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Work Incentives and Employment are the Wrong Explanation of Sweden's Success

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CONTINUATION OF THE EXCHANGE BETWEEN ANDREAS BERGH AND PETER LINDERT FROM THE MAY 2006 ISSUE OF *EJW*.

[Bergh Comment on Lindert \(May 2006\)](#)
[Lindert Reply \(May 2006\)](#)

IN HIS RESPONSE TO MY COMMENT (BERGH 2006), LINDERT insinuates repeatedly that my criticisms of his book are little more than ideological bias. In this response, I will try even harder to recur to the facts. Still my conclusion is that Lindert is wrong about work incentives and employment in Sweden. To explain the so called free-lunch puzzle, we probably need to look closer at institutional quality and economic freedom.

I comment on Lindert's remarks in order of their appearance.

Econometric evidence

Regarding the econometric evidence on the relation between government size and growth, Lindert writes "We should not push the econometric testing aside as if it were just a faulty camera that cannot take the picture Bergh knows to be true" (239). I didn't claim to know that the true picture is a negative correlation. In fact, I wrote:

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Tax funded government activities include many things, some of which are probably bad for growth, whereas others are more likely to have a positive effect. Another possible explanation is that growth and big government are correlated because they are both at least partially the result of other omitted variables, such as certain socio-political traditions. (212)

On this point, I think that actual disagreement is very small.

Work-incentives for low-income earners

Lindert writes:

[Bergh] denies that Sweden has marginal rates as low as 30-35 percent (as I had said), arguing that benefit losses would give a job-getting single mother a much higher marginal tax rate. Given the complexity of quantifying all the marginal incentives, he could be right on this specific point. (242)

First of all, my comment made it very clear that the issue was work-incentives not just for single mothers (who are not necessarily poor), as Lindert suggests, but for poor and low-income earners in general.

Second, the complexity of the calculations is no excuse since the OECD has done most of the work. Their data confirms that work incentives, not only for single parent households, but for low-income earners in general in Sweden are much weaker than in the United States.¹

Lindert also says that the Sweden-US comparison should be made before the 1993 Earned Income Tax Credit reform. But, as one can learn from Lindert's book, in 1967 the dollar-for-dollar benefit reduction of public assistance was abolished in the United States because it created poverty traps. It was reintroduced by the Reagan administration in 1981, and in 1993 the EITC reform once again strengthened work incentives substantially. Throughout this whole period, the Swedish social assistance has been reduced crown-for-crown, creating poverty traps that are still in place today. The upshot is that Sweden and the United States have

¹ OECD (2004).

sometimes had similar poverty traps, and most of the time since 1967 work incentives have been stronger in the United States.

For some convincing empirical evidence that the structure of economic work incentives for low-income earners created by different benefit reduction schemes have substantial behavioural effects, see Munts (1970).

In his reply, Lindert notes that the provision of health care, child care, and other services can be included when comparing work incentives. This would strengthen his case, because in Sweden these services are less means-tested against income than in the United States (242). However, first, while these services are highly subsidized in Sweden, they are not free. For example, child care and dental care are not negligible expenditure for low-income earners. But more importantly, if needed, these costs are covered by social assistance, adding to the poverty trap. Thus, including these services when comparing work incentives for poor in Sweden and the United States strengthens my initial point that Lindert has missed the poverty trap created by social assistance in Sweden. Lindert should acknowledge that he overlooked something important when he overlooked Sweden's social assistance program.

Work incentives for high-income earners

Lindert goes on:

While there lingers some uncertainty about those low-income single mothers, [Bergh] surely owes us an explanation of why he passed up all the evidence that top income earners [in Sweden] did not pay much higher rates than middle earners, either before or after the tax reform of 1991. Before the reform, they had huge opportunities to pay less than the high top rates that got into the media, and the reform slashed those top rates. Nor does he mention the important point that Sweden levies low corporate income taxes. (243)

Lindert's argument here is that before the 1991 reform high-income earners could get away with not paying the marginal tax rates. I agree, but this does not change the fact that statutory tax rates for high-income earners were very high. Furthermore, the mechanism Lindert points to

means that high-income earners spend resources on tax-avoidance, resources that could have been used more efficiently. This is one of the costs associated with high and progressive taxes.

After the tax-reform, marginal tax rates for high-income earners are lower, but they are still higher than for middle-income earners. Furthermore, as I discuss in Bergh (2004), high-income earners in Sweden not only pay an extra 20 or 25 percent in state income tax, their incomes are also not fully covered by the social insurance systems, because there is an upper limit on the positively income-related benefits. For this reason, the disposable income curve, as shown in Figure 1, has three segments: The poverty trap created by social assistance, a segment with moderate work incentives with marginal effective tax rates below 50 percent, and a section with lower work incentives where the marginal effective tax rate is above 50 percent. The difference created by the state income tax is always 20 percentage units or more (as can be seen in Figure 2, page 216 in my first comment). The structure of marginal taxes can easily be confirmed by OECD (2004).

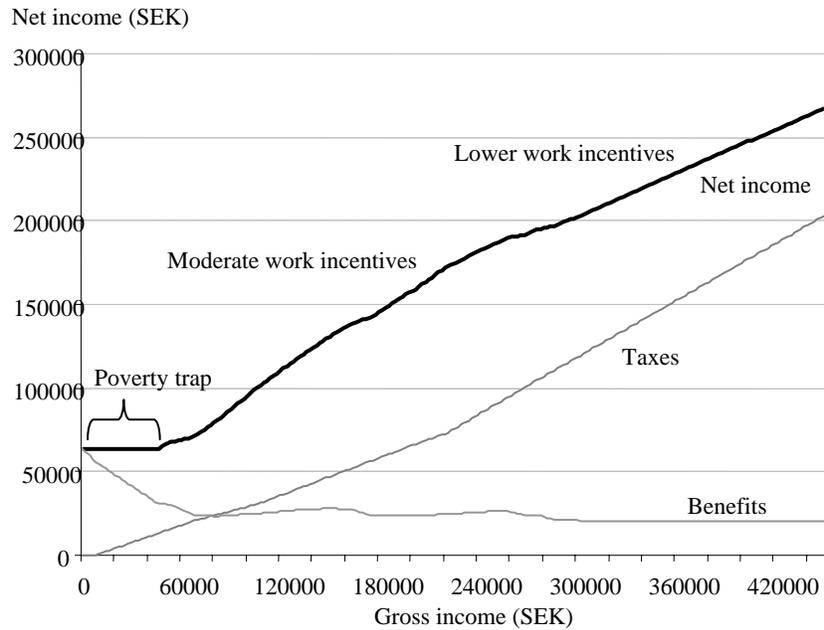
When Lindert moves on to note that taxation of corporations is low in Sweden he is right, but he is no longer talking about work incentives for employed workers. Furthermore, the combination of high labor taxation and lower taxation of corporations produces incentives to keep profits within the corporation rather than to pay wages—an effect that is not obviously desirable.

Employment of women

I remarked that Lindert's picture of high gender equality in Sweden is biased because he does not take into account that Swedish women often work part-time. Lindert responds by asking about the value of household work:

Are we to imagine that women are forced into useless partial idleness because of taxes? Do they knock off formal work at 3:00 pm because taxes are too high for a full day, or quit their jobs for part of the year and get a new job later to cut taxes? Instead, should we not look at the greater part-timing and partial unpaid work for women in Sweden (and Netherlands and elsewhere) as a response to a better opportunity set? (244)

**Figure 1:
Work incentives created by taxes and benefits in Sweden 1995**



Source: Bergh (2004).

Lindert may well choose to view greater part-timing and unpaid work as a response to a better opportunity set. My point was much simpler: Displaying only employment ratios is not a convincing way to explain why the welfare state seems to have no negative effect on GDP. Household work is not included in GDP. My noting this says nothing about my personal opinions regarding the value of unpaid work and idleness.

Lindert's rhetorical questions make fun of my argument, as if Lindert did not understand that my point was the following: High labor taxation means that it is expensive for a person to hire another person to do a job. One reason why Swedish women work part-time is that there is no functioning market for household services. One major reason is that high

labor taxation creates a do-it-yourself incentive—not only in theory but also in reality, as verified for example by Davis and Henrekson (2004).

Lindert wants me to explain why I am skeptical about his explanation of high female employment in Sweden based on high female labor supply elasticity (244, footnote 12). I am skeptical because, while labor supply elasticities describe how the number of hours worked depends on the net wage, Lindert does not use the number of hours worked he uses employment ratios. I clearly stated (220) that when we consider the number of hours worked instead of employment ratios, female employment in Sweden is actually lower, not higher, than in the United States. To explain the two facts that Sweden has a higher female employment ratio, but lower number of hours worked, Lindert's elasticity story does not work.

If Lindert's elasticity story were to work, presumably it should work in both the public and the private sectors. To help explain my doubts about Lindert's story, I noted that the female employment expansion in Sweden has been entirely in the public sector. Rather than address this matter, Lindert simply acknowledges the fact (which was strangely omitted from his book), and diverts us with another ideology play: "Are readers supposed to shake their heads in knowing disapproval, because they all know that public employment is inferior to private?"

Retirement

Lindert writes, "for women, the share [in Sweden] still working in the 55-64 age bracket is also high by international standards, despite Bergh's claims to the contrary" (244-5).

I did not claim the contrary. I wrote that "[Lindert] has not verified that the high employment ratio in the age group 55-64 implies that Swedish elderly actually work more hours" and that Lindert is wrong to claim that "Swedish women work to later average retirement ages than women anywhere else in the world" (Lindert 2004, 289), noting as I did that in fact women in Iceland, Mexico, Korea, Ireland, Japan, Portugal, Switzerland, United States, Norway, and Denmark work to a later age (227). Again, I simply recurred to the facts, and Lindert never answered the challenge.

Economic freedom

In my reply, I suggested that a number of institutional reforms may explain the perhaps surprisingly good economic performance of Sweden and other high tax societies. Lindert comments:

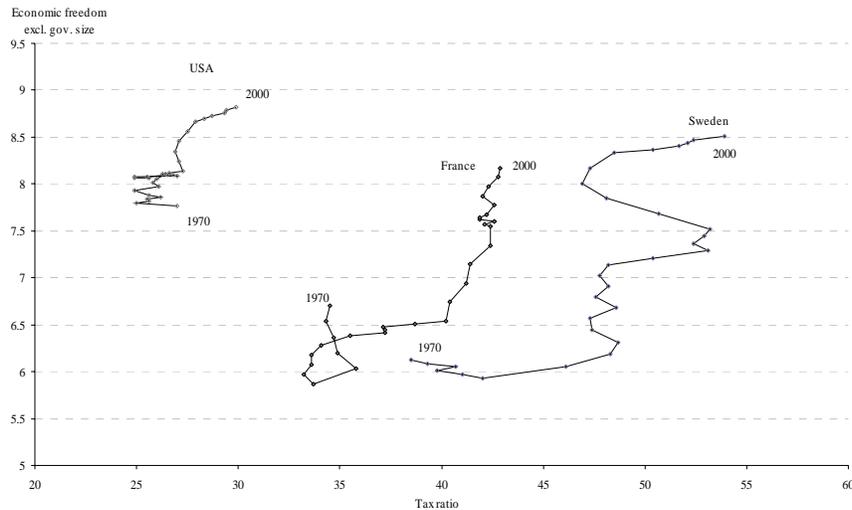
Most of the article tries to stress that Sweden has painted itself into a corner today, yet this part emphasizes that Sweden reformed its way out of problems: [...] It is hard to make out what this final section is trying to achieve, beyond putting in a plug for subjective indices of "freedom" by the Heritage Foundation and the Fraser Institute. (245-246)

First of all, the index developed for the Fraser institute by James Gwartney and Robert Lawson has been used for serious research published in many established scholarly journals, as well as in work by the IMF and the World Bank. Indices are never perfect, but many scholars seem to agree that this is a good attempt to quantify various aspects of institutional quality and economic freedom.

Second, Lindert puts *freedom* in sneer quotes, without explanation. I find this curious. I wonder how Lindert reads Adam Smith's economic treatise on the meaning, worthiness, and limitations of natural liberty. It is undisputed that, as Smith argued, economic freedom has a big and robust positive effect on growth. Doucouliagos and Ulubasoglu (2006) conduct a meta-study of 52 studies dealing with the impact of economic freedom on economic growth, and conclude that "economic freedom has a robust positive effect on economic growth regardless of how it is measured" (68).

In Bergh (2006) I develop the idea that big welfare states can use economic freedom to compensate for negative effects caused by big government and high taxes. Figure 2 illustrates Sweden's development by showing the economic freedom index average for legal structure and property rights, access to sound money, freedom to trade and regulations of credit, labor and business as well as total taxes relative to GDP. This collection of components is the total index except for the government-size component.

Figure 2: Economic freedom and taxes in Sweden, France, and the United States: 1970-2000



Source: Gwartney and Lawson (2005) and OECD.

I think it is clear that reforms toward increasing economic freedom could well be one of the keys to the so-called free-lunch puzzle. It's simple enough, but Lindert says he doesn't see the point.

Concluding remarks

In the final section, Lindert goes on to claim that he agrees with me on the importance of reforms in Sweden. He goes on to remark about the negative effects in Europe of employment protection laws, product market regulation, and the centralization and under-pricing of Sweden's university education (247).

Lindert mentions all this because he wants to persuade me and the readers that "[t]he welfare state is the wrong target" (246). To some extent, I agree with him on this point. Throughout his reply, Lindert presumes that I am an opponent of the welfare state. Since Lindert predicates so much of his reply on my presumed ideological sensibilities, it seems appropriate that I disclose what they actually are. I am in fact rather friendly to the welfare

state, and, otherwise, to economic freedom. In my view, the Swedish welfare state creates problems in employment and work-incentives, problems that are much bigger than they have to be. I would never claim that the welfare state is a free lunch.

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