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The welfare state, thresholds, and economic growth

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Abstract

Can a growing welfare state induce a regime switch in the growth rate of an economy? This paper constructs a dynamic political economy model of economic growth and the welfare state in which both variables are nonlinearly related and jointly endogenous. Using a Markov switching framework over the period 1950–2001, we find that the structural decline in growth rates that several welfare state economies experienced during 1970–1975 is preceded by movements to a high welfare state regime. This suggests that expanding welfare state regimes are associated with low economic growth regimes, while contracting welfare state regimes are associated with high growth regimes. However, we also find that the structural decline in growth rates leads to a downward structural break in the welfare state for many welfare state economies. This suggests that declining growth regimes are associated with contracting welfare state regimes, as lower growth forces politicians to cut the size of the welfare state. We also report strong evidence that both expansion and contractions in the welfare state affects growth nonlinearly. These results are able to characterize a predictable and general pattern of welfare state-growth evolution.
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1. Introduction

In the late 1960s–mid 1970s, several of the world's industrialized economies experienced a reduction in their growth rates. For instance, in a symposium devoted to the issue of long run growth, Kahn (1992) notes that the potential rate of economic growth in industrialized countries is substantially lower than what it was in the 1960s. The structural break in growth is also confirmed by Shigehara (1992) who finds that nearly all the OECD economies experience a slowdown occurring between 1968 and 1975.

The most widely accepted cause of the growth slowdown in the US is a reduction in total factor productivity (Griliches, 1980; Nordhaus, 1982; Romer, 1987; Baumol, 1984), a phenomenon now referred to as the productivity puzzle. In the last decade, however, a growing literature has begun to focus on the growth implications of unproductive government spending, and whether such expenditures can induce structural breaks in growth (see Levine and Renelt, 1991; Easterly and Rebelo, 1993; Turnovsky and Fisher, 1995; Tanzi and Zee, 1997; Ghate and Zak, 2002; Romer, 2003). This literature, which has specific relevance to welfare state economies, posits two channels through which fiscal choices induce structural breaks in the growth rate of an economy. First, unproductive government expenditures (government consumption and transfers) hinder growth because such expenditures are a less-than-perfect substitute for private consumption in the aggregate (or possibly even a complement). This makes private savings decline, affecting investment and growth in the long run. A related channel adds a political economy explanation to declining investment and growth because of a rising welfare state. To wit, because politicians determine government expenditures, fiscal flows reflect political objectives (Ghate, 2003). Hence, political decisions have an important impact on the allocation of resources (Ghate and Zak, 2002; Romer, 2003). This suggests that some fiscal choices (e.g., higher transfer spending) could lead to a bloating of the welfare state because of populist pressure for redistributive spending. In the long run, growth is affected adversely because higher welfare state spending is financed by higher taxation which generates an economic inefficiency (Lindbeck et al., 1994; Organization for Economic Cooperation and Development, 1994a,b; Atkinson and Werner-Sinn, 1999; Ghate and Zak, 2002).

Barr (1992), Tanzi and Schuknecht (1997), and Hansson and Stuart (2003), document the expansion of the public sector created by higher expenditures on redistribution in public budgets in several countries. For instance, Barr (1992) shows that welfare spending constitutes a higher proportion of GDP in several countries since 1960, with spending doubling in Netherlands and Sweden, and nearly tripling in Switzerland. Accordingly, Tanzi and Schuknecht (1997, p. 399) write that "after World War II, and especially after 1960, subsidies and transfers, especially in cash, (has been) the driving force behind government growth." Finally, Hansson and Stuart (2003) also report a substantial bloating of the welfare state for several countries throughout the 1960s, 1970s, and upto the mid-1980s. However, Tanzi and Schuknecht (1997, p. 399) also note that the 1980s and 1990s saw "additional but small" increases in transfers and subsidies in several welfare state economies. Similarly, Hansson and Stuart (2003) document that 1992 serves as a 'peak year', indicating some sort of empirical limit to transfer and total spending across industrialized economies.

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