EXPLAINING THE SURVIVAL OF THE SWEDISH WELFARE STATE: MAINTAINING POLITICAL SUPPORT THROUGH INCREMENTAL CHANGE

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Article**
UDC 364.013(485)
JEL H11, H53, I38, P43

Abstract

Despite challenges and doomsday predictions, the Nordic welfare states with high taxes and public expenditure are still with us. This paper describes strategic choices for policy makers of the welfare state and uses the case of Sweden to argue that the high tax welfare state has survived several challenges through a process of incremental change, where the welfare state is modified in order to maintain political support from voters who would otherwise favor cutbacks. This gradual adaptation leads to heterogeneous universality characterized by flexibility, freedom of choice, and financial solutions that involve both public and private funding. While such policies may increase inequality, they play a crucial role in maintaining political support for high taxes and expenditures. Compared to likely counterfactual scenarios, this gradual adaptation may be the political strategy that minimizes inequality in the long run.

Keywords: Welfare state, Nordic model, institutional change, taxation

1 Introduction

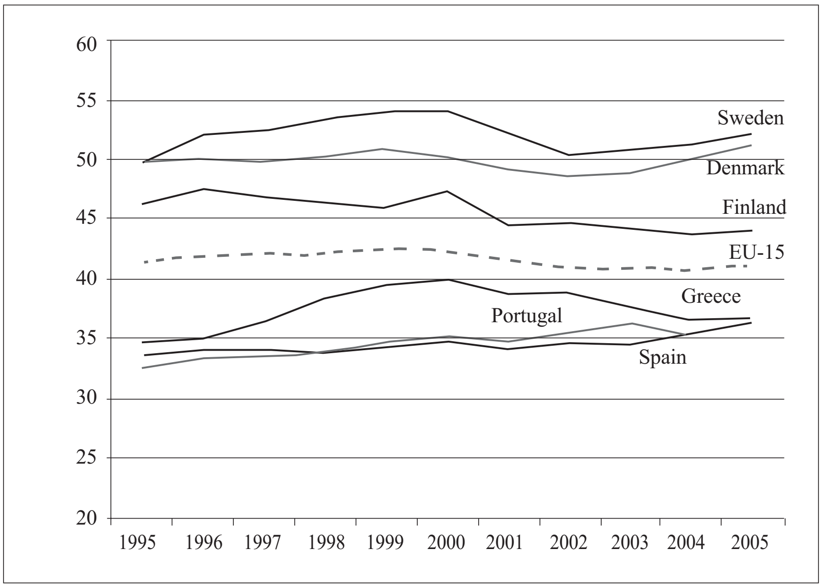
Over the latest two decades, social scientists have identified a number of challenges for big welfare states. Perhaps the most commonly mentioned factor is the increased mo-

* The author would like to thank Stefan Svallfors, Gissur Erlingsson and two anonymous referees for useful comments on earlier versions of this paper. Financial support from the Torsten and Ragnar Söderbergs Stiftelser is gratefully acknowledged.

** *Received:* January 29, 2008
Accepted: May 19, 2008

bility of labor and capital, possibly leading to states competing for production factors by lowering both taxes and benefits in a race to the bottom. Recently, however, empirical research has discovered a remarkable resilience in the big welfare states. For example, figure 1 below shows total taxes as a share of GDP for the three countries with the highest and the lowest total taxes in the EU in 1995. What we see looks very little like a race to the bottom. If anything, this decade of economic integration may have produced some small degree of convergence towards the EU-average: the average standard deviation was 4.6 for the years 1995-2000 and 4.3 for the years 2001-2005.

Figure 1 Taxes (percent of GDP) in high tax and low tax EU countries



Source: Eurostat

The conclusion that the big welfare states did indeed survive the crisis of the 90s, appears in several detailed case studies as well, see for example Bergh (2004b), Castles (2004), Bergqvist and Lindbom (2003), Lindbom (2001), Timonen (2001), Kvist (1999) and Kautto (1999).[1] These findings stand in contrast to doomsday stories like Snower (1993), and to the once frequent demise of the Swedish welfare model in publications such as the *Wall Street Journal* and *The Economist*.[2] For this reason, we must ask if the doomsday predictions for big welfare states were wrong, exaggerated or if the welfare state has found ways to adapt to changing circumstances.

[1] Blomqvist (2004) however points out that many important changes in Sweden during the 90s were qualitative rather than quantitative, and as we shall see these qualitative changes have been crucial for understanding the quantitative persistence of high tax societies.

[2] See Lindert (2004) chapter 11 for a list of such articles.

The answer given in this paper, is that while there have been some exaggerations concerning the impact of globalization on the welfare state, the main reason for the persistence of high tax welfare states is that the strategy chosen by policy makers involves gradually adapting the welfare state to new circumstances. In the words of Streeck and Thelen (2005), we are dealing with *incremental change with transformative results*. This paper contributes to our understanding of welfare state resilience by showing that a simple economic assumption takes us very far in understanding the type and direction of these incremental changes: in order to survive in a democracy, the welfare state needs to be supported by a majority of the population. When external forces put the welfare state under pressure, policy makers have responded with measures that maintain welfare state support among voters who are otherwise likely to favor large cutbacks and lower taxes.

If the forces that drive welfare state change continue to be incremental rather than abrupt, the framework presented in this paper can actually be used to predict the type of changes that will take place in the Nordic welfare states the coming decades. The crucial assumption is that politicians respond to external forces by incrementally modifying current welfare state institutions in order to maintain political support. Empirical evidence, mainly from Sweden but also from the other Nordic welfare states, clearly indicates that this strategy has indeed already been seemingly successfully implemented. If the strategy is maintained, high tax welfare states will continue to exist in the future, but they will become more heterogeneous and flexible.

This paper proceeds as follows. In the next section, I discuss some challenges and changes that the Nordic welfare states must adapt to. In section three I present a simple framework for analyzing political support for welfare states and the strategic choices policy-makers are facing. In section four I describe the gradual adaptation process in practice using examples mainly from Sweden. Section five discusses the distributional consequences of this adaptation, and section six concludes.

2 Four challenges for the welfare state

Before analyzing how the welfare can adapt to changing circumstances, let us review what these changing circumstances are. The literature offers several accounts of challenges facing big welfare states. For example, Snower (1993) argues that universal welfare states will come under budgetary pressure and therefore welfare services should be redirected from the middle class to the poor. Further, and less drastic, examples can be found in Lindert (2004) and Steinmo (2003). Analyzing all potential future challenges for the welfare state is not possible. In this paper, I focus on the following four challenges:

- Increased mobility of tax bases makes it more difficult to collect the taxes needed to finance the welfare state.
- An ageing population means that people may need support from the welfare state for a longer period towards the end of their life.
- Increased efficiency of private insurance markets means that the market alternative to the welfare state will be more competitive.

- Technology-driven increased expectations from publicly financed private consumption, especially in the health care sector, mean that citizens will demand more from the welfare state.

Granted, focusing on these four factors excludes many important challenges. For example, Lazar and Stoyko (1998) mention changed family structure, high fiscal deficits, incentive problems with generous benefits and changed political ideology. Still, the first two factors are probably the most frequently mentioned among the challenges for the welfare state, and the second two factors are included because they are likely to be important in the future. Let us now briefly discuss these four challenges. How severe are they?

Regarding the mobility of tax bases, capital is already more or less completely mobile between countries, whereas labor mobility in Europe is still very low. This is important, because labor mobility plays an important role in Sinn's (1997) theory of systems competition, which describes how countries compete for high-quality labor. In practice, labor mobility is not high enough to induce a race to the bottom as described by Sinn (2004), but there are signs that mobility is increasing. Pedersen et al. (2003) report that there was a marked increase in emigration from Sweden during the 90s, especially among the highly educated.

The ageing population is another challenge for the welfare state. The old-age dependency ratio in the EU (defined as the population aged 65 and above relative to the population aged 15 to 64) is projected to double between 2000 and 2040 (Disney, 2003). This development seems drastic indeed, and it has led to a debate in which the most extreme position is that the welfare state will collapse under the demographic pressure.

Increasing longevity does not necessarily mean that people need to be supported from the welfare state for a bigger part of the lifecycle. There are competing hypotheses regarding the so-called healthy life expectancy. The theory by Fries (1980) of compressed morbidity is the most optimistic, whereas Gruenberg (1977) suggests a more pessimistic scenario of morbidity expansion. Most likely, there are mechanisms working in both directions. For example, Karlsson et al. (2005) report that healthy life expectancy in the UK increased by around 1.5 years between 1981 and 2001, whereas overall life expectancy increased by 2.1 years for women and 3 years for men.

The increased efficiency of private insurance markets affects the political support for social insurance schemes. Hindriks and De Donder (2003) show that if private insurance companies can observe individual risks, and thus are able to avoid the adverse selection problem, the political support for social insurance will decrease. While it is less realistic to assume that private insurance firms can freely access individual risk information, it can be shown that the lower the cost of obtaining such information, the lower is the political sustainability of social insurance (see Bergh 2003; 2004). The increased efficiency of private insurance markets means that the market alternative to social insurance will become more attractive for those who know that their risk of becoming sick, disabled or experiencing a work related injury is less than the average risk.

Finally, the rapid development of modern medical technology means that it will be difficult publicly to provide health care at a quality level sufficient for everybody. In a recent Swedish survey, Rosén and Karlberg (2002) found that 59% of citizens and only

12% of physicians agreed fully with the statement that the public health services should always offer the best possible care, irrespectively of cost.[3] Increased expectations are caused not only by improved technology but also by increasing incomes. According to Fogel (1999), the long run income elasticity for health care services is 1.6. Thus, as we grow richer, we want to spend a bigger part of our budget on health care. For this reason, the universal level provided by the welfare state will be perceived as insufficient for an increasing number of high income earners.

Summing up, the four challenges do not pose a sudden and disastrous threat to the welfare state – they have been developing for some time now. However, they cannot be expelled as myths, and it seems likely that they will continue to grow stronger in the future.

3 Modeling welfare state support

Understanding welfare state support is a complex issue. Three possible explanations are self-interest, reciprocal support and altruism. The self-interest approach can be traced back to at least Meltzer and Richard (1978), who note that those who are net-gainers from welfare state redistribution are likely to vote in favor of the welfare state. While the self-interested approach is analytically convenient, the issue is much more complex than merely calculating if a person is a net-gainer or a net-receiver in monetary terms.

At the opposite explanatory extreme, we find altruistic support, where even net-payers to the welfare state vote in favor because they are altruistic towards those who gain from redistribution. Little is known for sure about the origin and nature of human altruism.[4]

It is fair to say, however, that reciprocal welfare state support is the most accepted explanation today – see for example Bowles and Gintis (2000) and Mau (2004). According to this hypothesis, people are willing to contribute to the welfare state – provided that there is a relation between efforts and rewards that is perceived to be just. The willingness to contribute is contingent on the assumption that there will be adequate future returns (Mau, 2004). One way of putting it is to state that people willingly support the welfare state, provided that others do so as well. People do not wish to be contributing but never receiving anything in return, and in this sense reciprocal welfare state support is not fundamentally different from self-interested welfare state support.

Supporting both the self-interested and the reciprocal explanations, there is substantial empirical evidence that big welfare states survive because they are beneficial for the broad middleclass – see for example Goodin and Le Grand (1987), Rothstein (1998) and Korpi and Palme (1998). Furthermore, there is also evidence that the historical expansion of the welfare state can largely be explained by political factors based on voters' self-interest (see Lindert, 2004).

For these reasons, the analysis in this paper will rely on a more sophisticated version of the simple self-interest model in combination with reciprocity. Figure 2 below shows a

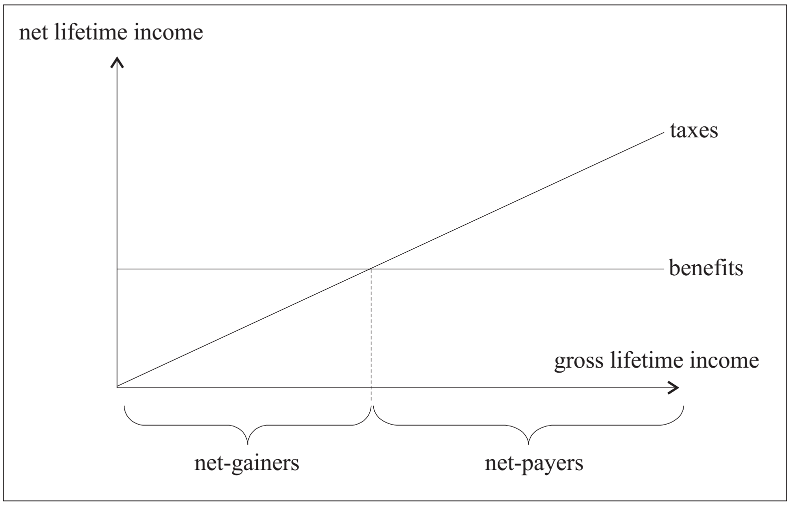
[3] Similar "expensive expectations" may exist in other publicly financed areas, such as schooling.

[4] This is, however, currently a very lively research field, see for example Fehr and Fischbacher (2003) and Ostrom and Walker (2003).

simplified model of a universal welfare state suggested among others by Rothstein (1998).[5] The idea is that approximately proportional taxes are used to finance benefits (both cash and in-kind), and that people are eligible for these benefits regardless of their income. With some extensions, this model will be used to analyze how welfare state support is affected by the four challenges mentioned in the previous section.

Because the welfare state redistributes both among individuals and over the life cycle of each individual, Figure 2 must be viewed in a lifetime perspective. Over the life cycle, ex post, some people will end up as net-payers and others as net-gainers. But ex-ante, this cannot be known! For this reason, there is an insurance motive for redistribution that must be taken into account. If people are risk-averse and worry about future income losses, even some who eventually end up as net-payers will support the welfare state, because of the safety it provides.

Figure 2 A simplified model of the universal welfare state



Source: Author

In addition to the insurance motive for redistribution, a model for welfare state support should also consider the perceived counterfactual scenario, the in-kind effect and the level effect – explained in the following.

Peoples' support for the welfare state depends on what they perceive to be the relevant counterfactual scenario. More important than being a net-gainer or a net-payer is whether people perceive that they are better off under current welfare state institutions than they would be under the most likely alternative scenario, probably a combination of market and family based solutions. For example, people who are net payers to social insurance sys-

[5] The universal welfare state is perhaps more well-known as the social democratic welfare state in the framework of Esping-Andersen (1990).

tems may well be better off under social insurance compared to market solutions, if market insurance to some degree is characterized by imperfect competition or adverse selection problems – see for example Sinn (1995), Casamatta, Cremer and Pestieau (2000) and Hindriks and De Donder (2003). But if the alternative to the welfare state is improved for some groups, the welfare state support in these groups will be undermined because they now feel that they would be better off under alternative arrangements.

The in-kind effect refers to the fact that receiving public consumption worth a certain amount is not equivalent to receiving the same amount in cash. For this reason, some groups may feel that the services they are entitled to are not what they would have chosen to consume had they been given cash transfers instead. When the difference between citizen's preferences and what the welfare state provides is bigger, the less likely is the citizen to support the welfare state.[6]

Finally, the level effect is closely related to the in-kind effect: Assuming that the services provided by the welfare state are exactly what citizens would buy anyway, there may still be a negative effect on welfare state support if the level spent is lower than the desired spending level. For example, in the absence of a welfare state, both low and high-income earners would likely spend some money on primary education. But low-income earners would spend less and high-income earners more than the equal amount provided by the welfare state. Thus, high-income earners may feel that the consumption level provided by the welfare state is insufficient, with negative consequences for welfare state support.

3.1 Political strategies: status quo, system shift or gradual adaptation?

The challenges to the welfare state mean that policy makers are faced with a strategic choice. Two extreme strategies can immediately be identified. One is to do nothing in order to maintain the status quo. The other is fundamentally to restructure the welfare state, a system shift. Between these extremes we find various types of incremental change, including a gradual adaptation of the welfare state to new circumstances. These strategies are described in Table 1.

Obviously, the distinction between gradual adaptation and a system shift is a matter of degree rather than one of kind, as pointed out by Hinrichs and Kangas (2003). Nevertheless, the incremental change of gradual adaptation can potentially explain the absence of a system shift in the Nordic welfare states. Small, strategic changes in tax- and benefit systems alter the welfare state in response to changes in its environment, so that voters who would otherwise favor radical changes with substantial cut-backs continue to support the welfare state.

The system shift is unlikely to be successful: we know from the literature on institutional change in welfare states that such radical changes typically only occur under extraordinary circumstances in an abrupt process of change.[7]

[6] Theoretically, the in-kind effect on political support could be positive. For example, if people know that they have myopic preferences and are unable to save privately for their ageing despite wanting to do so, the welfare state may serve as a desired commitment device.

[7] See for example Streeck and Thelen (2005), Pierson (2001) and Stephens, Huber and Ray (1999).

Table 1 How the policy makers of the welfare state can respond to changing circumstances – three strategies.

Political strategy	Description
Maintain status quo	Ignore challenges and changing circumstances. Aim to keep traditional welfare state institutions intact.
System shift	Use changing circumstances and challenges as arguments for a fundamental restructuring of the welfare state, such as abolishing universality in favor of a basic or a targeted welfare system.
Gradual adaptation	Modify the welfare state in response to changing circumstances, resulting in maintained welfare state support while avoiding self-interest turning supporters into voters that demand large cut-backs.

Source: Author

The political strategy of the status quo will appear the most egalitarian and most convenient in the short run. However, if external forces continue to grow stronger, this strategy may jeopardize political support for the welfare state in the long run. There are a number of case studies in the literature suggesting that countries trying to preserve the status quo for too long may run into problems, which subsequently lead to big institutional changes (see for example Lo Vuolo (1997) on the case of Argentina, and McClintock (1998) on the case of New Zealand).

The Nordic welfare states have clearly chosen the strategy of gradual adaptation. In the next section, I describe in more detail the way that several incremental changes have contributed to maintaining political support in Sweden and the other Nordic welfare states.

4 Maintaining political support for big welfare states through gradual adaptation

In short, the gradual adaptation of the Nordic welfare state has involved the following policy measures:

- changes in the tax structure
- increased work incentives
- accepting private topping up of public benefits.
- use of vouchers to combine freedom of choice, private provision and public funding.

This section provides empirical examples and describes how these measures affect welfare state support. While there are of course some parts of the welfare state where little has happened, the examples listed below concern the biggest transfer (the pensions system), publicly financed consumption and the tax-system, demonstrating that the changes taking place are more than marginal

4.1 Changing tax-structure

Big welfare states can tackle the problems caused by increased tax-mobility in different ways:

• accept lower revenue and run deficits.

• accept lower revenue and decrease expenditure.

• counteract increased mobility by offering compensating benefits to the production factors that would otherwise move.

• compensate the tax loss by increasing taxes on less mobile production factors.

Obviously, the first option is not economically feasible in the long run. As already noted, the second option is problematic for political reasons. This leaves options 3 and 4, both of which call for changes in the tax system. This is exactly how the Nordic welfare states have adapted so far.

To maintain high tax revenue when some tax bases are becoming more mobile, a bigger share of taxes must be shifted to relatively less mobile factors. Boadway (2005) argues that the system that best combines the objectives of a good tax system in an internationally competitive environment is the dual income tax system used in the Nordic countries where capital is taxed at a low, flat-rate and non-capital income is taxed progressively. Lindert (2004) points out that the Swedish tax level is substantially higher than for example US-taxes on all areas except capital taxes.

This argument can be taken further: When it comes to labor taxation, the Nordic welfare states have higher average taxes, but compared to the US and the UK, they collect a relatively bigger share of taxes from low and middle-income earners, and a smaller relative share from high-income earners – see Table 2.

Table 2 Proportion of taxes paid by the lowest (30%), the middle (40 %) and the highest (30%) of the population (based on final disposable adjusted income).

	Low (30%)	**Mid (40%)**	**High (30%)**
United States	6	28	65
United Kingdom	6	32	62
Finland	10	33	57
Norway	10	36	54
Sweden	11	36	53
Denmark	14	37	49

Source: Förster (2000)

Recently, welfare states have adapted by abandoning highly progressive tax schedules, but they have not lowered the level of total taxes. In the early 1990s, both Sweden and Norway conducted reforms that reduced tax-distortions by lowering the statutory tax rates and broadening the tax bases – see for example Agell, Englund, and Södersten (1996) and Aarbu and Thoresen (1997). Lazar and Stoyko (1998) show that the number of tax brackets and the top marginal tax rates have decreased markedly between 1975 and 1990 in almost all modern welfare states.

In addition to fundamental structural measures like changing the overall progressivity of taxes some problems caused by increased mobility can also be tackled by specific exceptions for specific groups. Sweden, Denmark and Finland have all introduced exceptions in the income taxation, according to which for example foreign experts are liable to substantially lower marginal income tax-rates. In Sweden, 25 percent of the gross wage is exempt from taxation for a period of maximum three years. Denmark goes even further: the highest marginal tax rate is roughly 60 percent, but foreign researchers staying for a maximum of three years pay only a proportional tax at 25 percent.[8] For further details regarding selective exceptions in income taxation, see ITPS (2005). Thus, welfare states have adapted by making the tax burden less of a burden on groups with higher mobility.

At this point, it deserves noting that it is wrong to ignore tax-financed benefits when analyzing the sustainability of high tax systems – as stressed by for example Steinmo (2003). The problem is that many of the benefits financed by the welfare state have public-good properties, leading to the classic free-rider problem: those who avoid paying high taxes may still be able to enjoy the benefits financed with taxes from others.

As it turns out, welfare states can handle the free-rider problem by tying benefits closely to individual labor market participation. For example, the biggest social transfer, the pension system, is typically designed specifically to avoid this problem. In Sweden, income related pension rights are earned-only for incomes in Sweden, and a full flat rate pension is granted only to citizens who resided in Sweden for at least 40 years between the age of 16 and 64.

Many potential problems related to so-called strategic welfare migration still remain though. If people enjoy publicly financed education until the age of 25, work abroad for most of their adult life, and move back to take advantage of publicly financed care for elderly, this will cause problems for the welfare state. Similarly, there have been worries that increased immigration from poorer European countries will put the Nordic welfare states under pressure.

So far, however, empirical research does not indicate that strategic welfare migration is a big problem, even among states in the US. Berry, Fording, and Hanson (2003) conclude that “the poor do not migrate in large numbers for more generous welfare assistance.” (p. 329) and also that “the magnetic effect of welfare is substantially weaker than the magnetic effect of high wages for low-skill workers and a low unemployment rate” (p. 344). In other words, labor migration is about people seeking work opportunities in richer countries, and not so much about strategically seeking the benefits of generous welfare states.[9]

[8] Before abandoning the wealth tax in 2007, Sweden also had a similar exception in the wealth tax for those who own at least 25 percent of the shares in a company, if these were bought before 1990.

[9] Tentatively, both of these findings are confirmed in a Swedish context. The most recent study by the Swedish National Social Insurance Board found that the EU-expansion taking in 10 new and substantially poorer countries only marginally affected expenditure on family benefits (see Försäkringskassan (2005) and http://www.eubusiness.com/East_Europe/040825093559.y65bxren). However, the fact that for example Latvian construction workers now

To sum up: big welfare states can maintain high tax revenue by shifting the tax burden towards less mobile tax bases, decreasing tax-progressivity, introducing compensating exceptions to highly sensitive production factors and by making it harder to free ride by enjoying tax financed benefits without paying the taxes that finance them. Many changes in this direction have already taken place in the Nordic welfare states.

4.2 Increasing work incentives

When the share of the lifecycle spent working falls because people leave school later, retire earlier and live longer, welfare states are faced with the choice between decreasing benefits and raising taxes. To alleviate the problem, policymakers are typically advised to increase work incentives (see for example OECD, 2005).

Increased work incentives can be achieved in different ways. In the long run, welfare states can encourage people to work longer before retiring. In the short run, reforms can increase incentives to work longer hours per day and more days per year. The Nordic welfare states are currently struggling with both types of reform, and not without success.

Increasing the age at which people retire can be achieved either through rules or incentives. The latter is the option best suited for maintained welfare state support as it lets each individual trade off leisure against consumption according to their own preferences. Disney (2003) reports that pension reforms in this direction have already been undertaken in many countries. In particular, the Swedish reform undertaken in 1998 means that pension benefits are adjusted actuarially to the (within limits) freely chosen retirement age, resulting in strong economic incentives to defer retirement until later in life. Pension reforms aiming at increasing the retirement age have also been undertaken in high tax countries like for example Belgium and Finland. Norway has been slower in this area, but in May 2005 the Norwegian parliament agreed on a reform including among other things a benefit adjustment factor to account for changes in life expectancies at age of retirement.

Sweden and to a slightly lesser extent Denmark and Finland still have substantial problems caused by weak work incentives in the short run. The combination of high taxes on labor, generous unemployment benefits and income-tested benefits creates high marginal effective tax rates – see Lindbeck (1994). Since Sweden drastically lowered tax progressivity in the early 90s, work disincentives now typically appear for low-income earners, mainly due to the means tested nature of social assistance – see Bergh (2004b).

To sum up: By reforming pension systems, many welfare states have begun to handle problems caused by low work incentives in the long run. Reforms aiming to increase short-run work incentives are currently at the heart of the political debate in the welfare states.

4.3 Topping up

As already noted, health care services are normal goods with income elasticity higher than one. This means that as the population in a welfare state grows richer, the demand

can compete for work in Sweden, has triggered some spectacular conflicts on the Swedish labor market (see http://www.eiro.eurofound.eu.int/2005/01/feature/lv0501101f.html).

for these services will increase, and more so among those who are relatively richer. Thus the difference in the absolute spending level desired by high-income earners and low-income earners will increase over time.

Maintaining the current level of benefits per capita when the ratio of old to adults increases requires higher taxes. Therefore, it will be very difficult to publicly finance an even higher level demanded by high income owners universally for the whole population. Thus, politicians must make a choice between allowing citizens to top up public funds with private money, or having citizens paying twice in order to attain the level of services they prefer: once by paying taxes, and once again to a private provider when topping up is not allowed.

A fundamental insight gained from our analysis is that political support for the welfare state is bigger when topping up is allowed compared to when people must pay twice. Theoretically, we expect welfare state support to decrease among those who feel that paying twice is the best way to attain desirable level and quality. This has also been verified empirically by Hall and Preston (1998) who showed that people who opt out from publicly provided health care and pay for private health insurance support less spending on the public system. This is one reason why the status quo strategy may work only in the short run: as more people prefer to pay twice, public welfare state support is jeopardized.

When topping up is allowed, those who desire to do so can increase the service level by adding private money on top of the public funding. This means that a smaller share of the taxes paid by the upper middle class is redirected to consumption by other groups.[10]

Topping up can not only complement publicly provided services, it can also complement monetary social insurance transfers of the Bismarckian type where incomes are replaced proportionally. In this case, topping up means increasing the effective replacement rate from the publicly provided level towards full insurance. Topping up alleviates the negative level-effect on welfare state support for the following reason. Mandatory social insurance with replacement rates close to 100 percent means that people who have low demand for insurance (because they have low risk aversion or low risk for income losses) are forced to consume more income protection than they otherwise would. If the mandatory replacement rate is lowered, people may complement protection up to the desired level, either individually through market insurance or group-wise through occupationally negotiated insurance schemes. Ståhlberg (2003) shows that the latter solution is indeed already well established: occupational contracts cover almost the entire working population, and as expected the details and conditions vary between groups.

Because they are mandatory, social insurance schemes can avoid costs of advertisement and also the costs associated with identifying risk groups. Empirically, it has also been shown that social insurance typically has lower administration costs than private insurance – see for example Gouyette and Pestieau (1999). For this reason, it may well be the case that the most preferred alternative for many voters is the combination of social insurance and private topping up, and this alternative may be strictly preferred to a system based only on market insurance, as well as to a system based only on social insur-

[10] Recently, public policy documents show that the Nordic welfare states are indeed facing exactly the strategic choice described here – see for example the Swedish Långtidsutredningen 2003/04, SOU2004:19.

ance. In fact, Bergh (2003) shows that topping up contracts can induce high income earners to support social insurance in situations when they would otherwise favor pure market insurance over social insurance without topping up.

Summing up, it has been shown that, perhaps contrary to popular belief, allowing for topping up of both public consumption and social insurance will in many situations increase political support for the welfare state. Furthermore, topping up is already very common in the Nordic welfare states.

4.4 Vouchers, private providers and profits

Using vouchers is a way of maintaining public financing while giving the citizens of the welfare state bigger influence over the service provided. Blomqvist (2004) describes the so called "choice revolution" in the provision of public welfare services in Sweden, which in addition to vouchers also contained the use of quasi markets such as purchaser/provider arrangements.

An increased use of vouchers can be seen as a way to dampen the negative effects on welfare-state-support caused by the in-kind effect, by giving people more freedom to choose what services to consume. Note that the opportunity to choose more freely may be appreciated and used only by a small part of the population – but if these are the voters who would otherwise stop supporting the welfare state, the use of vouchers may well be the policy that marginally secures majority support.

Indeed, the standard result from studies of voucher systems in practice is that the freedom to choose is used initially by very few, but that this share is constantly growing over time – see for example Edebalk and Svensson (2005). Also, for education, child care and health care, user satisfaction is higher among those who have chosen private providers compared to those who have chosen public providers.[11]

The pattern that private providers initially play only a small role, but that their share is slowly growing, is confirmed by Blomqvist (2004), relying mainly on data from a public expert commission report (Socialdepartementet, 2002):[12]

- the share of privately employed health-care staff increased from 5 to 7 percent between 1993 and 2000
- the share of privately employed workers in the elderly care sector grew from 2 to 13 percent between 1993 and 2000
- the share of children in publicly funded private day care facilities grew from 5 to 15 percent between 1990 and 1999
- by 2002, ten years after the introduction of school vouchers, the share of students attending publicly financed private schools had grown from 0 to 5 percent for primary schools and 6 percent for secondary schools.

[11] For elderly care, the difference is insignificant – see www.kvalitetsindex.se, used by the Swedish government in Långtidsutredningen 2003/04.

[12] Again, these trends are not limited to Sweden. For example, Edebalk and Svensson (2005) analyze customer-choice for elderly people and persons with functional disabilities, recently implemented in all of the Nordic countries. In some Swedish municipalities the process started as early as the early 1990s, but currently Denmark, with a nationally regulated customer-choice system since 2003, is the most progressive of the Nordic countries.

Furthermore, the share of private providers is typically higher in urban areas and in high-income municipalities. Also, parents with high income and high education are more likely to use the possibility of sending their children to a privately provided school (Blomqvist and Rothstein, 2000). Importantly, this shows that the increased freedom of choice is used more by citizens whose welfare state support is negatively affected by the in-kind effect and the level effect described in section 3. Also, as reported above, the highly educated constitute an increasingly mobile group of tax-payers. This leads to the conclusion that vouchers and similar reforms change the way the welfare state has traditionally been organized, but at the same time they alleviate some problems related to tax mobility and political support.

The market orientation has at least two additional effects. Even if voucher systems keep the public financing of welfare services, their introduction changes the political power structure in several ways: Blomqvist notes that further privatization may be accelerated by the dynamics set in motion by consumer choice, and that private provision of welfare services may lead to increased pressure for private financing as well. This argument is not new. In fact, an old article in the the *Cato Journal* describes exactly such an incremental strategy for social security privatization – see Butler and Germanis (1983).

However, some mechanisms point to the opposite conclusion. Vouchers and quasi markets may actually lead to increasing support for publicly provided welfare services. Competition and organizational experimentation speeds up the learning process, so that efficient ways of producing welfare services are spread more rapidly. Theoretically there should be positive effects of competition not only for private providers, but also in public units who have incentives to increase quality in order not to lose funding because people choose private providers instead. Studying the Swedish school voucher reform, Sandstrom and Bergstrom (2005) found empirical support for this hypothesis, and conclude that competition has a positive effect on school results in public schools.

Thus, market reforms such as vouchers and quasi-markets may affect the power structure and lead the way towards further privatizations, but to some extent this effect is counterbalanced by the fact that market reforms impose strong efficiency incentives for the whole public sector, which may dampen discontent with high taxes in marginally important groups of voters.

4.5 Result: Constant support for the welfare state

According to surveys, the support for public welfare expenditure in Sweden has been constantly high and possibly increasing during the period from 1981 to 2002 (Svallfors, 2004). As expected, these surveys clearly show that socio-economic groups with higher incomes report lower welfare state support.

More interestingly, welfare state support is constant or increasing over time for each socio-economic group. If no changes were made to the welfare state, we would expect the four challenges to induce decreasing support for the welfare state among high income earners. Instead, as result of gradual adaptation, high income earners, highly educated and relatively more mobile groups have benefited from several reforms, resulting in maintained political support for the welfare state.

The table below summarizes the challenges and the responses according to the strategy of gradual adaptation.

Table 3 Policy responses to welfare state challenges according to gradual adaptation

Challenges	Policy responses
Increased mobility of tax bases decreases possibilities for a majority to extract large amount of tax revenue from a minority without a substantial negative effect on the tax base.	Increased reliance on less mobile tax bases. Decreasing tax-progressivity. Selective compensation measures. Tying benefits closer to taxes.
Ageing population requires higher taxes and/or lower benefits per capita	Pension reforms increasing work incentives. Increased use of private topping up in care for elderly.
Increased efficiency of private insurance markets means that the market alternative to social insurance will become more attractive for those with risks below average.	Topping up of social insurance. Decreasing vertical income redistribution in social insurance schemes.
Increased expectations on publicly financed create a demand for private solutions, where people who pay twice support lower public spending.	Introducing freedom of choice through vouchers. Increased efficiency through competition. Allowing, simplifying or encouraging topping up of public consumption.

Source: Author

5 Distributional consequences

Clearly, the gradual adaptation of the universal welfare state implies a slightly lower degree of redistribution. But if the gradual adaptation strategy means that fundamental welfare state universality is maintained, the outcome is probably more egalitarian than the counterfactual situation that would arise if universality were replaced with a basic or a targeted welfare system.

The main reason for this is that the strategy of gradual adaptation keeps the most important redistributive mechanisms of the universal welfare state intact. For example, as pointed out by Rothstein (1998), the combination of proportional taxation and flat rate benefits creates a substantial amount of redistribution even in the absence of tax progressivity. Thus, fewer tax-brackets and lower marginal top rates do not necessarily indicate lower redistribution.[13] The redistribution of the welfare state depends on both progressivity and size of the welfare state (Åberg, 1989), and gradual adaptation trades off progressivity in order to maintain political support for a big welfare state.

Recent research also points to public expenditure on education as an important redistributive mechanism of the welfare state. While this effect does not show up when re-

[13] It should also be noted that a formally progressive tax schedule may be less progressive in practice, if there are deductions and exceptions which can be used by tax planning – see Agell, Englund, and Södersten (1996).

distribution is described using the standard approach of comparing Gini coefficients for gross and net income distributions, Sylwester (2002) showed that countries with higher education expenditure in the 1960s experienced lower inequality ceteris paribus 20 to 30 years later, and Meghir and Palme (2005) show that primary school reform in Sweden in the 1940s had a big negative effect on subsequent income inequality. When topping up is allowed, the upper middle class has an interest in maintaining a high quality of public schools: the higher the quality provided by the public level, the less will be spent on topping up by those who want to pay for even higher standards.

Another important mechanism for redistribution in the Nordic welfare states is the Bismarckian social insurance systems, where income losses are replaced proportionally. These systems create redistribution when income and risk are negatively correlated, which is typically the case for short term income losses such as illness. An illustration of this is given in Figure 3, which shows that sick leave in Norway is lower in occupations with higher salaries. For this reason, upper benefit limits have a relatively small redistributive effect, as indicated in figure 2b. Here, benefits and contributions to the Swedish sickness benefit system are described using data from the National Social Insurance board, with and without the upper limit.[14] As we can see, the net redistribution goes from high to middle-income earners, regardless of the upper benefit-limit.

Finally, topping up in itself have some interesting distributional consequences. When citizens are not happy with the level or quality of publicly provided welfare services, there are many ways to compensate. Even without monetary topping up, parents can for example participate in public child care and help on a voluntary basis in primary schools. In health care and care for elderly, the reliance on voluntary contributions is typically bigger. Thus, when monetary topping up is not allowed, people compensate through unpaid voluntary work.

When analyzing the distributional impact of allowing topping up, one must take into account people's varying capacities to complement welfare services with unpaid work. Allowing monetary topping up is beneficial for high income earners because the opportunity cost of their time is higher. On the other hand, monetary topping up is also relatively more important for people with lower degree of work flexibility, i.e. who find it more difficult to take the afternoon off in order to help out at school.

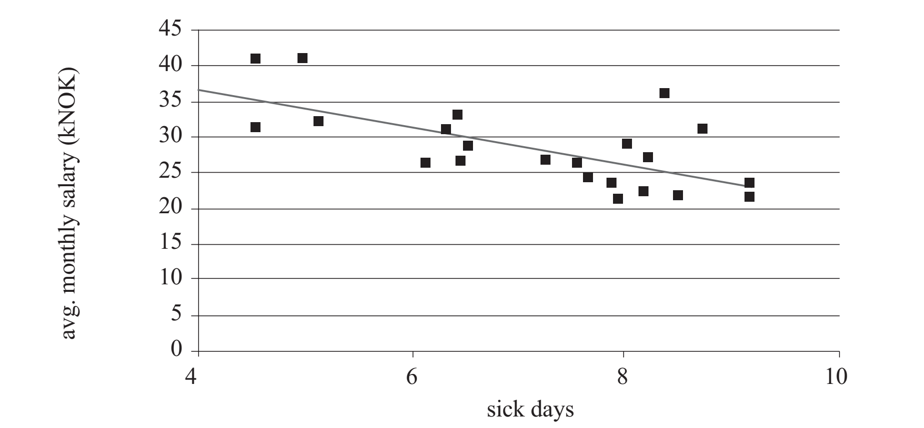
Thus, policy makers in the welfare states are faced with a difficult choice. Many of the policy measures that seem necessary to retain support for the welfare state in the long run are likely to lead to increased inequality in the short run. But a status quo strategy trying to preserve the old welfare state institutions may in the long run induce political support for a very different type of welfare state. For this reason the strategy of gradual adaptation is likely to be the preferred choice also among egalitarian policy makers.

6 Concluding Discussion

The four challenges analyzed in this paper have not led to the death of the Nordic welfare state – but they have led to a number of important changes.

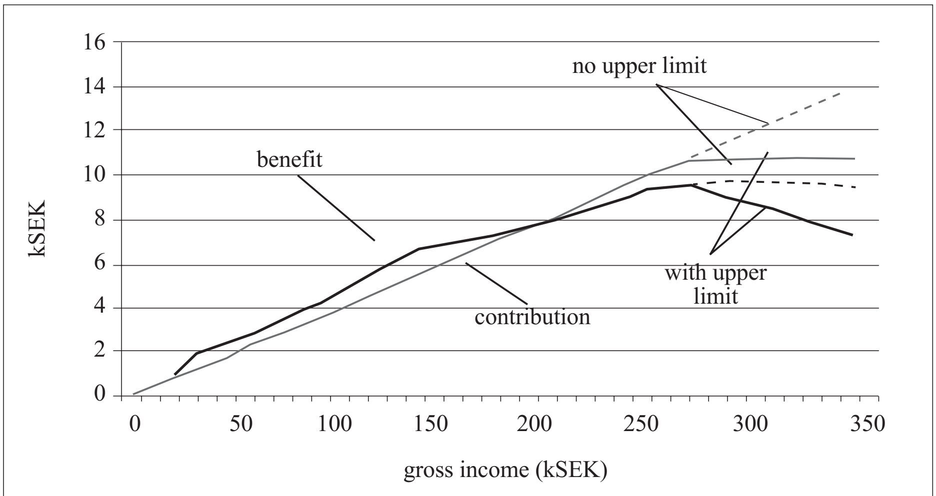
[14] Calculations are static, i.e. they do not include potential behavioral effects of removing the benefit limit.

Figure 3 Redistribution in Bismarckian social insurance



Source: Statistics Norway. Thanks to Geir Ivar Andreassen for assistance in providing data.

Figure 3a Redistribution in Bismarckian social insurance



Source: Calculations based on RFV (1995, 1996). Assumptions: The replacement rate is 80 percent for all incomes below 7.5 basic amounts (approximately 275 kkr). The insurance is financially balanced by a mandatory fee at four percent paid on all incomes below the upper benefit limit. This is an approximate description of Swedish sickness benefit in the 1990s.

- Labor is still immobile in Europe – but higher mobility seems to put a limit on tax progressivity.
- The populations are ageing – but at least some of the years gained are healthy years, and substantial steps have been taken to increase long-run work incentives.

- Private insurance markets are gaining ground in many areas – but politicians can respond with actuarial reforms, decreasing the amount of vertical income redistribution and allowing topping up.
- Finally, expensive expectations for publicly financed private consumption such as health care, schooling, child care and elderly care is handled by allowing (and sometimes even relying on) a mixture of public financing and private efforts in terms of both money and unpaid work.

Historically, the strategy of ensuring that the middle class supports the welfare state fits very well with the strategy used by the social democrats when the welfare state was under construction. Berman (1998:382) notes that the social democrats at the turn of the century were careful to address not only the proletariat or manual workers but instead addressed "Sweden's working people" or "all progressive citizens in the city and the country". Later, Svensson (1994) shows how the welfare program of the 60s was designed to fit the needs of white collar workers, indicating that social democrats were now addressing 'wage-earners' rather than 'workers'.

In the well-known framework of Esping-Andersen (1990), the Nordic welfare states are described as social democratic. Other authors have used other labels, such as encompassing, institutional or universal, but as shown in Bergh (2004b), these various labels all refer to roughly the same thing: the welfare state as it looks in the Nordic countries. A consequence of the gradual adaptation described in this paper, is that these welfare states are changing, and becoming more heterogeneous. Sure, the Nordic model as it existed in the year 1980 was arguably dead only 20 years later. On the other hand, the ability to change and adapt is also the ability to survive. Oppenheim (1997) summarizes the development eloquently:

"Finally, universal welfare state services are the cornerstone of the post-World War welfare settlement. Universalism remains important. […] However, welfare policies have to create unities of interest between the majority and the poor within a context of sharpening inequalities. Thus, it is not the universalism of the 1940s, but one which allows for diversity and combines universal membership and individual autonomy. It would open up the possibility of different contributions for different benefits and the tailoring of services for a variety of needs. Above all it promotes inclusion over and above strict equality in order to retain broad public support."

As has been shown, the changes made so far seem to have been sufficient to maintain political support for the Swedish welfare state, and represent a good candidate for explaining the persistence of a welfare model many times predicted to collapse. Whether similar changes are sufficient also for future challenges only time will tell.

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