

# Welfare States or Welfare Societies?

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## Introduction

One of the most relevant policy questions in the 1990s is the institutional choice between the welfare state or the welfare society. The welfare states honour the institutions of the market economy, but at the same time they are different from decentralised capitalism, as they involve large scale public expenditures of an allocative or redistributive import. In the welfare societies the private sector remains much larger than the public sector, as these market economies do not constitute mixed economies. In welfare state regimes the public sector is 50 percent of GDP on an average, whereas in a welfare society it hovers around 35 percent of GDP.

The regime problem of choosing between welfare states and welfare societies, which governments and the public are confronted with in the so-called capitalist democracies, is quite different from the old problem of democracy versus dictatorship or socialism versus capitalism. It concerns two basic alternative institutional configurations for countries which adhere to democracy and the market economy. Choosing a welfare state or a welfare society amounts to a macro institutional choice, but it has tremendous consequences for micro decisions about how service is to be provided to people as well as how far government should go in providing income maintenance.

One may see the political conflicts in various West-European countries as expressions of the tension between these two regimes for a democracy with a market economy. Yet, the regime choice between the welfare state and the welfare society is relevant to all the so-called OECD countries, and perhaps also to Eastern Europe and the newly industrialised countries in South East Asia. Whereas the case for a welfare state used to be well stated within the framework of a Keynesian economic argument and a Rawlsian justice theory, the edge in the debate is today with the adherents of Chicago School Economics, favouring the welfare society model, which is strongly anchored in the market economy and not the mixed economy (Krugman, 1994).

A choice between the welfare state and the welfare society is for many citizens based on complex deliberations concerning advantages and disadvantages for themselves as well as for fellow citizens. One should not assume that merely self-interests play a role, as choosing institutional arrangements involves also altruistic considerations about what social justice requires.

We suggest as a contribution to the debate that one makes a performance assessment based upon a few outcomes related to efficiency: economic growth, unemployment and inflation, as well as an outcome related to social justice, namely income equality.

### **Politico-economic regimes**

Welfare states or welfare societies? This is the critical question in the debate in the 1990s about the size of the public sector, very much initiated by Chicago School Economics (Lucas, 1987; Barro, 1990), favouring the welfare society model. But what are the outcomes? Do welfare societies perform better than welfare states? What is at stake here? Can we speak of a performance crisis of the welfare state? It is well-known that the welfare state no longer performs as it did under the heydays of Keynesian macro economics in the 1960s and 1970s. Could it be the case that large public expenditures are counterproductive, meaning that they worsen state performance on politico-economic outcomes?

A welfare state is a politico-economic regime where the government is active in the economy in various ways though without extensive ownership, which results in a mixed economy instead of the system of decentralised capitalism where markets prevail and there is less of income redistribution. The welfare state is active with public resource allocation, transfer payments and policies that promote full employment. The difficulties of the welfare states are analysed by means of an efficiency-equity trade-off, meaning that huge efforts in the public effort driven by equity considerations can only be effectuated with a cost in terms of total output (excess burden). Thus, societies must decide where on the efficiency-equity trade-off they wish to place themselves, more towards efficiency as with the welfare societies or more towards equality as with the welfare states (Okun, 1975).

The efficiency-equity trade-off never rose under a pure Keynesian regime, as the argument for a large public sector was that it enhanced both economic efficacy and social justice. Acknowledging the existence of a trade-off between the size of the cake and its distribution, between total output on the one hand and social equality on the other hand, does not entail that one endorses the welfare society. One can argue that the efficiency losses are so marginal that the gains with regard to social solidarity outweighs the loss in total output, or average income. These questions may be researched by examining if the welfare societies really tend to outperform the welfare states in terms of macro economic criteria as well as whether the welfare states perform better on equity criteria.

To connect a politico-economic regime with outcomes is far from a straightforward task. It requires methodological deliberations concerning the data to be employed as well as the specification of models to be tested. Here, we take a few steps only towards evaluating the welfare states and the welfare societies, looking at a series of average values on a few evaluation criteria as well as

Table 1. Types of Societies: public-private sector mixes around 1990

Welfare States		Welfare Societies
Allocation	Redistribution	
Austria	Austria	Ireland
Denmark	Denmark	Spain
Finland	Finland	Portugal
France	France	Switzerland
Germany	Italy	USA
Greece	Netherlands	Japan
Iceland	Norway	Australia
Norway	Sweden	New Zealand
Sweden	Belgium	Turkey
Luxembourg	Luxembourg	
U.K.		
Canada		

Note: Allocative welfare states use about 18 per cent or more of the GDP for general government consumption; redistributive welfare states employ 18 per cent or more on social security payments. Welfare societies include the remaining countries. Source: Lane et al. (1996).

conducting a couple of regression analyses about the link between economic growth rates and public expenditures.

A few countries have switched from the welfare state format to the ideal of a welfare society, as for instance Australia, New Zealand and Canada. The United Kingdom under the Thatcher government remodelled the British welfare state on the basis of market ideals, whereas the debate about the future of the American welfare state became intense when the Republicans won the 1994 elections to the Congress.

Among the large welfare states, one may distinguish first between those that have large allocative expenditures or large redistributive expenditures. Secondly, we identify those that are large mainly on transfer payments. And thirdly, we have a set of countries which are low on both allocative and redistributive expenditures, when military expenditures have been taken out. Table 1 contains a classification of the three types of public sectors.

There are, one may suggest, two kinds of welfare states, the allocative and the redistributive ones. Only to a limited extent are these the same countries, when for instance the Scandinavian countries and Finland score high in both. The redistributive welfare state offers a larger space for markets than allocative welfare states where government is responsible for the supply of numerous services virtually free of charges. Transfer payments in the form of cash contributions to individuals play a major role in the redistributive welfare state. The critical question is now whether it matters whether a country has one or the other kind of welfare state or adheres to the welfare society ideal. By "matters" we refer to social and economic outcomes such as unemployment, economic growth and inflation as well as income equality.

### **The efficiency-equity trade-off**

The adherents of the two regimes – the welfare state and the welfare society – both employ economic and social theory in order to substantiate their arguments in favour of their respective regime. Actually, both schools use arguments about economic efficiency and social justice in order to state their case.

The pro welfare state argument focuses much upon social justice in the form of equality. However, it used to argue that welfare states could also achieve a very high level of output by means of its labour market policies, which would reduce unemployment. Under a Keynesian economic regime it was believed that a large public sector would enhance the full utilisation of resources in the short-run perspective as well as bolster economic growth in the long-run perspective. Later on it was perhaps realised that there could be an efficiency-equity trade-off between maximising total output and accomplishing social justice under egalitarian notions. If there is such an efficiency-equity trade-off, then the welfare state argument entails that a reduction in total output could be traded against a higher level of income equality. Equality would thus be worth a certain reduction in total output, although not to an extent that involves a drastic reduction in national income.

The pro-welfare society argument underlines economic efficiency, as it claims that a market economy with a small public sector would maximise total output in the short-run and long-run perspective. Since social justice is defined as freedom, the problem with a trade-off between efficiency and equality does not rise here. But welfare society adherents would in any case no doubt choose a reduction in equality, if it meant a higher level of total output.

The claim to economic efficiency on the part of the welfare state adherents rests very much the unemployment argument. According to welfare state theory, labour markets in a decentralised market economy with a small public sector tend towards a high rate of unemployment, which reduce output. Only government control of the real economy can bring down unemployment through first and foremost demand management but also policies that increase labour market flexibility. Government intervention in the economy is feasible, given the use of fiscal and monetary policies in some attractive combination. If there exists a Philips curve interaction between inflation and unemployment, then welfare state theory favours a trade-off that emphasises low unemployment, but at the cost of inflation.

The pro welfare society argument is to some extent a negative theory about the welfare state, claiming that such a regime cannot accomplish what it promises. First, it will not achieve a high level of economic output because of the negative impact of a high level of taxation upon the economy. High taxes create so-called tax wedges right through the economy which reduce economic efficiency. The occurrence of tax wedges takes place in both the commodity markets and in the labour market resulting in excess burden. The difficulties on the income side in the form of taxation are augmented by the policies on the expenditure side through the use of subsidies in various markets, again causing excess burden.

Positively, welfare society theory claims that its regime may accomplish a high level of economic output, if markets are allowed to operate freely and with full force. There is no Philips curve interaction between inflation and unemployment, as unemployment will fall towards its natural rate, which is consistent with a low level of inflation. Distribution matters will be solved by the trickle-down effect, meaning that maximising aggregate output will in the long-run also benefit the poor automatically. The market economy can find solutions to most social problems, if state regulations do not hinder entry and rent-seeking is minimised.

Negatively, welfare society theory argues that governments cannot govern an advanced market economy as the market anticipates government policies by means of the reign of rational expectations. Any attempt to bring down unemployment for instance would only start an inflationary spiral during which unemployment will eventually rise again. If the government attempts to impact upon the real economy, then it has to act through the financial economy, where interest rates are extremely sensitive to government actions to boost the economy by means of for instance deficit spending. As a matter of fact, according to one argument welfare states are prone to engage in deficit spending which worsens politico-economic outcomes.

First, we ask which regimes perform the best on a few macro outcomes, related to criteria on economic efficiency and social justice. Second, we enquire into whether the size of the public sector has a lasting effect upon economic growth, meaning there would be a tendency of welfare states to perform less well than welfare societies which reflects the very nature of this regime. Thus, we will ask what the comparative evidence is for the two theories?

### **Politico-economic outcomes**

When one looks at outcomes in the literature on the political economy of the advanced capitalist countries, then one often employs the so-called misery index, consisting of inflation and unemployment. The difficulty is that these two indices may cancel each other out, which is the reason that why we prefer to look at these two outcomes separately. There is of course no natural set of outcomes to which one must stick. However, it seems evident that economic growth and income equality should be added to the list of outcomes when one examines the OECD countries. We begin with economic growth.

#### **(a) Economic growth**

The expansion of economic output is considered a contribution to well-being, because it makes a higher standard of living possible. The size of the cake to be divided among the stakeholders of society increases, but it is an open question how the cake is to be divided between labour and capital. A process of sustained economic growth can within a few decades result in a doubling of economic output. How affluence is divided among the groups in society is measured by the indices on income inequality. Table 2 reports on the expansion

Table 2. Economic Growth 1965-1994 in Three Regimes

	1965-69	1970-74	1975-79	1980-84	1985-89	1990-94
Austria	4.46	5.44	2.76	1.42	2.66	2.30
Denmark	4.20	2.54	2.48	1.72	2.00	1.88
Finland	4.36	5.38	2.34	3.32	4.08	-1.58
France	5.20	5.12	3.12	1.46	3.10	1.20
Germany	4.28	3.50	3.04	0.96	2.62	2.92
Greece	7.52	5.54	5.26	1.10	2.54	0.80
Iceland	2.16	7.78	3.36	2.82	3.66	0.68
Luxembourg	3.62	5.42	0.98	2.10	4.60	2.30
Norway	4.44	4.22	4.84	3.14	2.26	3.14
Sweden	3.58	3.38	1.54	1.70	2.40	-0.30
UK	2.50	2.80	1.96	0.84	4.02	0.80
Canada	5.60	5.28	3.34	2.30	3.94	1.12
Mean	4.33	4.70	2.92	1.91	3.16	1.27
Austria	4.46	5.44	2.76	1.42	2.66	2.30
Belgium	4.30	5.08	1.82	1.50	2.50	1.60
Denmark	4.20	2.54	2.48	1.72	2.00	1.88
Finland	4.36	5.38	2.34	3.32	4.08	-1.58
France	5.20	5.12	3.12	1.46	3.10	1.20
Italy	5.82	4.24	2.36	1.72	3.12	1.00
Luxembourg	3.62	5.42	0.98	2.10	4.60	2.30
Netherlands	5.20	4.72	2.32	0.68	2.76	2.26
Norway	4.44	4.22	4.84	3.14	2.26	3.14
Sweden	3.58	3.38	1.54	1.70	2.40	-0.30
Mean	4.52	4.55	2.46	1.88	2.95	1.38
Ireland	4.46	4.46	4.66	2.58	3.56	4.74
Portugal	6.02	7.20	3.56	1.24	4.96	1.44
Spain	6.68	6.16	1.88	1.28	4.26	1.50
Switzerland	3.60	3.64	-0.68	1.54	3.08	0.48
Turkey	6.16	7.02	5.50	3.56	4.62	3.44
USA	4.34	2.62	3.34	1.84	3.12	2.02
Japan	10.32	6.20	4.60	3.48	4.52	2.10
Australia	5.52	4.62	2.78	2.76	3.94	2.14
NZ	3.22	4.80	-0.60	3.92	0.90	1.22
Mean	5.59	5.19	2.78	2.47	3.66	2.12

Sources: OECD (1985, 1995).

of total output or growth in real GDP in the various regimes: allocative welfare regimes, redistributive welfare regimes and welfare societies.

Three things stand out clearly when one examines Table 2: first there is a general decline in the average growth rates of all the three regimes – reflecting the notion of a slowdown of economic growth when affluence reaches high levels (the maturity hypothesis); second some of the less affluent countries have done rather better than the already rich countries (the catch up hypothesis); finally, it is almost always the case that welfare societies outperform the welfare states on average growth rates. For each five period the welfare societies do slightly better than the welfare states of about one per cent, which ac-

Table 3. The Variation in Economic Growth Rates 1965-1994 (Pearsons' correlations)

	RG6569	RG7074	RG7579	RG8084	RG8589	RG9094
RG6569	1.0000	.3567	.5170	.0950	.3468	.1688
RG7074		1.0000	.3240	.3164	.5063	-.0031
RG7579			1.0000	.1535	.3084	.4445
RG8084				1.0000	.0634	.0815
RG8589					1.0000	.0324
RG9094						1.0000

Sources: see Table 2.

accumulated over a long time period means a lot for the level of affluence. The welfare societies will if this trend continues become much more affluent than the welfare states.

A note of caution is in place here. There are at each five year interval considerable variation between the OECD countries. It is not the case that the countries with high growth rates or with meagre growth rates are the same ones for each five year period. Economic growth reflects both the ups and downs of the world economy as well as country specific events such as the choice of unsuccessful economic policies or the failure in adaptation to internationalisation or globalisation. One may list the winners of the 1960s and 1970s as: Austria, France, Germany, Greece, Ireland, Norway, Portugal, Turkey, Canada and Japan. In the 1980s and 1990 the list of the top scores would contain: Ireland, Norway, Turkey, USA and Japan. Countries move up and down the growth ratings, scoring high during some periods and low during other periods. Table 3 contains the correlation between the economic growth data (RG) of six time periods.

Economic growth used to be a policy goal, because it brought with it employment. What we have witnessed in the early 1990s is that economic growth does not necessarily reduce unemployment, which has become the major problem in some of the OECD countries.

#### (b) Unemployment

The sharp increase in unemployment of most countries appears from Table 4. It is true that a few countries remain at very low levels, but several face two digit numbers in the 1990s.

The finding in Table 4 is that welfare societies tend to have a slightly higher level of unemployment than the welfare states. Thus, economic output is rising more rapidly in the welfare societies at the same time as employment is somewhat higher in the welfare states.

Although the long term trend is a sharp increase in unemployment, it is still the case that a few countries manage with very little unemployment: Luxembourg, Switzerland, and Japan – welfare societies – as well as Iceland and Austria – welfare states. One may note that unemployment has been reduced in the US during the last decade when unemployment has shot up in Western

Table 4. Unemployment 1965-1994 in Three Regimes

	1965-69	1970-74	1975-79	1980-84	1985-89	1990-94
Austria	1.86	1.18	1.92	2.88	3.44	3.78
Denmark	1.22	1.42	6.56	9.30	8.50	11.12
Finland	2.48	2.12	4.98	5.12	4.70	12.10
France	2.04	2.70	4.88	7.92	10.10	10.50
Germany	0.94	1.06	3.70	5.98	7.56	7.82
Greece	5.22	2.70	1.92	5.72	7.56	8.54
Iceland	1.54	0.68	0.20	0.74	0.86	3.06
Luxembourg	—	—	0.60	1.26	1.58	1.82
Norway	0.90	1.24	1.84	2.60	2.96	5.60
Sweden	1.80	2.24	1.86	2.86	2.20	5.22
UK	1.68	2.48	4.58	8.90	9.14	8.68
Canada	3.90	5.74	7.54	9.86	8.84	10.28
Mean	2.14	2.14	3.38	5.26	5.62	7.38
Austria	1.86	1.18	1.92	2.88	3.44	3.78
Belgium	2.24	2.18	6.36	11.28	10.96	10.64
Denmark	1.22	1.42	6.56	9.30	8.50	11.12
Finland	2.48	2.12	4.98	5.12	4.70	12.10
France	2.04	2.70	4.88	7.92	10.10	10.50
Italy	5.50	5.68	6.82	9.10	11.50	11.00
Luxembourg	—	—	0.60	1.26	1.58	1.82
Netherlands	1.06	1.88	5.34	7.98	8.06	6.20
Norway	0.90	1.24	1.84	2.60	2.96	5.60
Sweden	1.80	2.24	1.86	2.86	2.20	5.22
Mean	2.12	2.29	4.12	6.03	6.40	7.80
Ireland	4.92	5.70	8.08	11.62	16.30	14.64
Portugal	2.50	2.34	6.84	7.92	7.06	5.10
Spain	2.58	2.86	5.72	16.10	19.96	19.58
Switzerland	—	—	0.42	0.56	0.68	2.66
Turkey	10.08	6.34	8.58	7.50	8.04	8.64
USA	3.74	5.28	6.92	8.32	6.24	6.50
Japan	1.22	1.28	2.04	2.38	2.62	2.36
Australia	1.74	2.20	5.52	7.52	7.46	9.56
NZ	0.28	0.22	0.88	3.84	4.86	9.20
Mean	3.38	3.28	5.00	7.31	8.14	8.69

Sources: OECD (1985, 1995).

Europe. In some countries unemployment has reached 15 per cent or more: Spain, Ireland, Finland and Italy.

An increase in unemployment reflects a reduction in economic growth at the same time as there is no longer any strong link between economic growth and employment. The correlation between economic growth and unemployment is generally very weak at the macro level: .28 (1965-69), -.03 (1970-74), .36 (1975-79), -.32 (1980-84), .10 (1985-89) and .02 (1990-94).

In the political economy literature there has been much debate about a connection between unemployment and the price level. The well-known Phillips curve predicts that low inflation can only be accomplished by means of high levels of unemployment and vice versa. When we turn to the inflation numbers, we observe that inflation has come down rather drastically in the last decade at the same time as unemployment has shot up.



## (c) Inflation

In the late seventies and early eighties it was not unusual that countries had inflation rates around or above 10 per cent. In the 1990s such a high rate of inflation is very unusual as only Turkey displays signs of hyperinflation (Table 5). Inflation rates have come down considerably with Greece as the major exception, most countries hovering around 3 per cent as an average yearly rate in the 1990s.

Actually, inflation is highly subdued in the 1990s with only Greece, Turkey and Portugal displaying considerable price instability. One notes though, that inflation varies considerably from one country to another. Some countries have only 2 per cent inflation per year in the early 1990s: Denmark, France, Japan and New Zealand on an average basis. It seems as if the OECD countries as a

Table 5. Inflation 1965-1994 in Three Regimes

	1965-69	1970-74	1975-79	1980-84	1985-89	1990-94
Austria	3.42	6.50	5.70	5.50	2.16	3.44
Denmark	6.58	8.56	9.86	9.46	4.34	2.08
Finland	5.16	8.80	12.04	9.72	4.92	3.32
France	3.76	7.58	10.14	11.16	3.58	2.56
Germany	2.62	5.62	4.20	4.56	1.28	3.30
Greece	2.48	10.58	14.08	21.78	17.18	16.22
Iceland	11.70	18.68	40.20	55.08	23.78	6.38
Luxembourg	2.74	6.02	6.96	7.62	1.82	3.16
Norway	3.72	8.18	8.56	10.12	6.58	2.70
Sweden	4.06	7.40	9.74	10.26	5.60	5.78
UK	4.26	9.62	15.64	9.62	5.26	4.64
Canada	3.66	5.90	8.88	8.70	4.32	2.78
Mean	4.51	8.62	12.17	13.63	6.73	4.70
Austria	3.42	6.50	5.70	5.50	2.16	3.44
Belgium	3.54	6.68	7.62	7.30	2.42	2.84
Denmark	6.58	8.56	9.86	9.46	4.34	2.08
Finland	5.16	8.80	12.04	9.72	4.92	3.32
France	3.76	7.58	10.14	11.16	3.58	2.56
Italy	2.92	9.08	15.54	16.48	6.18	5.40
Luxembourg	2.74	6.02	6.96	7.62	1.82	3.16
Netherlands	4.90	7.30	6.74	5.02	0.70	2.86
Norway	3.72	8.18	8.56	10.12	6.58	2.70
Sweden	4.06	7.40	9.74	10.26	5.60	5.78
Mean	4.08	7.61	9.29	9.26	3.83	3.41
Ireland	4.66	10.84	14.68	14.98	3.72	2.66
Portugal	4.90	12.84	22.66	22.66	12.62	9.08
Spain	6.58	9.88	18.92	13.60	6.88	5.56
Switzerland	3.40	7.08	2.88	4.40	2.14	3.90
Turkey	7.48	16.04	38.00	51.74	51.10	73.76
USA	3.40	6.14	8.08	7.48	3.60	3.64
Japan	5.24	10.90	7.32	3.90	1.14	2.02
Australia	3.14	8.08	11.58	9.00	7.82	3.04
NZ	4.16	8.62	14.32	12.42	11.28	2.54
Mean	4.77	10.05	15.38	15.58	11.14	11.80

Sources: OECD (1988, 1995).

whole have moved considerably towards the acceptance of a monetarist regime, where low inflation is considered the main objective as well as also the main means for achieving other objectives in accordance with New Classical Economics (Hoover, 1988).

Is there evidence of a Philips curve in the data about unemployment and inflation in the 1980s and 1990s? One would assume that there is a correlation between inflation and unemployment and that it is negative meaning that countries with high unemployment having little inflation, or vice versa. However, this is not so, despite the fact that unemployment has shot up and inflation fallen back – a characteristic which applies to almost all countries. It is not the case that on the country level a high level of unemployment goes together with little inflation, as we actually can observe all kinds of combinations. The correlation between inflation and unemployment is almost nil: .07 (1965-69), .06 (1979-74), .17 (1975-79), -.07 (1980-84), -.03 (1985-89) and .02 (1990-94). In general, inflation is higher among the welfare societies than in the welfare states whereas unemployment tends to be higher in the welfare societies than in the welfare states.

Examining country data we see that some countries are characterized by low inflation rates as well as low unemployment rates – e.g. Switzerland, Austria, Luxembourg, the United States and Japan, while other countries exhibit both high inflation rates and high unemployment rates – e.g., Greece, Turkey and to some degree also Sweden. The 1990s, finally, is characterized by the rates of unemployment and of inflation that vary quite independently of each other.

#### (d) Income equality

Measures of income equality are not as easily accessible as information about the other outcomes described above. Typically, one faces difficult problems about indicator validity and reliability when one sets out to compare various countries. A rough picture is given in Table 6 which contains income information based upon two indicators, TOP 20 or the income share of the 20 per cent most wealthy families and a GINI-index.

If the welfare states do worse on economic growth, i.e. efficiency in the sense of total output, then it is true that they score higher on social justice. The main finding in Table 6 is that the distribution of income is more equal in welfare states than in welfare societies. However, the differences in income inequality between the three regimes is hardly large, as some welfare societies score lower on the income inequality indices than a few welfare states.

High scores for the share of income of the lowest 20 per cent of the income earners as well as low ratios between the shares of the top income earners and the bottom income earners are to be found among the welfare states: Scandinavia, Finland, Germany and Belgium. One welfare society also displays much income equality, viz. Japan, but the characteristic feature is that the welfare societies have larger income inequalities than the welfare states. Thus, the US, Australia and New Zealand display income inequalities to a much larger extent than France, Germany and Italy.

Table 6. Income inequality in the 1980's in three Regimes

	TOP20	GINI
Austria	44.00	0.37
Denmark	43.00	—
Finland	—	—
France	47.00	0.38
Germany	45.00	0.36
Greece	—	—
Iceland	—	—
Luxembourg	—	—
Norway	37.00	0.30
Sweden	41.00	0.29
UK	40.00	0.31
Canada	41.00	0.34
Mean	42.25	0.34
Austria	44.00	0.37
Belgium	40.00	0.30
Denmark	43.00	—
Finland	—	—
France	47.00	0.38
Italy	57.00	0.38
Luxembourg	—	—
Netherlands	40.00	0.30
Norway	37.00	0.30
Sweden	41.00	0.29
Mean	43.63	0.33
Ireland	39.00	0.30
Portugal	49.00	0.40
Spain	45.00	0.36
Switzerland	46.00	—
Turkey	59.00	0.49
USA	45.00	0.36
Japan	43.00	0.30
Australia	42.00	0.34
NZ	42.00	0.31
Mean	45.56	0.36

Source: TOP 20 = Simpson, 1990, GINI-index = Muller, 1988.

Switzerland being a welfare society scores high on income inequality. Actually, Switzerland is an interesting case on all outcome measures, as they tend to have extreme values. In particular, the development over time has meant that Switzerland faces difficulties, as it is no longer doing as well as it used to do on growth, inflation and unemployment.

### Explanations

Looking at average scores for the three regime sets, the welfare societies do better on economic efficiency than the welfare states, although unemployment and inflation tends to be higher among the welfare societies. Since the early 1960s, economic growth has gone down, unemployment has risen and infla-

tion has been reduced. What is the explanation of these trends? We examine two explanations, one focusing upon deficit spending and the other referring to the size of public expenditures. Is the variation in economic growth related to the size of the public sector, or more specifically to either the allocative or redistributive welfare state? Does deficit spending play a role in reducing overall economic efficiency?

#### (a) Deficits

The deficit spending theory of Buchanan and Wagner (1977) claims that welfare states are more prone to engage in deficit spending than welfare societies. And new classical economics argues that deficit spending will reduce economic growth, either through its negative impact upon interest rates or through the Ricardian equivalence, i.e. deficit spending is the same as future higher taxes which have an immediate impact upon the economy by means of rational expectations. Is there evidence for these two hypotheses in the data? Table 7 shows the development of general government surpluses over time, where current receipts/GDP minus current disbursements/GDP equals surpluses or deficits according to OECD National Accounts.

Whereas governments used to be in the black, most of them are in the red since the seventies, eighties and early nineties. The direction of change in the OECD countries has been one towards less and less of budgetary surpluses and more and more of budgetary deficits. One may observe this at two levels. First there is the central or national government deficit and second the general government deficit, i.e. for the entire public household. Central governments are prone to engage in deficit spending, while it is a general principle of public finance that the general government, i.e. the total public sector, can only for so long stay in the red, as deficits and surpluses must cancel each out in the long-run.

In 1970 only the US and Italy had no total public sector surpluses, but in the 1980s quite a number of democracies could not balance total public sector expenditures and revenues: Ireland, Belgium, Portugal, Greece, Denmark, United Kingdom, Sweden, and the US and Canada. Not surprisingly, even more countries failed to balance their general government budget which as a matter of fact was rather a common phenomenon in 1970. Looking at the development between 1970 and the 1990s the trend towards deficit spending is striking as all nations have moved towards smaller surpluses or larger deficits at both levels of government. If deficit spending is a major problem, it has to be faced by some welfare states – Sweden, Belgium and Italy – as well as by some welfare societies – USA and Canada. It is not the case that only welfare states have to struggle with huge yearly deficits, which result in a large accumulated state debt. But how dangerous is deficit spending? Does deficit spending lead to bad outcomes?

The criticism of public borrowing argues that deficit spending is an improper means which is conducive to improper growth in public expenditures. Deficit spending feeds on fiscal illusion and results in a choice between private and public spending that is neither intended nor desirable (Buchanan and Wagner,

Table 7. General Government Surpluses 1950-1992 in Three Regimes

	1950	1955	1960	1965	1970	1975	1980	1985	1990	1992
Austria	6.70	6.50	6.00	7.30	6.60	4.30	3.30	2.50	1.90	2.00
Denmark	3.70	4.30	5.80	5.50	7.10	2.60	0.00	0.30	-0.60	-1.30
Finland	10.60	9.50	9.70	7.80	6.00	6.60	3.50	2.80	3.40	-3.70
France	5.90	3.20	3.80	4.80	4.30	1.10	2.50	-0.90	0.70	-2.40
Germany	3.30	7.80	7.70	5.80	5.80	-0.70	1.80	2.00	0.60	0.80
Greece	-4.10	1.90	2.50	2.10	4.40	0.70	0.10	-10.50	-15.40	-8.80
Iceland	7.70	6.90	13.10	8.50	10.10	7.20	7.10	5.10	3.20	3.00
Luxemb.	9.20	3.10	7.00	5.60	6.40	7.60	5.70	5.20	—	—
Norway	7.70	6.40	6.50	5.80	7.00	7.80	8.90	12.10	0.00	-2.40
Sweden	2.70	6.30	6.30	10.20	9.90	5.80	-0.40	-1.40	5.30	-5.10
UK	3.40	1.60	0.30	2.30	7.60	-0.30	-1.40	-1.20	1.30	-4.10
Canada	4.90	2.60	1.50	4.30	3.00	0.10	-0.50	-5.00	-2.70	-5.90
Mean	5.14	5.01	5.85	5.83	6.52	3.57	2.55	0.92	-0.21	-2.54
Austria	6.70	6.50	6.00	7.30	6.60	4.30	3.30	2.50	1.90	2.00
Belgium	-1.30	0.10	-1.20	0.80	2.20	-0.70	-4.90	-5.80	-4.00	-4.80
Denmark	3.70	4.30	5.80	5.50	7.10	2.60	0.00	0.30	-0.60	-1.30
Finland	10.60	9.50	9.70	7.80	6.00	6.60	3.50	2.80	3.40	-3.70
France	5.90	3.20	3.80	4.80	4.30	1.10	2.50	-0.90	0.70	-2.40
Italy	0.30	1.60	3.20	0.70	0.20	-7.10	-4.00	-6.60	-6.50	-7.90
Luxemb.	9.20	3.10	7.00	5.60	6.40	7.60	5.70	5.20	—	—
Netherl.	9.10	3.40	5.40	3.80	4.30	2.10	0.80	-0.80	-2.10	-1.50
Norway	7.70	6.40	6.50	5.80	7.00	7.80	8.90	12.10	0.00	-2.40
Sweden	2.70	6.30	6.30	10.20	9.90	5.80	-0.40	-1.40	5.30	-5.10
Mean	5.46	4.44	5.25	5.23	5.40	3.01	1.54	0.74	-0.21	-3.01
Ireland	0.50	0.40	0.10	0.40	1.10	-6.70	-6.70	-6.10	-1.60	-1.60
Portugal	3.70	3.20	2.30	2.60	4.80	-2.50	-2.30	-3.70	-1.80	—
Spain	—	—	4.40	3.50	3.80	3.10	0.60	-1.50	1.10	-0.40
Switzerl.	6.10	5.50	6.40	4.10	5.20	3.30	3.60	3.50	3.20	-0.40
Turkey	—	—	—	4.40	7.20	—	—	—	—	—
USA	4.00	2.50	2.50	2.10	0.00	-3.10	-0.70	-4.20	-3.20	-5.00
Japan	7.30	4.40	7.10	6.10	6.70	3.20	2.60	4.30	8.40	7.80
Australia	—	—	6.50	6.70	5.90	3.40	3.00	-1.80	0.50	-3.80
NZ	6.70	6.50	6.00	7.30	6.60	4.30	3.30	2.50	1.90	2.00
Mean	4.72	3.75	4.41	4.13	4.59	0.63	0.43	-0.88	1.06	-0.20

Source: Lane et al, 1996.

1977). It misleads democratic decision-making as it creates the fiscal illusion that benefits may be enjoyed without paying the cost. Is it true that deficit spending is typical of welfare states more than welfare societies?

The evidence in Table 8 indicates actually that welfare societies have done more of deficit spending than the welfare states on an average, except for the early 1990s when clearly welfare states displays a worse performance than welfare societies. The finding holds for both general government surpluses (GGDEF) and central government surpluses (CGDEF).

Table 8. Deficit Spending (Pearson's correlations)

REGIME: Welfare state (= 0); Welfare society (= 1)

GGDEF50	-.04	GGDEF75	-.27	CGDEF50	-.01	CGDEF75	-.33
GGDEF55	-.20	GGDEF80	-.18	CGDEF55	-.36	CGDEF80	-.17
GGDEF60	-.14	GGDEF85	-.11	CGDEF60	-.05	CGDEF85	-.07
GGDEF65	-.24	GGDEF90	.20	CGDEF65	-.13	CGDEF90	.18
GGDEF70	-.24	GGDEF92	.30	CGDEF70	-.29	CGDEF92	.32

Note: GGDEF = General Government Surplus ; CGDEF = Central Government Surplus ;  
Source: Lane et al. (1996).

Can one see in the evidence from the early 1990s a corroboration of the negative theory of public deficits, as the larger the surpluses the better the growth rate, the lower the unemployment and the lower the rate of inflation. Table 9 suggests some clues.

Deficit spending at the national or general government level is only strongly and persistently connected with one of the outcomes identified above, viz. unemployment. The relationship is probably that high levels of unemployment call for deficit spending due to the increased costs for unemployment benefits and falling tax revenues accompanying a rise in unemployment. Rising unemployment costs also entail bigger public expenditures, which accounts for the negative association between deficits and current disbursements. However, it

Table 9. Pearson's correlations between deficits and outcomes

(a) General Government Surpluses

	Current Disbursem. (years)	RGDP Growth (five-years averages)	Unemploym. (five-years averages)	Inflation (five-years averages)
1965	-.00	-.18	-.40	.29
1970	-.12	.18	-.62	.34
1975	-.09	-.21	-.72	.01
1980	-.29	.38	-.72	.14
1985	-.27	.03	-.61	-.12
1990	-.39	-.11	-.32	-.62
1992	-.53	.28	-.42	-.42

(b) Central Government Surpluses

	Current Disbursem. (years)	RGDP Growth (five-years averages)	Unemploym. (five-years averages)	Inflation (five-years averages)
1965	-.11	.01	-.55	.42
1970	.21	.11	-.49	.43
1975	.09	-.30	-.58	.01
1980	-.13	.29	-.50	.19
1985	-.38	.26	-.52	-.05
1990	-.39	-.03	-.23	-.61
1992	-.49	.46	-.24	-.50

Sources: Lane et al. (1996).

is far from always the case that deficit spending reduce economic growth or result in higher inflation, as argued in New Classical Economics (Hoover, 1988). Only in the 1990s we do see a clear negative connection between deficits and inflation. The larger the public sector, the larger the deficits, in the early 1990s.

The conclusion of the examination of the deficit spending hypothesis is that when the welfare state regime is evaluated against the welfare societies, the critical question is whether large public expenditures promote or reduce economic growth. Can we find any evidence from the early 1990s that large public allocative or redistributive expenditures are harmful to these politico-economic outcomes?

#### (b) Public Expenditures

Given the evidence above about different country performance in terms of politico-economic outcomes, can we conclude that the size of the public sector matters? The argument that public expenditures are conducive to policy failure has been launched in a consistent manner from scholars connected with Chicago school economics. The main function of the state is to maintain law and order, protecting the freedom and validity of contracts, as well as the price level (Friedman, 1962; Friedman and Friedman, 1980; Stigler, 1988; Posner, 1992). When governments take on other tasks, there will be a process of public sector expansion which is not conducive to economic performance. Can we find any evidence for these effects in our data about growth, unemployment and inflation for the OECD countries?

Tables 10 and 11 report on a number of Pearsons' correlations between on the one hand two measures of the size of welfare state expenditures, allocative versus redistributive expenditures as percentages of GDP, and a set of outcome measures on the other hand.

There is one clear finding in Table 10 which corroborates the theory about welfare state failure: large allocative expenditures drag down the average growth rate. In relation to unemployment and inflation there is no transparent finding, which is a little bit surprising as one would expect large allocative

Table 10. Public Expenditures and Outcomes: government final consumption (GGGFC)

	Real GDP (averages)	Unemploym. (averages)	Inflation (averages)
GGGFC65	-.38	-.09	-.42
70	-.66	.17	-.42
75	.00	.31	-.37
80	-.12	.05	-.09
85	-.50	-.07	.12
90	-.30	.04	.18
92	-.44	.12	.15

Source: Lane et al. (1996).

Table 11. Public Expenditures and Outcomes: social security transfers (GGSST). (Pearson's correlations)

	RealGDP (averages)	Unemploym. (averages)	Inflation (averages)
GGSST65	-.30	-.39	-.41
70	-.34	-.29	-.52
75	-.24	.04	-.36
80	-.44	.14	-.47
85	-.36	.22	-.56
90	.24	.15	-.20
92	-.17	.22	-.18

Source: Lane et al. (1996).

expenditures to reduce unemployment and increase inflation. Evidently, it is not possible to increase employment by large allocative expenditures, at least not in the long run. How about the impact of large redistributive expenditures – see Table 11.

Transfer payments do decrease economic growth, increase unemployment and lead to higher rates of inflation, but the connections are not strong although the direction or sign of relationships is in accordance with the teachings of Chicago School Economics about the negative impact of tax wedges and excess burden from high tax rates.

Economic growth is the most critical of the outcomes, we argue. If there is even a minor difference in yearly economic growth rates but it is a consistent one over time, then the consequences will be tremendous in the long run. The fact that economic growth rates move up and down not only when one compares countries but also as a function of time entails that it is difficult to find constant explanatory factors. One such is, however, the size of the public sector (Table 12).

The correlations between total public outlays (GGCU) and economic growth are consistently negative for all time periods except the early 1990s when there is no interaction, meaning that the welfare states must face a growth problem. However, the Lucas prediction about the lower the rate of inflation the higher the rate of economic growth is not supported in Table 12. Is the finding about

Table 12. Economic growth, inflation and public expenditures (Pearson's correlations)

Growth	Inflation	Growth	GGCU
RG6569	-.12	RG6569	-.53
RG7074	.66	RG7074	-.61
RG7579	.34	RG7579	-.16
RG8084	.31	RG8084	-.33
RG8589	.24	RG8589	-.55
RG9094	.24	RG9094	.08

Sources: OECD (1985, 1995); Lane et al. (1996).



the public sector – economic growth robust in the sense that it shows up also when we examine partial effects in regression analyses?

### Regression analyses

In order to examine the interaction between public expenditures and economic growth more closely we do two types of regression analysis, cross-sectional and time-series. In the cross-sectional regressions we hold constant for a few factors that have been adduced as relevant to determining economic growth. The time-series regressions include only the relative size of the public sector.

#### (a) Cross-sectional evidence

Let us first test cross-sectional regression models of economic growth. Table 13 focuses upon the impact of large public expenditures upon economic growth in addition to the level of affluence, which the maturity as well as the catch-up hypotheses suggest as relevant for understanding country differences in economic growth.

The hypothesis that a large public sector (GGCU = general government current disbursements) drives down the growth rate receives support. In fact, the negative effect of this factor is as pronounced that of the level of affluence or real GDP per capita (RGDPC), which other factor in accordance with the catch-up and maturity hypotheses also drives down economic growth. The hypothesis that trade union strength – here trade union density in terms of membership (TUD) (OECD, 1994) – is negative for economic growth can only be corroborated for the first time period. Examining economic growth between 1965 and 1980 a clear effect is the Barro model prediction that less affluent countries tend to catch-up (Barro, 1991), but public sector size is as important, the cross-sectional findings indicate.

Finally, we look at the determinants of long-term economic growth, covering the entire time period 1965 to 1994. Which effect is strongest: level of affluence or public sector size? Table 14 has the answer, including besides public expenditures the maturity hypothesis as well as the institutional sclerosis hy-

Table 13. Economic Growth (RGD) in OECD countries: regression analysis

	RGD6569		RGD7074		RGD7579		RGD8084		RGD8589	
	Beta	t-stat	Beta	t-stat	Beta	t-stat	Beta	t-stat	Beta	t-stat
RGDPC	-.46	-2.92	-.50	-3.13	-.70	-3.69	.30	1.6	.30	1.58
GGCU	-.39	-2.53	-.44	-2.67	.14	.70	-.52	-2.60	-.52	-2.59
TUD	-.45	-3.25	.12	.80	-.18	-.98	.48	2.41	.49	2.41
R2a	.61 (N=22)		.55 (N=23)		.35 (N=23)		.26 (N=22)		.22 (N=22)	

Sources: RGDPC60, 70, 80, 90: Summers and Heston (1994); GGCU60, 70, 80, 90: Lane et al. (1996); TUD70, 80, 90: OECD (1994).

Note: R2a = adjusted R-squared.

Table 14. Regression analyses: economic growth 1965-1994

	Beta-Wt	t-stat	Beta-Wt	t-stat	
GDP6090	-.37	-2.05	RGDPCH60	-.46	-2.68
GGCU6590	-.33	-1.88	GGCU65	-.27	-1.68
SCLER	.32	1.70	SCLER	.23	1.34
R2a	.45	(N=21)	R2a	.59	(N=23)

Note: GDP6090 = average gross domestic product scores for the period 1960-1990; GGCU6590 = average general government current disbursements for the period 1965-1990; R2a = adjusted R-squared. Sources: RGDPCH: Summers and Heston (1994); GGCU: Lane et al. (1996); SCLER: Black, 1966.

pothesis, according to which economic growth will be low in countries where modern institutions were introduced early in time (Olson, 1982).

The impact, we see, from affluence is slightly more pronounced than that from total public sector size, but the direction of causality is clear. Large public expenditures tend to reduce economic growth meaning that the welfare states have a profound growth problem. Interestingly, there is also the impact of institutionalisation – Olson's factor (SCLER) – meaning that countries with more recently established state structures (low sclerosis) grow faster than countries with more of institutional sclerosis. Yet, Olson's factor has a weaker impact than the overall size of the public sector.

Table 15. Regression coefficients, 1970 – 1992: Growth Rates and Total Public Outlays/GDP.

	1970:92	1975:92	1980:92
Canada	-0.6299	-0.8036	-0.8392
USA	-0.7409	-2.2630	-1.6150
Japan	-0.3587	-0.6540	-2.3022
Austria	-0.5055	-0.8853	-1.7919
Belgium	-0.2756	-0.2816	-0.4600
Denmark	-0.1084	-0.3644	-0.7118
Finland	-0.6734	-0.6721	-0.7099
France	-0.4299	-0.6390	-0.7699
FRG	-0.2812	-2.7660	-2.7862
Greece	—	—	—
Iceland	-1.5940	-1.5727	-1.2723
Ireland	-0.1143	-0.2370	-0.0597
Italy	-0.2631	-0.4911	-0.4316
Luxembourg	-0.3203	1.4754	—
Netherlands	-0.3144	-1.4737	-4.3822
Norway	-0.4030	-0.5229	-0.3893
Portugal	-0.3438	0.0665	-0.0742
Spain	-0.1359	-0.1674	-0.3054
Sweden	-0.1700	-0.3290	-1.3272
Switzerland	-0.4921	-1.2573	-1.7396
Turkey	—	—	—
UK	-0.0408	0.1677	0.3599
Australia	0.3570	0.1683	0.0136
NewZealand	—	—	—

Source: OECD (1992, 1995).

## (b) Time-series evidence

Secondly, we move on to examine time-series regression analysis, two for each country. Table 15 reports on the sign of the beta-coefficient in an equation regressing the yearly growth rate upon the size of the total public sector, using a data series from 1970 to 1992. Almost all the coefficients are negative and significant, which is strong evidence for the hypothesis that the larger the public sector becomes, the less will be the rate of economic growth.

Yet, public expenditures do not always mean less of economic efficiency. When we make the same type of time-series regressions for the period 1950 to 1975, then we receive the opposite finding. Table 16 indicates that when public expenditures remain at a lower level of GDP, then increases in allocative or redistributive expenditures as a percentage of the total economy increase the yearly growth rates.

Comparing Table 15 with Table 16 we arrive at the conclusion that the relationship between the overall size of the public sector and economic growth takes the form of a *hyperbola*. At low levels increases in public expenditures augment economic output, but a high level of public expenditures the impact of public sector increases is negative upon total output.

Table 16. Regression coefficients, 1950-1975: Growth Rates and Total Public Outlays/GDP.

	1950:75	1955:75	1960:75	1965:75
Canada	0.5101	0.6940	0.8112	0.6617
USA	0.3378	0.4511	0.4755	0.2023
Japan	-0.5740	-0.5012	-0.6158	-0.7214
Austria	0.1708	0.2240	0.3954	0.6623
Belgium	0.4323	0.4695	0.4505	0.3868
Denmark	0.1512	0.1378	0.1152	0.1494
Finland	0.3559	0.6252	0.6626	1.1156
France	0.3505	0.4963	0.4832	0.3884
FRG	0.0365	0.1492	0.2899	0.2059
Greece	0.5960	0.5746	0.6317	0.0212
Iceland	0.4244	0.4999	0.4236	0.4999
Ireland	0.3699	0.4076	0.3390	0.3476
Italy	0.0384	0.1816	0.1652	0.0548
Luxembourg	0.0535	0.2180	0.1787	-0.2332
Netherlands	0.2182	0.2481	0.2223	0.2210
Norway	0.2853	0.4272	0.4995	0.5143
Portugal	0.4040	0.4609	0.2862	-0.1796
Spain	—	—	—	—
Sweden	0.2786	0.3846	0.4510	0.6295
Switzerland	0.2165	0.2284	0.1209	0.1068
Turkey	—	—	—	—
UK	0.4457	0.4919	0.5007	0.4544
Australia	—	—	—	—
New Zealand	—	—	—	—

Source: OECD (1985).

## Conclusion

Welfare state or welfare society? Which politico-economic regime performs best? This a critical question as we move closer towards the next millennium. The two evaluation criteria that one uses to discuss this question consist of economic efficiency and social justice.

When we evaluate the so-called advanced capitalist countries with a democratic system, then we find that there is a basic efficiency-equity trade-off in how these regimes score on the evaluation criteria. The welfare societies do better on economic growth than the welfare states, but the welfare states perform better on social justice than the welfare societies. Choosing the mixed economy or the market economy is thus a matter of your preferences for various combinations of efficiency and equality, where you have to face the trade-offs.

It seems though that the distance between the two regimes in terms of overall economic efficiency is slightly higher than the distance in terms of social justice. This entails a corroboration of the teachings of Chicago School Economics, namely that the advantages of the welfare states in terms of equality comes at a high cost in terms of output, compared with the welfare societies. What the mixed economy or welfare state gains in equality would be more than offset in terms of the gains in economic growth by the pure market economy or welfare society.

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- Projektet skall röra forskning som syftar till att belysa effekterna av arbetsmarknadspolitiskt motiverade åtgärder
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- Ansökan om bidrag skall ha inkommit till IFAU senast torsdagen den 1 oktober 1998
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