



# Benefits conditional on work and the Nordic model<sup>☆</sup>

Ann-Sofie Kolm<sup>a,\*</sup>, Mirco Tonin<sup>b,c,d,e</sup>

<sup>a</sup> Department of Economics, Stockholm University, S-106 91 Stockholm, Sweden

<sup>b</sup> Economics Department, University of Southampton, UK

<sup>c</sup> Economics Department, UniCredit & Universities Fellow, Central European University, Budapest, Hungary

<sup>d</sup> IZA, Bonn, Germany

<sup>e</sup> CESifo, Munich, Germany



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## ABSTRACT

Welfare benefits in the Nordic countries are often tied to employment. We argue that this is one of the factors behind the success of the Nordic model, where a comprehensive welfare state is associated with high employment. In a general equilibrium setting, the underlining mechanism works through wage moderation and job creation. The benefits make it more important to hold a job, thus lower wages will be accepted, and more jobs created. Moreover, we show that the incentive to acquire higher education improves, further boosting employment in the long run. These positive effects help in counteracting the negative impact of taxation. Through numerical simulations, we show how this mechanism can contribute to explain the better labor market performance and more equitable income distribution of Nordic countries compared to Continental European ones.

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## 1. Introduction

A prominent feature of the so-called Nordic model is a comprehensive welfare state financed by taxes on labor. In fact, the public sector in many of the Nordic countries is responsible for the distribution and allocation of resources amounting to more than half of their country's GDP (Eurostat, 2012). With an emphasis on redistributive transfers and service provision financed by taxes on labor, a concern with the model is, of course, that it induces weak incentives to work. In a more long term perspective, such a system may also reduce incentives to acquire skills, with a negative impact on future productivity and labor

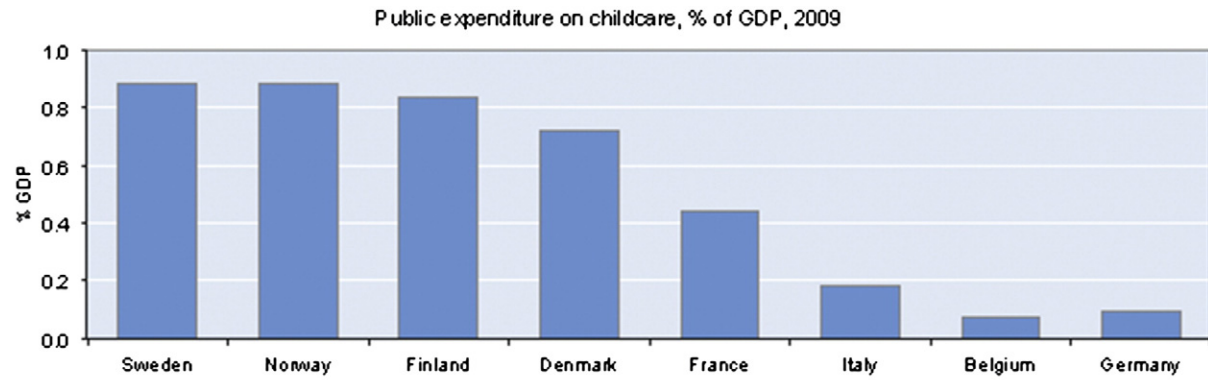
market outcomes. However, external observers are often surprised that the Nordic countries manage to combine low unemployment and high labor force participation with high taxes, generous welfare arrangements, and a more equitable income distribution. So, how is this possible?

One answer to this question is that many of the welfare arrangements in the Nordic countries are closely tied to market work. The generosity of many welfare benefits is, in general, related to earnings. In addition, eligibility to a number of benefits and social services is conditional on employment. One obvious example is the recently introduced Earned Income Tax Credit, which by definition is exclusively targeted to employed workers. In the case of Sweden, for instance, the credit applies for all individuals with income from work and has no phase-out region (Edmark et al., 2012). Other examples are subsidized childcare and paid parental leave schemes. These are very important policies in the Nordic countries. Comparing, as in Rogerson (2007), four Nordic and four Continental European countries, it is indeed evident (top panel of Fig. 1) that public expenditures on childcare as percent of GDP are substantially larger in the Nordic countries compared to Continental Europe. Only in France subsidies are fairly generous, however they can be reaped irrespective of how the secondary earner, usually the mother,

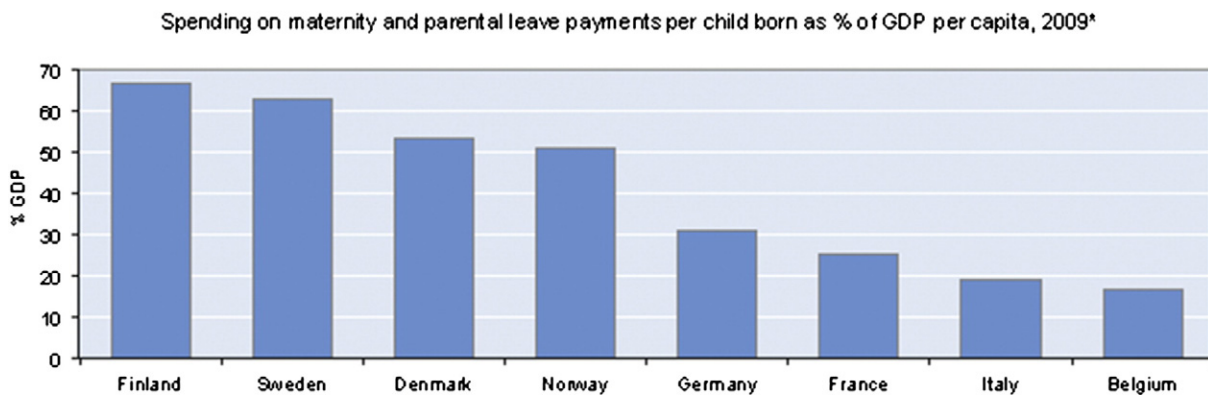
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\* Corresponding author. Tel.: +46 8 163547; fax: +46 8 161425.

E-mail addresses: [ann-sofie.kolm@ne.su.se](mailto:ann-sofie.kolm@ne.su.se) (A.-S. Kolm), [m.tonin@soton.ac.uk](mailto:m.tonin@soton.ac.uk) (M. Tonin).



Source: Social Expenditure database 2013; OECD Education database.



\*2008 for Germany

Source: Social Expenditure database 2013.

Fig. 1. Spending on childcare and parental leave.

spends her time. In Sweden, on the other hand, the childcare subsidy is contingent on that both parents work.<sup>1</sup> It is also worth noticing that, at 0.9% of GDP, expenditures on childcare subsidies in Sweden are about three times as large as the US expenditures on the EITC.<sup>2</sup> The importance of childcare subsidies in explaining labor market performance in Sweden and the other Nordic countries is also stressed by *Rosen (1997)* and *Rogerson (2007)*. The Nordic countries also spend substantially more resources on paid parental leave than countries in Continental Europe (bottom panel in Fig. 1).<sup>3</sup> The leave schemes are constructed so to provide generous payments to employed workers on leave, while non-employed workers get no or very low payments. In addition, a lengthy period of time in a job is needed to become entitled to the

benefit. The idea behind these policies is that, by increasing the net returns from working, they increase the supply of labor.

The observation that the Nordic countries have sustained high economic activity because benefits are closely tied to market work is not new. In fact this was noted as a contributing factor to the high participation rate observed in Sweden when a group of NBER economists studied the Swedish welfare state in the mid 1990s (see *Freeman et al., 1997*). In that volume, *Björklund and Freeman (1997)* indeed write “[w]hat is impressive is that so much of the Swedish welfare system is work based” (page 50). Also *Andersen (2010)* writes that the “social safety net in the Scandinavian countries is at the same time both generous and employment conditioned”.

The starting point for this paper is that entitlement to many of the benefits available in the Nordic countries is conditional on employment. As discussed above, this tends to increase the gains from working, which encourages labor supply. However, we argue that this is not the end of the story. To investigate the full impact of welfare state arrangements of this type, one needs to account for the general equilibrium effects. This is particularly relevant because many benefits have been available to the whole population for a long period of time. Clearly, to investigate the effects of these benefits on employment, which is an equilibrium outcome, both supply-side and demand-side factors must be included in the analysis. Moreover, besides considering the equilibrium outcome for the existing workforce, it is important to account for the impact of these benefits on incentives to acquire skills. The equilibrium composition of the workforce in terms of educational attainment is a crucial variable for the sustainability of the Nordic model, both in terms of its growth potential and international competitiveness

<sup>1</sup> From 2001, the program in Sweden was expanded to allow the children of parents who were unemployed the right to attend childcare for fifteen hours per week, in order to enable job search. See *Kolm and Lazear (2010)* for a description of the childcare subsidies in Sweden. In Denmark unemployed workers are entitled to childcare subsidies conditional on full time search and participation in active labor market programs. For a short description of the French system see <http://www.cleiss.fr/docs/regimes/regimefrance/an4.html>.

<sup>2</sup> By transferring about \$45 billion to around 25 million low income families in the US, the Earned Income Tax Credit (EITC) is one of the most important programs for stimulating employment and fighting poverty in the US. The spending on EITC corresponds to about 0.3% of GDP. There are very strong similarities in the construction of the employment contingent childcare subsidies in Sweden and the EITC in the US, although an important difference, of course, is that the childcare subsidies are in kind.

<sup>3</sup> For a review of the parental leave policies in different countries see *Moss (2012)*.

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