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Expansionary effects of the welfare state in a small open economy

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Abstract

We examine the relationship between welfare state policies and economic performance in a small open economy with (i) free trade in final goods and international capital mobility, and (ii) aggregate increasing returns to scale. Contrary to the conventional wisdom, we find that a retrenchment of welfare programmes is not an inevitable consequence of economic integration. Instead, by improving the exploitation of aggregate scale economies, social expenditure policies and international openness complement each other in facilitating an improvement in economic performance that can sustain a more generous welfare protection.

JEL classification: E6; F1; F4; H3; J5

Keywords: Welfare state; Circular causation; International trade; Capital mobility

1. Introduction

The aim of this paper is to shed light on the contentious question of the compatibility between welfare state and globalisation which, despite its colossal policy importance, is still fairly unexplored at the theoretical level. In the last two decades, welfare state policies have come increasingly under attack by an emerging consensus that sees them as being inimical to economic growth and incompatible with successful participation in a highly integrated world economy. Two major arguments characterise this conventional wisdom: (i) the distortionary effects

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of redistribution policies and the taxation necessary to finance them translate into high firms' costs—this is the 'efficiency' argument developed, for instance, by Alesina and Perotti (1997); and (ii) the revenue raising capacity of governments is hindered by increasing economic integration, thus making it more difficult for them to finance these policies. From a normative point of view, the main implication of this view is the inevitability of welfare state retrenchment. However, despite the rhetorical calls for change (which have not been limited to centre-right governments), there is very little evidence that the increased extent of goods and capital market integration during the last few decades has contributed systematically to the rolling back of mature welfare states, and reforms have generally been limited to a restructuring of expenditure.[1] Furthermore, empirical evidence exists pointing to a positive relationship between welfare state and openness (Rodrik, 1998) and welfare state and competitiveness (De Grauwe & Polan, 2005).

In this paper we develop a theoretical model that shows that international openness does not inevitably reduce the revenue raising ability of governments. Our framework is inspired by Alesina and Perotti's (1997) contribution; contrary to their findings, however, we show that openness can complement welfare state policies in improving economic performance and enhancing welfare. At the core of our argument lie the imperfectly competitive nature of markets and the fact that in a second best world economic policy can be used to correct the effects of market imperfections.[2] As in Alesina and Perotti, our model is characterised by imperfect competition in the labour market (in the form of unionisation); however, the input–output structure with a monopolistically competitive intermediate sector assumed here gives rise to aggregate increasing returns to scale. We show that social security programmes can lead to higher levels of economic efficiency by improving the exploitation of potential aggregate scale economies.[3] This channel is particularly relevant in mature industrial countries where unprecedented depths of the division of labour have resulted in highly complex economic systems and production externalities. We argue that the acknowledgment of these externalities – whose effects on the economy may not be easily predictable – is essential for any meaningful debate about the sustainability of social expenditure and welfare state programmes. Our findings challenge the view that free trade and capital mobility undermine governments' ability to pursue income redistribution policies. We show that, by enhancing the exploitation of aggregate scale economies, a more generous welfare state increases overall welfare regardless of the tax instrument used to finance the policy, even when (in the presence of capital mobility) the policy is financed through an increase in capital taxation that may initially stimulate a capital outflow. The rest of the paper is organised as follows. Section 2 outlines the model, Section 3 describes the general equilibrium and carries out the policy analysis, and Section 4 draws some conclusions.

[1] Despite wide cross-country variations in spending levels, social expenditure in OECD countries, with the exception of Norway, has increased up to the mid-1990s and whilst some areas of social protection have modestly declined, others have enjoyed stability or even a slow growth (European Commission, 2002).

[2] The macroeconomics literature has devoted comparatively little attention to welfare states and redistribution policies and has mostly shown how conventional tax-and-spend policies can reduce inefficiencies stemming from market imperfections—e.g., Devereux, Head, and Lapham (2000). Amongst the exceptions, van der Ploeg (2003) examines the effects of social policy on employment and growth and shows that conditional unemployment benefits may spur job creation.

[3] In Acemoglu and Shimer (2000), unemployment insurance improves allocative efficiency by enabling workers to pursue riskier and more productive options. In De Grauwe and Polan (2005), social expenditure affects workers' productivity by entering directly the production function of the private sector. In our model, the effects of government policy on aggregate efficiency emerge *endogenously* and do not result from an *a priori* link between social transfers and productivity.