We are beginning to understand that the elitist nature of many Third World public pension systems is a global phenomenon. One telltale sign of elitism in public pensions is that they do not cover agricultural laborers or casual workers. Many are specific to government officials and the relatively well-off industrial and commercial sectors.²² The generosity of pensions for the elite is one reason why Third World public pensions seem to claim such a high share of GDP even under non-democratic governments.²³

Such public sector pensions take their hits in general budget crises, long before the population has aged much. The crises are usually due to the general overspending and under-taxing of Third World governments, and the pensions are cut as part of the usual medicine, whether or not it is administered by the IMF.

Conclusion: Global Convergence and Divergence in Social Transfers

In the year 2020, which countries will still be spending a smaller share of national product on social transfers than they do today? Which countries will be spending a greater share than they do today? The 1990s have planted some suggestions here for three kinds of countries. For the OECD countries the 1990s sat as jury to the earlier forecasts about the dismantling of the welfare state. For the transition economies the decade offered our first glimpse at post-communist social programs. And for Third World countries the decade brought rises in social transfers for several countries that were aging.

A safe initial prediction is that by 2020 most countries cutting the share of GDP spent on social transfers and public education will be troubled countries. The way to keep social spending from rising over the first half of the twenty-first

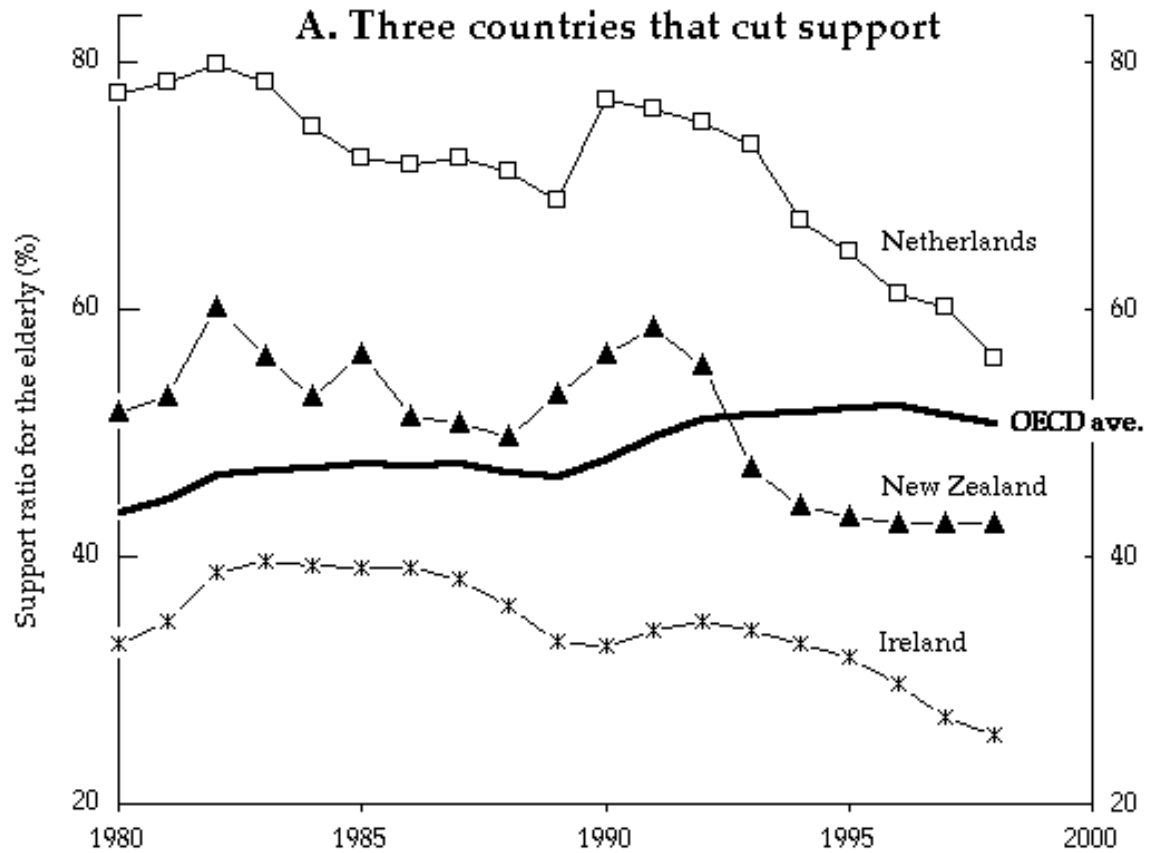
century would be have no growth in average real income, no gain in life expectancy, and no shift toward democracy.

The most likely candidates for this dubious slim-budget distinction would be countries that fall apart, like Somalia or Sierra Leone. Indeed most of sub-Saharan Africa, afflicted with rising AIDS mortality and rulers like Mugabe and Arap Moi, is the region where social transfers will remain meager. In social transfers, as in other respects, the main global divergence may be the widening gap between an expanding world and a stagnant Africa. The great divergence in social transfers and in education will probably be a widening of the gap between Africa and the rest of the world.

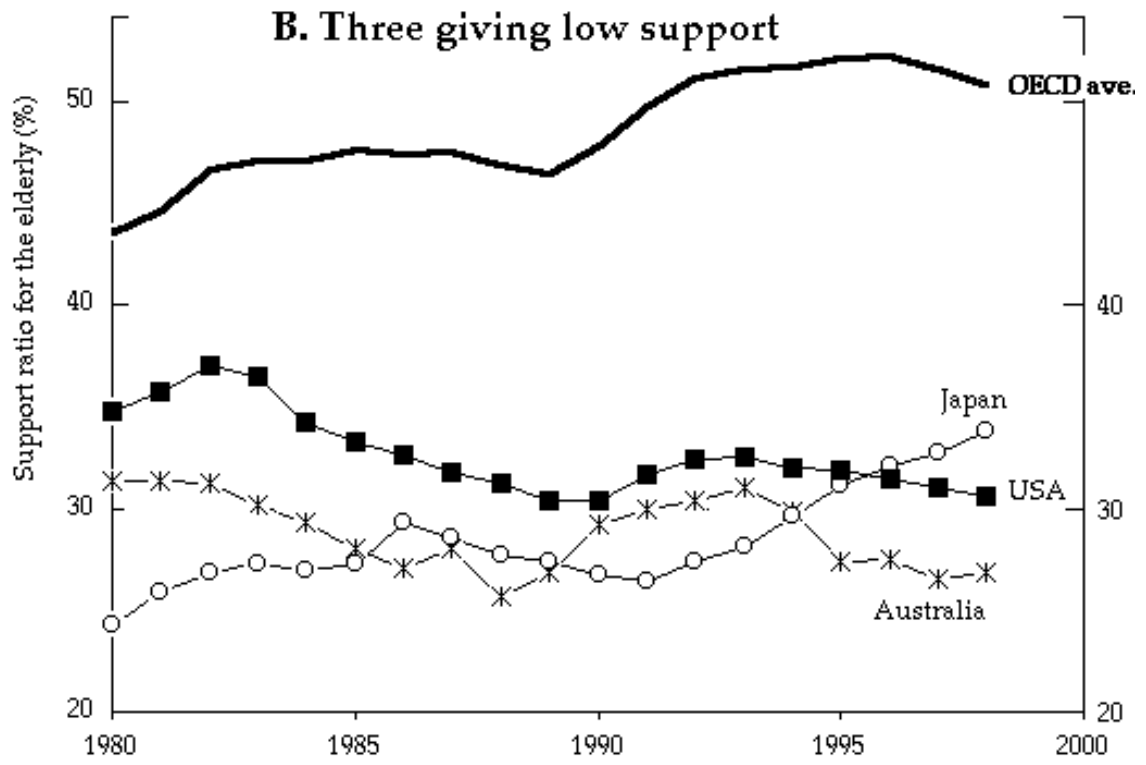
By contrast, there is likely to be a convergence on the shares spent on social transfers and public education in the rest of the world. The twentieth century saw a convergence of income growth and in life expectancy. The income convergence took the form of having successive waves of newly industrializing countries reform their economic institutions and catch up with the leading countries. At first the fast-growing catchers-up were European countries and Japan, followed later by the East Asian Tigers, and a few Latin American success cases. To the extent that the social transfer share is driven by population aging, we should expect a convergence in such shares outside of Africa.

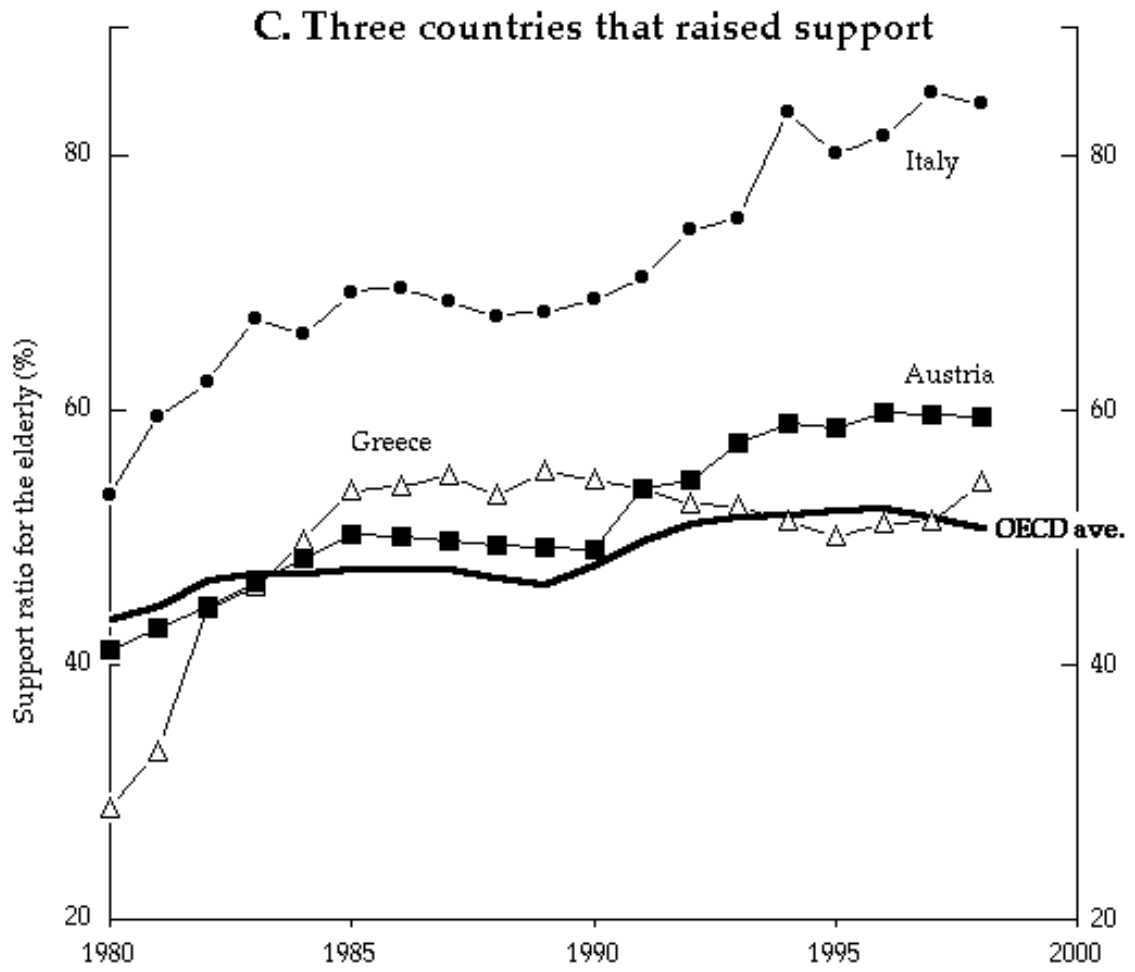
As a corollary, there is no sign of a global race to the bottom. That is, nothing even faintly suggesting that countries are scrambling to reduce the tax rates implied by their social budgets, to compete for mobile factors of production. Nations have not been recoiling from the cost from the tax-and-transfer package.

Figure 1. Support Ratios for the Elderly in Selected Countries since 1980



Support ratio for the elderly = (benefits/person over 65) / (GDP/person over 16).
Source = same as for Table 1.





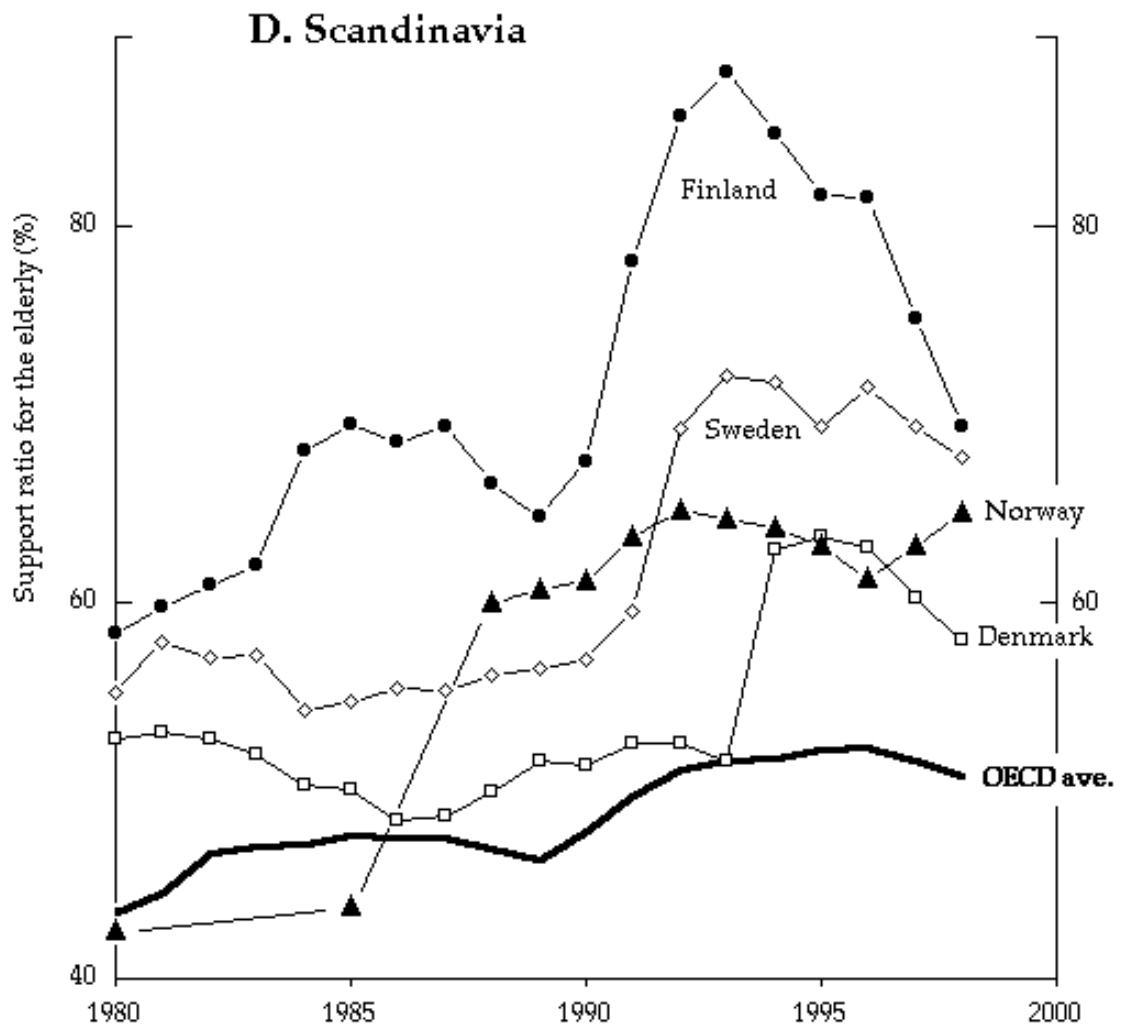
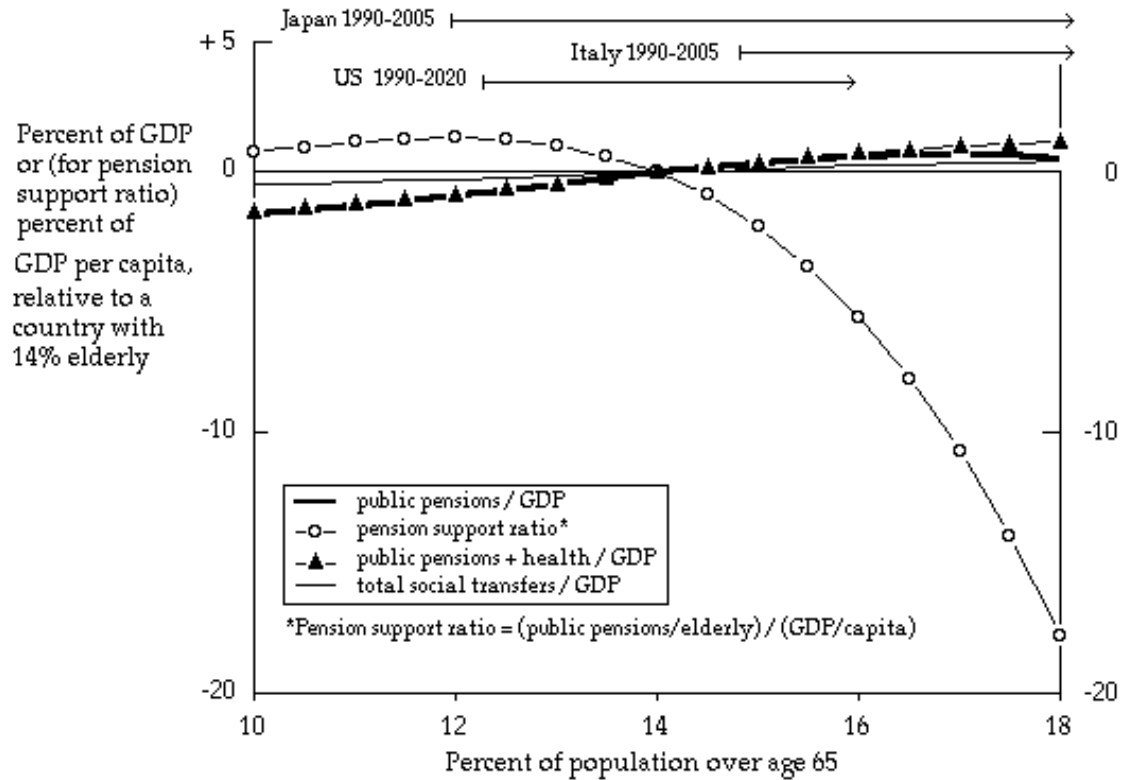


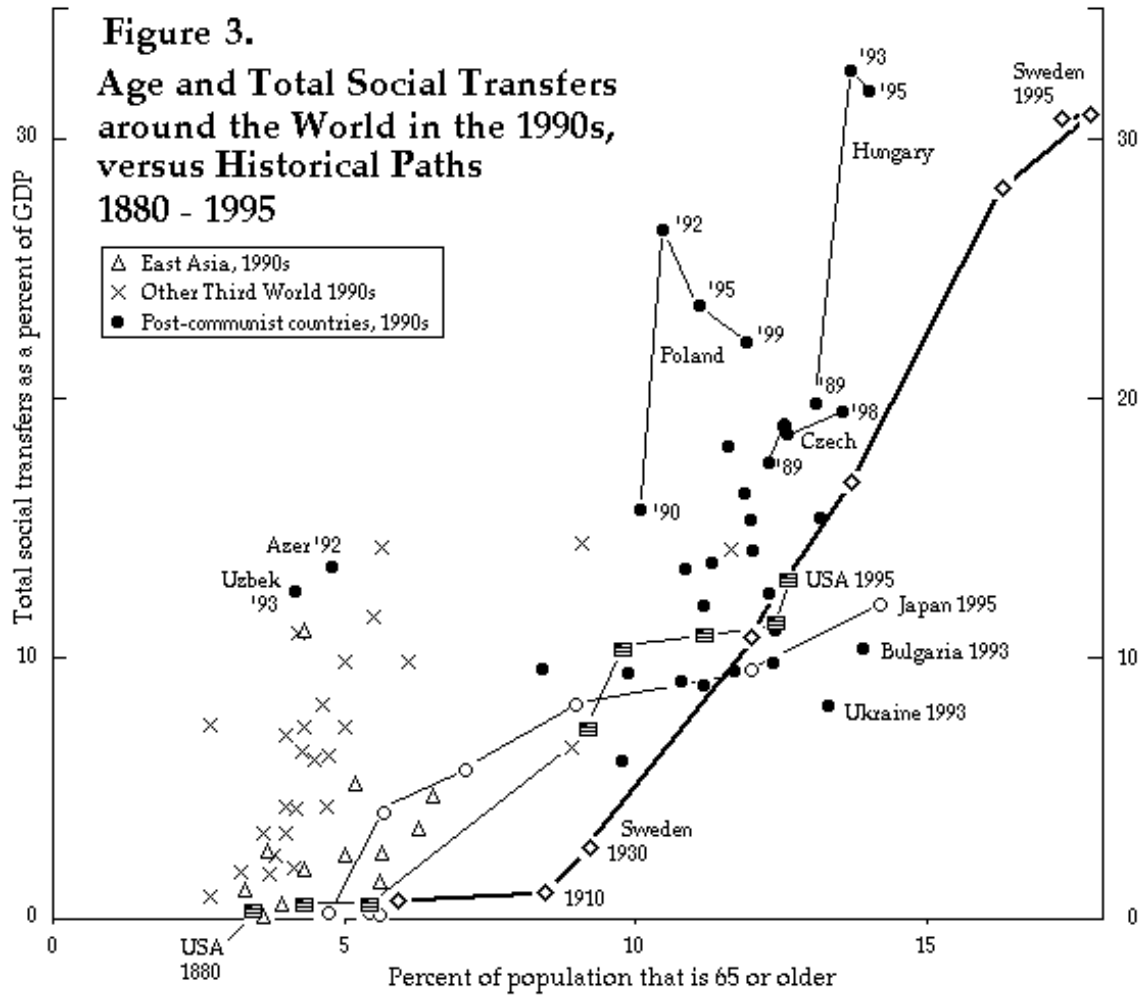
Figure 2. How Population Aging Affected Pensions and other Social Transfers in the OECD, 1978 - 1995



(Source = GP, Volume 2, Appendix Table E3, equations without full fixed effects.)

For the figures that follow, this legend applies:

○ = Japan path, 1880 - 1995	△ = East Asian country 1990
◇ = Sweden path, 1880 - 1995	• = other Third World 1990
≡ = USA path, 1880 - 1995	× = transition country of East Europe or Central Asia 1990



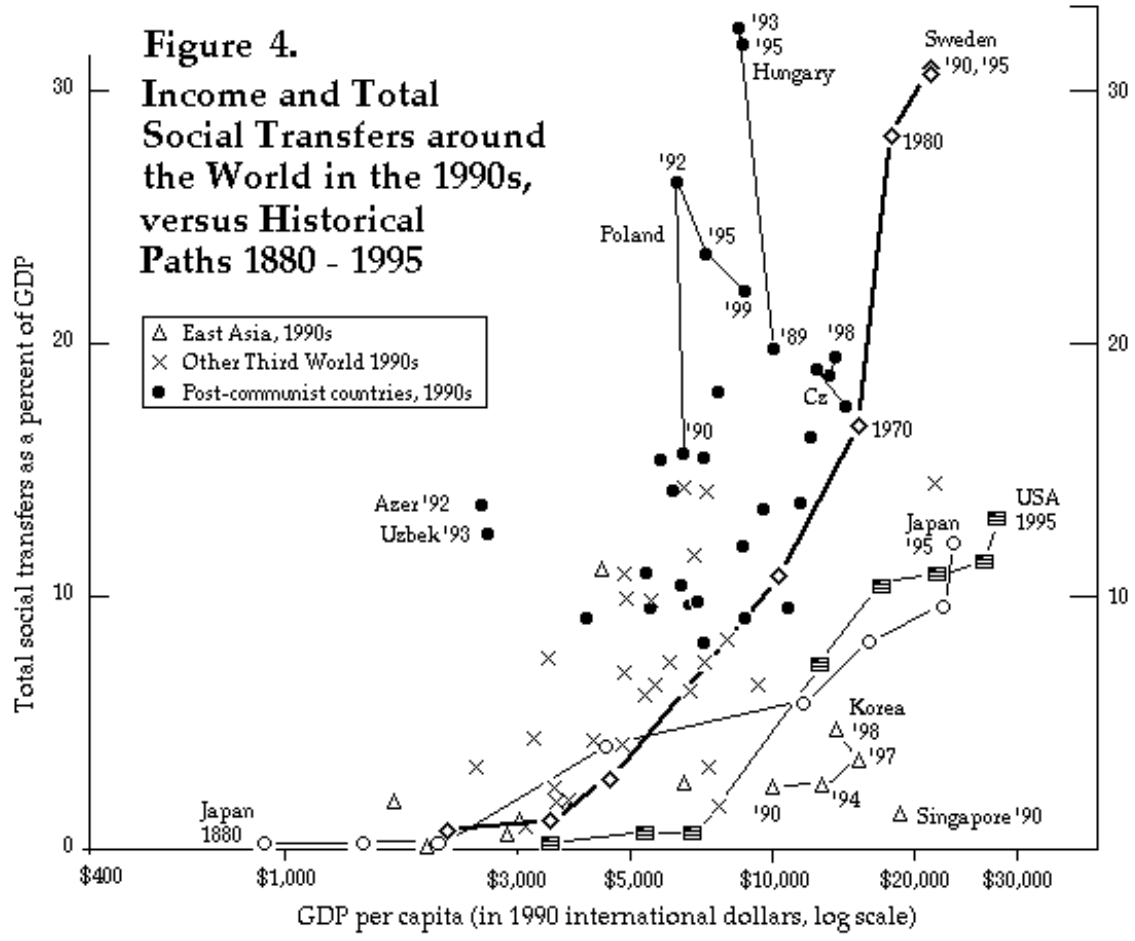
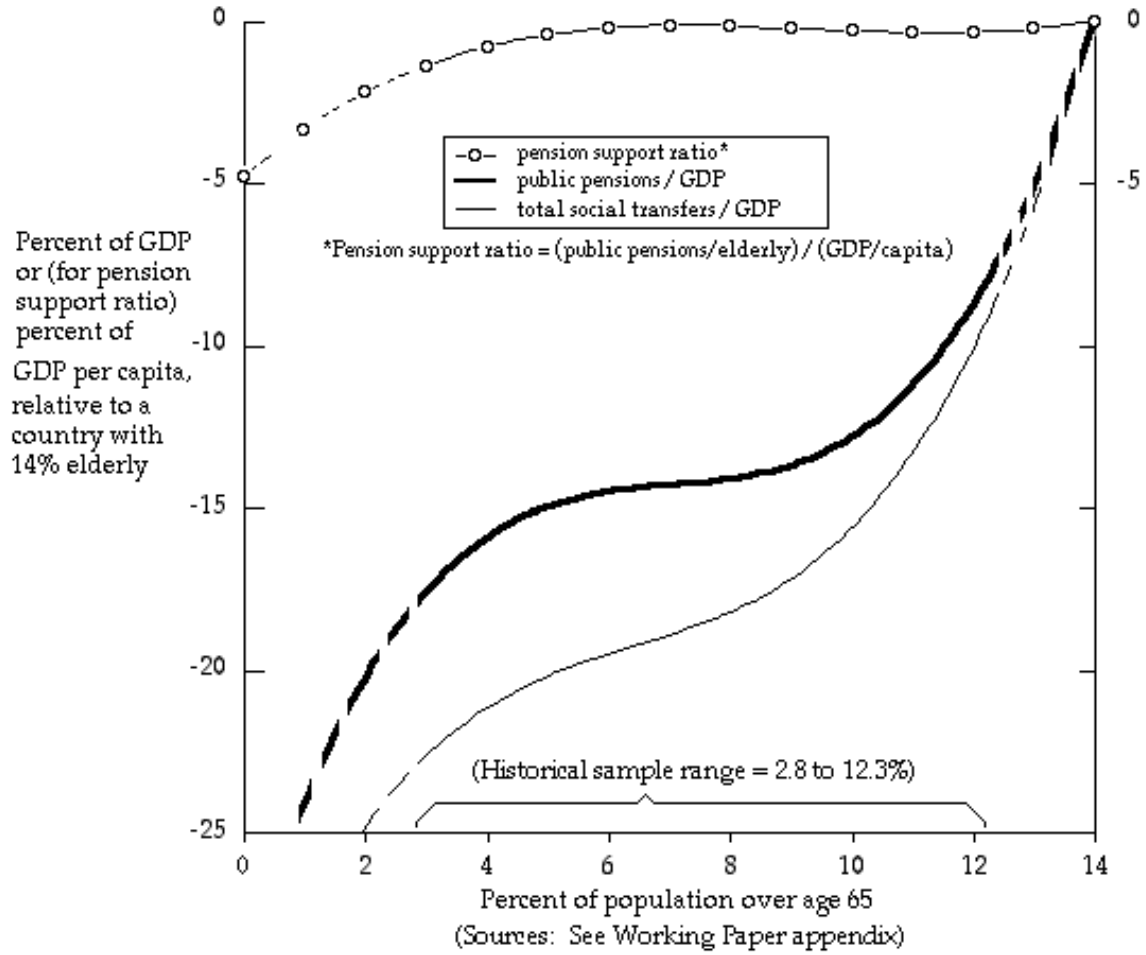


Figure 5. How Population Aging Affected Pensions and Total Social Transfers in 21 Developing Countries, 1975-1995



REFERENCES CITED

- Alesina, Alberto, Reza Baqir, and William Easterly. 1999. Public Goods and Ethnic Divisions. *Quarterly Journal of Economics* 114, 4 (November): 1243-1284.
- Alesina, Alberto, Arnaud Devleeschauwer, William Easterly, Sergio Kurlat, and Romain Wacziarg. 2002. Fractionalization. NBER Working Paper 9411 (December) .
- Alesina, Alberto, Rafael DiTella, and Robert MacCulloch. 2001. Inequality and Happiness: Are Europeans and Americans Different? *Brookings Papers in Economic Activity* no. 2: 187-277.
- Blake, David. 2002. The United Kingdom: Examining the Switch from Low Public Pensions to High-Cost Private Pensions. In Martin Feldstein and Horst Siebert (eds.), *Social Security Pension Reform in Europe*. Chicago: University of Chicago Press: 317-348.
- Blöndal, Sveinbjörn and Stefano Scarpetta. 1997. Early Retirement in OECD Countries: The Role of Social Security Systems. *OECD Economic Studies* 29, 2.
- Blundell, Richard and Paul Johnson. 1999. In Jonathan Gruber and David Wise (eds.), *Social Security Programs and Retirement around the World*. Chicago: University of Chicago Press: 403-436.
- Brugiavini, Agar. 1999. Social Security and Retirement in Italy. In Jonathan Gruber and David Wise (eds.), *Social Security Programs and Retirement around the World*. Chicago: University of Chicago Press, pp. 181-238.
- Buti, Marco, Paolo Sestito, and Hans Wijkander (eds.). *Taxation, Welfare, and the Crisis of Unemployment in Europe*. Cheltenham: Edward Elgar.
- Center for International Comparisons, University of Pennsylvania. 2003. *Penn World Tables 6.1*. Downloaded from pwt.econ.upenn.edu, October 2003.
- Conner, Walter D. 1997. Social Policy under Communism. In Ethan B. Kapstein and Michael Mandelbaum (eds.). 1997. *Sustaining the Transition: The Social Safety Net in Postcommunist Europe*. New York: Council on Foreign Relations, 10-45.
- Disney, Richard and Paul Johnson (eds.). 2001. *Pension Systems and Retirement Incomes across OECD Countries*. Cheltenham: Edward Elgar.
- Feldstein, Martin and Horst Siebert (eds.). 2002. *Social Security Pension Reform in Europe*. Chicago: University of Chicago Press.
- Giordano, James. 2003. Using the Survivor Technique to Estimate Returns to Scale and Optimum Firm Size. *Topics in Economic Analysis & Policy* 3, 1: 23 pp. <http://www.bepress.com>.
- Goodman, R., G. White, and H. Kwon (eds.). 1998. *The East Asian Welfare Model: Welfare Orientalism and the State*. London: Routledge.
- Grubb, David. 2000. Eligibility Criteria for Unemployment Benefits. *OECD Economic Studies* no. 31, 147-181.

- Gruber, Jonathan and David Wise (eds.). 1999. *Social Security Programs and Retirement around the World*. Chicago: University of Chicago Press.
- Gurr, Ted Robert and Keith Jaggers. *Polity98 Project. Regime Characteristics 1800-1998*. Computer file. Ann Arbor: University of Michigan, 1999.
- Gwartney, James, Robert Lawson and Walter Block. 1996. *Economic Freedom of the World 1975-1995*. Vancouver: Fraser Institute.
- International Currency Analysis, Inc. *World Currency Yearbook*, annually.
- Kramer, Mark. 1997. Social Protection Policies and Safety Nets in East-Central Europe: Dilemmas of the Postcommunist Transformation. In Ethan B. Kapstein and Michael Mandelbaum (eds.), *Sustaining the Transition: The Social Safety Net in Postcommunist Europe*. New York: Council on Foreign Relations, 46-123.
- Kremers, Jeroen J.M. 2002 Pension Reform: Issues in the Netherlands. In Martin Feldstein and Horst Siebert (eds.), *Social Security Pension Reform in Europe*. Chicago: University of Chicago Press: 291-316.
- Lindert, Peter H. 2004. *Growing Public: Social Spending and Economic Growth since the Eighteenth Century*. Two volumes. Cambridge: Cambridge University Press.
- McAuley, Alastair. 1979. *Economic Welfare in the Soviet Union: Poverty, Living Standards, and Inequality*. Madison: University of Wisconsin Press.
- Mulligan, Casey, ricard Gil, and Xavier Sala-I-Martin. 2002 Social Security and Democracy. NBER Working Paper 8958 (May).
- Organization for Economic Cooperation and Development (OECD). 1999. *Social Expenditure Database, 1980 - 1996*. CD-Rom, Paris, OECD.
- Organization for Economic Cooperation and Development (OECD). 2003. *SourceOECD Social Expenditures Data Set*. Downloaded November.
- Palmer, Edward. 2002. Swedish Pension Reform: How Did It Evolve, and What Does It Mean for the Future? In Martin Feldstein and Horst Siebert (eds.), *Social Security Pension Reform in Europe*. Chicago: University of Chicago Press: 171-210.
- Republic of China, Directorate General of Budget, Accounting, and Statistics. 2002. *Statistical Yearbook of the Republic of China 2002*. Taipei, author.
- Sala-i-Martin, Xavier. 1996. A Positive Theory of Social Security. *Journal of Economic Growth* 1, 2 (June), 277-304.
- Singapore, Department of Statistics. 1988. *Yearbook of Statistics: Singapore 1988*. Singapore: published by author.
- Stigler, George J. 1958. The Economies of Scale. *Journal of Law and Economics* 1: 54-71.
- Stockholm International Peace Research Institute. Annually. *SIPRI Yearbook of World Armaments and Disarmament*. Stockholm, SIPRI.
- Subbarao, K., Aniruddha Bonnerjee, Jeanine Braithwaite, Soniya Carvalho, Kene Ezemenari, Carol Graham, and Alan Thompson. 1997. *Safety Net Programs*

- and Poverty Reduction: Lessons from Cross-Country Experience*. Washington: World Bank.
- Taylor, Charles Lewis and David A. Jodice. 1983. *World Handbook of Political and Social Indicators*, 3rd edition. New Haven: Yale University Press.
- Tremewan, Christopher. 1998. Welfare and Governance: Public Housing under Singapore's party-State. In R. Goodman, G. White, and H. Kwon (eds.). 1998. *The East Asian Welfare Model: Welfare Orientalism and the State*. London: Routledge, 77-105.
- United Nations, Population Division. 2000. *World Population Prospects: The 2000 Revision*. Volume 1: Comprehensive Tables. New York: United Nations.
- U.S. Department of Health and Human Services. *Social Security Programs Throughout the World*.
- Van Vugt, Joos P.A. and Jan M. Peet (eds.). 2000. *Social Security and Solidarity in the European Union*. Heidelberg: Physica-Verlag.
- World Bank. Annually. *World Development Reports*.

ENDNOTES

¹ Before 1977, *The Wall Street Journal*'s editors had already expressed doubts about Sweden's economic wisdom, but less frequently. See the editorial on Sweden's problems in paying for its advanced public welfare systems, August 12, 1960; New Swedish Budget Would Increase Taxes, Impose Other Burdens, January 12, 1967; and Unrest in Utopia: Lavish Welfare Isn't Enough for Advocates of Equality, January 2, 1970. A sampling of post-1977 critiques in the American press includes Sweden's Social Model Shows Signs of Cracks, *New York Times* February 20, 1990, A2; Welfare Stagnation Besets Smug Sweden, *Wall Street Journal* April 5, 1990, A19; The Swedish Model Doesn't Seem Quite So Lovely These Days, *Los Angeles Times* June 18, 1991, H1; Sweden's Socialist Utopia Gets a Conservative Jolt; Welfare State Slated for Radical Overhaul. *Washington Post* May 30, 1992, A13; Sweden Trims Vaunted Safety Net, *Christian Science Monitor* May 5, 1993, 8; Sweden's Socialist Economy Due for a Major Overhaul; High Unemployment May Bring Free-Market Reforms, *Christian Science Monitor* October 27, 1994, 8; Sweden Seeks Big Social Cuts, *Wall Street Journal* January 11, 1995, A10; A Socialist Third Way Turns Out to be A Dead End, *Wall Street Journal* June 17, 1998, A16.

The *Economist* joined the attack, especially in the early 1990s. See Sweden: End of an Era? *Economist* September 7, 1991, 50; Sweden: Toughing It Out, *Economist* September 19, 1992, 64; Sweden: In Retreat, *Economist* September 26, 1992, 53; Sweat It Out, Sweden, *Economist* November 28, 1992, 22; Sweden: Worse and Worse, *Economist* October 9, 1993, 58; and A Case Study in Collapse, within the survey supplement The Nordic Countries: Heading South, *Economist* November 5 1994, Survey 5 Survey 7.

² It is desirable to exclude contributory pensions, that is, the amounts paid by one's self or one's employer. They are not a controversial redistribution of resources, but rather just part of one's employment contract. Therefore it is desirable to exclude government-employee, and military, pensions from the measures used here.

³ Sitgler (1958). For a critique and updated application of the Stigler survivor analysis, see Giordano (2003).

⁴ The OECD, the ILO, the IMF, and the U.S. Social Security Administration have all had difficulty developing social transfer data that are comparable across countries and over time. For the 21 core OECD countries, I have preferred a spliced series based on the penultimate OECD set of estimates. In what follows the estimates from the OECD's (1999) CD-Rom are preferred for the

core 21 countries up through 1995, and the latest OECD estimates are spliced onto this base for years from 1995 on.

I did not prefer the latest OECD estimates for the whole 1980-1998 time span. The latest set of estimates contains a major change of series for all countries at 1990, and peculiar behavior in its Swiss and UK series. The ILO estimates on *The Cost of Social Security* seem shakier and are not available annually. The IMF figures from *Government Finance Statistics* are highly aggregated and under-explained.

⁵ On the changes in eligibility for benefits, see Grubb (2000). For an in-depth discussion of all dimensions of change in unemployment policy, see Allard (2003).

⁶ On the recent history of British pension policy, see Blundell and Johnson (1999), Disney and Johnson (2001, Ch. 9), and Blake (2002).

⁷ Kremers (2002, 308-309).

⁸ For the fuller view see Gruber and Wise (1999) and Lindert (2004, Chapter 8).

⁹ The 21 countries used in the 1978-1995 sample period are those listed in Table 1. The panel estimation used three-year averages for 1978/80, 1981/83, , 1993/95. A later version of this paper will extend the sample to include the newly available data for 1996/98. For a fuller view of the determinants of postwar social budgets, see Lindert (2004, Chapter 7, 8, and 16, and Appendix E).

¹⁰ The double-digit percentage drops in the support ratio for the average pensioner may look implausibly large. Bear in mind, though, that they merely match the large percentage rises in the population share of the elderly.

¹¹ Brugiavini (1999).

¹² So says a combination of the OECD employment ratios for 1998/9 in Table 3 and the studies by Blöndel and Scarpetta (1999) and Gruber and Wise (1999).

¹³ Lindert (2004, Chs. 10 and 18, and Appendix E).

¹⁴ McAuley (1979, 260-301); Connor (1997); Kramer (1997).

¹⁵ Subbarao *et al.* (1997, 40).

¹⁶ The fallback in Poland's social transfer shares is evident in Figures 3 and 4. For Hungary it is evident in separately available figures for public pensions as a share of GDP. See Roberto Rocha and Dimitri Vitas, in Feldstein and Siebert (2002, 365-400). All the pressures that seem likely for Hungary and Poland have already been manifest for East Germany. The government of reunified Germany has paid a high social-budget price, and reunification will continue to heighten both the budgetary pressure for cuts and the political resistance to them.

¹⁷ See Appendix F in Volume 2 of Lindert (2004).

¹⁸ As cited in Tremewan (1998, 78).

¹⁹ See the regression appendix to the working paper version. The 21 developing countries are Argentina, Bolivia, Brazil, Colombia, Chile, Ecuador, El Salvador, Guatemala, Mexico, Panama, Uruguay, Venezuela, India, Indonesia, Israel, Malaysia, Philippines, Singapore, Thailand, Taiwan, and Turkey.

²⁰ Alesina *et al.* (1999), Alesina *et al.* (2001), Alesina *et al.* (2002), Mulligan, Gil, and Sala-i-Martin (2002, and in progress), Lindert (2004, Chs. 7, 16, 17, Appendices D and E). One reason why democracy might still have a positive effect on social transfers is that the Third World samples giving the null result (like the current sample) lack data for distinguishing the share of the population that has political voice. The available democracy indices, such as Polity, miss this dimension, which proved so important in the past history of the OECD countries.

²¹ For expositional convenience, this paragraph welcomes Turkey as a new member of Latin America. Israel was given its own separate dummy variable, and can be set aside here.

²² On Brazil's runaway public-sector pensions, see *Wall Street Journal*, 9 September 1999, 1. On the restrictive coverage of public pensions around the globe, see Sala-i-Martin (1996, 281-6).

²³ Mulligan, Gil, and Sala-i-Martin (2002). The elitist bias may also explain how the pension support ratios for Brazil, Chile, and Panama are projected to exceed 100 percent by the year 2020. They were already nearly that high in 1990, because they were pensions for people with salaries well above the national average.