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Second Reply to Bergh

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I AM PLEASED THAT IN HIS SECOND COMMENT ANDREAS BERGH (2006b) has decided to "try even harder to recur to the facts," and agrees that on the key econometric front our "actual disagreement is very small" (pp. 452, 453). He also now reveals that he is "in fact rather friendly to the welfare state." We seem to have achieved some convergence.

Still, he retains some lingering disagreements with my analysis, and two main disagreements deserve to be noted briefly. The common element in these disagreements is the basic clash that I noted both in my book (Lindert 2004) and in my first reply to Bergh (Lindert 2006): While they concede that the econometrics and the raw correlations fail to show any negative GDP effect or growth effect of higher total social transfers, some economists, like Bergh, insist that the costs predicted by their theories must be there.

TAXES AND FREEDOM

"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" (Bergh 2006b, 459). Readers wanting to see the point should look again at his new chart on taxes and the freedom index. What Bergh apparently wants to show is that the rise of economic freedom since 1970 was bigger for Sweden than for the USA or France, with the United States retaining a lead as of 2000. What stands out in the diagram is that Sweden's much higher tax ratio is consistent with

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economic freedoms that are both rising and high by the standards of the USA of 1970 and earlier. So if Bergh feels that "reforms towards increasing economic freedom could well be one of the keys to the so-called free-lunch puzzle" (p. 459), he should perhaps point out that the high and rising tax shares that concern him have not dragged down economic freedom or Sweden's success.

The coexistence of high tax rates and a high freedom index in Sweden is all the more remarkable since the freedom index Bergh uses (Gwartney and Lawson 2005) was *designed* to give lower freedom marks for countries with high taxes and big government. The leading component of the Fraser Institute "economic freedom" index loads on the following factors (9):

1: Size of Government: Expenditures, Taxes, and Enterprises
- A. General government consumption spending as a percentage of total consumption.
- B. Transfers and subsidies as a percentage of GDP.
- C. Government enterprises and investment as a percentage of GDP.
- D. Top marginal tax rate (and income threshold to which it applies).
  - i. Top marginal income tax rate (and income threshold at which it applies)
  - ii. Top marginal income and payroll tax rate (and income threshold at which it applies)[1]

Thus dragged down in the index by design, Sweden nonetheless has ranked close to the United States in economic freedom ever since the index was first calculated for 1970. Alternatively, one could have used an alternative index of good government institutions, one that doesn't define bigger government budgets as a loss of freedom. One such index is the clean government rating given by Transparency International's Corruption Perceptions Index, which found that all four Nordic countries were consistently at the top of the clean-government ranks (with Singapore and New Zealand, as of 2003), while the United States is tied for 18th and 19th (Transparency International 2003). Whichever institutional rating one tries, Sweden's high tax take has

[1] Note that these top marginal tax rates featured in the freedom index are the same ones that Bergh agrees were seldom paid by Swedes before they were lowered in 1991. Thus part of what passes for a "freedom reform" that Bergh sees in his Swedish freedom graph may simply reflect Sweden's removing these ineffectual high rates.

not been inconsistent with good institutions, either before or after the "reforms toward increasing economic freedom" (Bergh 2006b, 459).

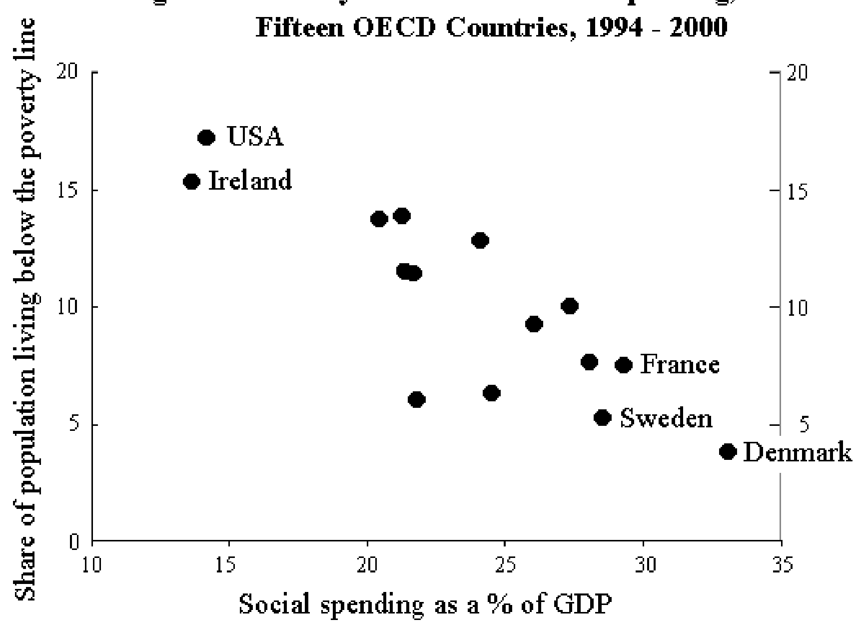
Given that freedom and clean government seem so consistent with the welfare state and high taxes, one might wonder how it is that Doucouliagos and Ulubasoglu (2006) concluded, as Bergh cites them, that "economic freedom has a robust positive effect on economic growth regardless of how it is measured" (458). They got this plausible result from global samples, not from samples of OECD rich democracies. The positive effect of economic freedom on economic growth comes from the bad performance of dysfunctional dictatorships like those in Zaire and Zambia. The same inclusion of the world's worst in global samples also explains how some economists find a negative effect of government consumption (not social transfers) on GDP growth. We could call it the Mobutu effect. It says nothing about the effect of social transfers or the welfare state in a context of highly educated democracies. Adam Smith is right about freedom, but freedom can't explain much here simply because it doesn't differ much between OECD countries.

On the alleged effect of Sweden's high statutory top tax rates before 1991, Bergh again lapses back into theory when the facts fail to produce for him. Having agreed with me that "before the 1991 reform, high-income earners could get away with not paying the marginal tax rates" he still feels that Sweden's tax system must be costly: "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" (455). We are back to that same I-see-a-tax-wedge reasoning that I questioned both in the book and in my earlier reply to him. It is one thing to have a tax rate on the books and another to show that people respond to it. He shows no statistical evidence that a significant share of GDP was lost in tax-avoidance activities.

POVERTY TRAP

Bergh's second comment steps up the frequency of his references to a "poverty trap created by social assistance in Sweden" (454). That will seem odd to anybody who knows the poverty rates measured by the OECD and by the Luxembourg Income Study. Using comparable measures of absolute purchasing power parity for the year 2000, one finds that only 5.3 percent of the population was below the poverty line in Sweden, versus 17.2 percent falling below the same absolute poverty line in the United States. How did Sweden achieve that? It might have something to do with Sweden's willingness to redistribute to the poor. Figure 1 shows the well-known correlation between countries' efforts to help the poor with social spending and their relative success in cutting poverty.

Figure 1. Poverty Rates versus Social Spending, Fifteen OECD Countries, 1994 - 2000



Correlation = - 0.84. Source = Pestieux (2006, p. 11), using OECD and LIS data.

What Bergh seems to mean by the "poverty trap" is simply that statutory rates of taxation and withdrawal of benefits imply that the poor face an ostensibly strong incentive to avoid work. Once again, he reverts to that I-see-a-tax-wedge reasoning. We need evidence that people respond to it. Econometric studies have consistently shown that the employment response to ostensibly large tax wedges is very small in today's democracies.

The alleged "evidence" of large work effects comes overwhelmingly from theory and not from any robust econometrics, despite his new claim that Ray Munts's 1970 study showed big effects.

The welfare state remains a "free lunch" in the same sense that I used this phrase in my 2003 NBER paper, my 2004 book, and my first reply to Bergh earlier this year: The higher social transfers of the welfare state have brought less poverty, less inequality, and longer life expectancy with no statistically significant cost in terms of GDP.

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