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Growing Public: Is the Welfare State Mortal or Exportable?

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ABSTRACT

The welfare state is not an endangered species among the industrialized OECD countries. There is no race to the bottom.

OECD experience since 1980 does not show any negative effect of larger tax-financed transfers on national product. There are good reasons for this “free lunch puzzle.” High-budget welfare states feature a tax mix that is more pro-growth than the tax mixes of low-budget America, Japan, and Switzerland. The high-budget states also have more efficient health care, better support for child care and women’s careers, and other features that mitigate the negative incentives on transfer recipients.

Experience from the 1980s and 1990s suggests how population aging and the pension crisis will affect government budgets in this century. The countries with the oldest populations had already begun to cut the relative generosity of their transfers to the elderly per elderly person. They did not, however, cut real benefits or the shares of public pensions or other transfers in GDP. Pay-as-you-go programs for the elderly are sustainable, with parametric adjustments. Historically they have proved as durable as “reformed” or “privatized” systems in the experience of Britain, Chile, and the United States.

Several developing countries already transfer high shares of their national product. Of these, only some formerly Communist countries of Central and Eastern are likely to remain welfare states under democracy. By contrast, few Third World countries will become welfare states anytime soon. Their tax-transfer systems are often regressive, subsidizing public elites. Hopefully, the regressive transfers can be replaced by more egalitarian systems as political voice and prosperity slowly spread.
Governments all over the world now tax and transfer large shares of national product. Even governments in low- and middle-income countries tax and transfer more than any government did before the twentieth century. Have today’s social transfers raised or lowered the growth of national production? Have they raised or lowered economic inequality?

The mainstream view sees a trade-off between growth and equality. On this view, Europe’s welfare states and the governments of many low-income countries have equalized incomes at a cost in terms of national product, relative to the alternative of keeping taxes and transfers as low as in the United States or Japan. I read history differently. The experiences of the rich countries seem to show that Europe’s welfare states have equalized incomes and improved life expectancy at zero cost in terms of national product. The tax and transfer systems of lower-income countries or may not have sacrificed some national product, but not on the altar of equality. On the contrary, many of their social transfer systems, and the taxes behind them, have worsened economic inequality. Robin Hood has suffered many defeats in today’s developing countries, as well as in European history.

The road to these conclusions needs to start by clarifying what I mean, and what I do not mean, by social transfers and the welfare state. Social transfers consist of these kinds of tax-based government spending:

- basic assistance to poor families, alias “poor relief” (before 1930), “family assistance,” “welfare” (in America), or “supplemental income;”
- unemployment compensation, alias “the dole;”
- public pensions, excluding those for government and military employees;¹
- public health expenditures; and
- housing subsidies.²

Such tax-based transfers tend to redistribute income somewhat progressively. Their progressivity is not uniform or easily measured, however. I define a welfare state as a country resembling those European countries the media often call welfare states. These countries devote 20 percent of GDP or more to social transfers, and that 20 percent threshold conveniently, though arbitrarily, defines a welfare state for present purposes.³

The welfare state does not include any direct market controls by government, such as worker protection laws, high minimum wages, import barriers, or government regulation or ownership of industry. This exclusion is important to my conclusions about growth, since related research confirms that there are negative growth effects from some kinds of direct market interventions. Among welfare state transfer programs, only unemployment compensation has a negative effect on national product, and this limited effect is offset by the pro-growth effects of other kinds of social transfers (Lindert 2004, vol. 2, Chapter 19; Allard and Lindert, in progress). More specifically, the road leads to the following conclusions:

1. The welfare state is not an endangered species among the industrialized OECD countries. Since 1980, social transfers have continued to take a slowly rising share of GDP in most OECD countries. There is no race to the bottom.

2. OECD experience since 1980 does not show any negative econometric effect of larger tax-financed transfers on national product.
There are good reasons for this. High-budget welfare states feature a tax mix that is more pro-growth than the tax mixes of low-budget America, Japan, and Switzerland. The high-budget states also have more efficient health care, better support for child care and women’s careers, and other features that mitigate the negative incentives on transfer recipients.

We can use OECD experience from the 1980s and 1990s to judge how population aging and the pension crisis will affect government budgets in this century. The countries with the oldest populations had already begun to cut the relative generosity of their transfers to the elderly per elderly person. They did not, however, cut the average shares of public pensions or other transfers in GDP, nor did they lower the absolute real value of the average pension.

Transfers to the elderly will be under more severe pressure in some countries than in others. On the pension front, perhaps the biggest trouble is brewing for Italy and Japan. On the health care front, the United States is in the most trouble, with its combination of unregulated markets and socialized medicine aimed at the elderly alone.

Several developing countries already transfer high shares of their national product. Of these, only some formerly Communist countries of Central and Eastern Europe are likely to remain welfare states under democracy. By contrast, few low- or middle-income countries will become welfare states anytime soon. Their tax-transfer systems are often regressive, subsidizing public elites. Hopefully, the regressive transfers can be replaced by more egalitarian systems as political voice and prosperity slowly spread.

**Little Retreat since 1980**

As an economic species, the welfare state has shown strong survival instincts in the countries where it emerged in the twentieth century. Within the expanding OECD, the number of welfare states is stable or expanding. Since 1980, these exits, entries and borderline cases have stood out:

- Ireland definitely left the ranks of welfare states on the 20-percent yardstick.
- Switzerland took Ireland’s place in the late 1990s, silently becoming a welfare state with major increases in pensions and public health.4
- Others are approaching the 20-percent borderline from above and from below. The Netherlands dropped down to the border, with major cuts in its disability and other programs after 1995. Japan is approaching welfare state status, now transferring over 17 percent of national product.
- In Eastern Europe, at least the Czech Republic, Hungary, and Poland are preserving their welfare states, first through the depression of the 1990s and though subsequent prosperity.
- Six other OECD countries continue to hover near the 20-percent borderline -- Australia, Canada, New Zealand, Portugal, Spain, and Britain.
The “Free Lunch Puzzle”

The welfare state’s survival over the last quarter century has puzzled many observers. Don’t tax-based social transfers dampen the incentive to be productive, dragging down the growth of the economy? This fear rests on some familiar and plausible suspicions about taxes and transfers. We often suspect that tax and transfers cut the productivity of both the taxed and the subsidized, since both sides face higher marginal tax rates of exerting themselves productively. Many have also suspected that welfare states tend to run bigger government budget deficits.

Yet experience from the late nineteenth century to the early twenty-first fails to support these common suspicions. So say the numbers, both when you look at them in the raw and when you statistically measure the different forces that determine economic growth. There is no international correlation at all between the share of social spending in the economy and either the level or the growth of GDP. Of course, places differ in other ways than just in their views of taxes and welfare, so we need an econometric analysis that gives many forces their due. Several economists have performed such tests, and most have found no robust or significant negative effect of higher social transfers on GDP per person. The effect could just as easily be positive, say the majority of tests, with a zero effect near the center of the confidence interval.

Before we accept this null result, the past literature needs to be re-shaped to fit the issue of social transfers and the welfare state. Three key refinements concern the choice of fiscal variable, simultaneity, and non-linearity. First, no past study showing a negative growth effect in a large sample has ever used social transfers as the fiscal variable. Rather, they used total government spending or total taxes, so that any kind of unproductive government consumption, unrelated to the welfare state, could appear to drag down growth. Second, very few of the studies addressed the simultaneous feedback from GDP itself to social spending. Finally, the literature has generally failed to test for the non-linearity of the costs of taxes and transfers. Since conventional theory clearly predicts that costs should rise non-linearly with the rate of taxation and transfers, the statistical tests must allow for this curvature. Elsewhere, I have presented test results honoring all these commitments. In all the new tests, as in most earlier studies, the welfare state looks like a free lunch, for the nation as a whole.

Facing facts like these, someone believing in a high cost of the welfare state has a tough choice to make. One can be strong, standing by long-held beliefs and demanding alternative econometric tests until one of them forces the data to confess. Or one can be weaker, and retreat in the face of the apparent facts. The more promising road is to accept the statistical verdict, and then explore how that could be true. In fact, there are good reasons why the net cost is probably zero, when you look at how welfare state run in the real world.

How Can That Be?

The Key: Imagined Blunders versus Real-World Policies
The usual tales about the high incentive costs of the welfare state are based on a compelling economic logic. The logic might have been borne out in the real world if governments had blundered by simply taxing capital and entrepreneurship and effort heavily, while offering young adults the chance to avoid a lifetime of work with a near-wage benefit. Yet the overriding fact about such blunders is that they never happened. Only if we extend the econometric estimates out into a world that never happened, a blundering world that taxes 40 percent of capital and top incomes and pays people who never work, would some of the estimated equations predict those high cost of foolish policy. Within the range of true historical experience, there is no clear net GDP cost of higher social transfers. The econometric evidence suggests -- though it cannot yet quantify -- major roles for the following institutional and historical facts.

The Welfare-State Tax Mix Looks Better for Growth

A closer look reveals that the high-budget welfare states actually favor types of taxation that mainstream economists think are better for economic growth (Wilensky 2002, Kato 2003, Lindert 2004, Timmons 2005). To see how their choice of taxes departs from some common beliefs about the sloppy and bloated welfare state, consider the kinds of taxes shown in Exam Question #1.

**Exam Question #1**

Which of the following tax rates is not higher in big-government welfare states than in a small-government country like the United States?

- (a) tax rate on corporations, capital, and top property incomes
- (b) tax rate of labor income
- (c) tax rate on general consumption (like sales tax)
- (d) sin taxes (on tobacco, alcohol, gasoline)

Many think of the welfare state as a place where big government soaks the rich, taxing corporations, capital, and top property incomes so heavily that many of them try to take their money out of the country. Not so. The correct answer in Exam Question #1 is answer (a), that the welfare states do not tax corporations or capital or top property incomes more heavily than low-social-budget countries like the United States or Japan. One might have been mislead on this point back in the 1970s or 1980s when reading news that the top income tax rates were very high in, say, Sweden. Yet even back then corporations and the richest seldom paid the top statutory rates, thanks to a host of deductions and loopholes. And since the early 1990s Sweden and other European countries have simplified their tax systems so as to levy lower top tax rates.

If the high-budget welfare states don’t tax corporations, capital, and top property incomes any more heavily than does the United States, what other taxes do they levy to pay for those bigger social budgets? For one thing, they do levy higher taxes on the human earnings of everybody from janitors up through doctors and lawyers, labeled as “labor income” in answer (b). This kind of tax could by itself have negative effects on economic growth. Yet North American economists, when polled on the subject of taxation, feel that taxing labor income is definitely better for economic growth, because
labor supply is less sensitive to taxation than in capital supply. One should also note that the heavy taxes on labor bring the tax burden to rest on the same income groups that vote in favor of the welfare state. To a large extent, workers themselves pay for the safety nets designed to protect the least fortunate among them.

Welfare-state governments also levy heavier taxes on general consumption, the kind of levy mentioned in answer (c). Such taxes, in the efficient form of a European “value added tax” (VAT), are favorites among economic conservatives. They have the pro-growth virtue of not double-taxing savings. It is striking that this pro-growth kind of taxation takes a bigger tax bite in the welfare states of Europe than in the United States, where conservatives have traditionally called for it.

Finally, it is the welfare states, especially those in the Nordic countries, that have the heaviest “sin taxes.” Again, they have chosen taxes that mainstream economists would defend. Such addictive products as alcohol, tobacco, and gasoline, bring negative externalities to society, in the form of bad health and bad air. How does relying on these kinds of taxes harm economic growth and well-being? Yet these are the kinds of taxes that are kept lower in the United States.

**Their Work Disincentives are Not Much Worse**

It is natural to fear that the welfare state, in addition to taxing those who work, also discourages work by transfer recipients. Giving generous unemployment compensation seems like the most obvious example of a policy that cuts jobs and output by subsidizing non-work. It turns out that this fear is qualitatively correct, but the effects on GDP are small enough to be outweighed by the favorable effect of other welfare state transfers on GDP.

More generous unemployment compensation does indeed cut the share of adults who work. A rich econometric literature has made this point, and our latest tests agree. But by how much does it cut GDP? The solid findings on the work losses from raising the level of unemployment benefits miss the mark here, for at least two reasons. For a start, they usually focus on the simple “replacement ratio,” the ratio of a standard unemployment benefit to the average wage rate. Users of this key parameter of unemployment compensation miss these facts: Only a fraction of the unemployed qualify for such standard benefits, only a further fraction of those who qualify actually claim the benefits, and these in turn draw benefits only for a fraction of a year. When we multiply the replacement ratio by the fractions covered and paid, the effective rate of unemployment compensation actually moves in a lower and narrow fractional range. Between 1975 and 1998 the well-known replacement ratio for core OECD countries averaged 34 percent of an average wage, with a standard deviation of 15 percent. Yet the more relevant measure of the effective rate of unemployment compensation averaged only 13 percent of the wage, with a standard deviation of 8 percent. So instead of imagining the job effects of two-deviation jumps in the replacement ratio from, say, 30 percent to 60 percent of an average wage, we should be measuring the effects of a jump from 13 percent to 29 percent.

A second difficulty with the usual thought experiments is that they stop with estimating effects on jobs, with no extension to GDP effects. Yet we know that any labor-supply restriction cuts output less than it cuts employment, while raising labor productivity. That would happen ever if labor were of uniform quality. Add to this the
fact that unemployment compensation typically looks attractive only to persons with below-average earning potential, leading to a further rise in output per worker. All things considered, unemployment compensation has only a small effect on GDP.

While many observers over-estimate the percentage effects of classic unemployment compensation on GDP, they also overlook the way in which basic family assistance, alias welfare, is often designed to avoid discouraging work. The unemployed are given retraining and job search help, and are pressured to take it. To illustrate how a higher-budget welfare state has actually given some people more incentive to take a job, consider the case of jobless single mothers. The realities of recent history on this front are illustrated by Exam Questions #2.

Exam Question #2

In which case was a poor single mother given the least incentive to get a job?
   (a) U.S.A. under Reagan
   (b) U.S.A. under Clinton
   (c) Britain under Tony Blair today
   (d) Sweden’s welfare state today

What has given poor single mothers the least incentive to work has been a policy environment that takes away their welfare and other public benefits as soon as they get a job. What would make a country actually do that, and face such women with a huge marginal tax rate? The desire to keep welfare expenditures very low, so that no one person above the poverty line gets any aid. Such penny-pinching, known as strict means testing, was practiced by the conservative Thatcher-Reagan revival of the early 1980s. Hence (a) is the correct answer to Exam Question #2.

Later on, bipartisan reforms in the Clinton years improved work incentives at the bottom of the U.S. income spectrum. The first improvement came when the Earned Income Tax Credit (EITC) was made more generous in 1993. That, and accompanying adjustments of state-level benefits, gave jobless single mothers a stronger incentive to take that first low-paying job and get started on an employment history. Then the 1996 welfare reform added a tough-love dimension by setting term limits on welfare. The combination of the two has decreased welfare caseloads without raising poverty, even after the recession of 2001-2002. Meanwhile, Britain under Tony Blair made a similar reform to the EITC, undoing the strict means testing of the Thatcher era. And a welfare state like Sweden never had such a heavy tax on getting a first job, because family benefits were retained when one got a job, and the tax rate on extra earnings remained moderate.

Investing in Women’s Careers

The welfare states also gain jobs and productivity through public policies that invest in career continuity and skills accumulation for mothers. This matters a lot, now that such a large share of women’s adulthood is career-oriented. Welfare states provide paid parental leaves and public day care with qualified providers. While it is not easy to estimate the gains in productivity from micro-data, there is at least one aggregate sign of strong gains: Women
in such countries have market wage rates that are much closer to wage rates for men in the United States or Japan or Switzerland (Lindert 2004, Chs. 10, 11).

Public Health: Uncle Sam’s Achilles Heel

The strongest pro-growth dimension of social transfers occurs in public health, the social sector where reliance on ordinary market mechanisms breaks down most frequently. The best international evidence on this front comes from the regrettable experience of a single outlier nation, the United States.

Americans die younger than people in countries that have a greater share of their health expenses paid for by taxes. We rank 19th out of 20 rich countries in life expectancy. Not all of this is due to our health care system. Americans have worse health habits and slightly more pollution exposure. Our health habits are world famous -- especially bacon double cheeseburgers, fries, Krispie Kremes, double lattes, and a high homicide rate. Yet when you weigh all the separate effects statistically, the health care system looks guilty of causing a significant part of our early death (e.g. Or 2000).

And the more private system costs much more. Part of the extra expense of American health care is a justifiable purchase of higher-quality care, a tendency that the rest of the world will soon emulate. Part of it, though, consists of higher bureaucratic costs. Contrary to the usual rhetoric assuming that bureaucracy means government bureaucracy, the private health insurance sector in the United States imposes greater administrative costs trying to keep people from being insured and compensated than other countries spend administratively on providing public care to all. The World Health Organization has ranked the United States 37th in the quality of health care delivery. Obviously, we have the best cutting-edge medical care in the world. But few can afford it. Little wonder that in recent surveys of opinions about health care, Americans were more dissatisfied about their health care than were people in most other surveyed countries. The locus of the American health care problem is not the public sector as such. Rather it centers on this country’s peculiar combination of unregulated markets and the lobbying power of an increasingly expensive demographic group, the population over age 65.

Only time will tell whether the United States can escape the trap of its overworked health care system. Canadian history suggests that in a federal system, the reforms would have to come from below. Over half a century ago, Saskatchewan and other provinces took the lead in universal health insurance, long before the federal government stepped in. Perhaps innovative states could lead the United States toward the healthy heresy of extending “socialized medicine” to the under-65 population.

Europe’s Policy Defects

If the American approach of relying heavily on market mechanisms is at its worst in the health care sector, Western European growth and well-being have been dragged down by two other policy failures.

One of these European shortcomings is evident in higher education, the social sector that is most removed from the poor, the sick, and the elderly. Higher education calls for a wise mixture of market competition and limited public subsidy. Here the United States and Canada have chosen a better institutional mix than Western Europe or Japan. North American government subsidies for higher education seem to approximate the (hard to measure) amount appropriate to the fact that higher education does bring
some “external” benefits, some favorable spillovers to the general population through the advancement of knowledge. Yet we have wisely avoided making the government pay for all of higher education, or even half of it. We force the public universities to compete with each other and with private universities for research grants, for faculty talent, and for student talent. Individual faculty members have to compete by teaching well, since America attaches more importance to student evaluations of faculty than does any other country. By contrast, top universities in Western Europe and Japan have not been allowed, or forced, to compete sufficiently with each other and with American universities.

The other European shortcoming is also anti-competitive. Through a host of direct market interventions -- worker protection laws, high minimum wages, import barriers, and government regulation or ownership of industry -- privileged positions have been protected against competition, with familiar consequences for growth (e.g. OECD 1994, Blanchard and Portugal 2003; Lindert 2004, Ch. 19 and Appendix E.) Yet, as I have already emphasized, these protections of privilege are unrelated to the safety nets and egalité of the welfare states.

Longer Life in the 21st Century: A Crisis for Social Budgets?

If the welfare state seems innocent of dragging down growth in the twentieth century, might it nonetheless fail in the twenty-first? Daily media coverage emphasizes that a rapidly aging population may find it harder and harder to keep budgets in balance and to sustain economic growth. Will the welfare state be one of the casualties in this aging world? For most countries, the budgetary tensions have centered on public pensions, and to a lesser extent on health care budgets.

Three Familiar Sources of Pension Trouble

Aging too fast. The trend toward improved senior longevity and lower fertility is pressuring high-income countries to recalibrate their pension programs. Actuarial changes are been forced not only on public pensions and health systems, but on private job-based plans as well. If aging were the only problem, then we could rank different countries’ dangers just by looking at the UN projections for population aging out to, say, the middle of this century. As of 2050 the countries with the highest population shares over age 65 will probably be Italy and Japan, followed by the rest of Europe. North America, Australia, and New Zealand face less difficulty here, thanks to their accepting immigrants and their generally higher fertility. Most developing countries also face less demographic threat over this half-century. The exceptions tend to be East Asian: China, Taiwan, and Singapore are all aging so rapidly that by mid-century they will face pension problems as severe as those faced by most OECD countries today.

Asking for trouble with early retirement policy. A second source of pension trouble is avoidable, but widespread in Southern and Western Europe. Stuck with their own laws against firing workers, several European countries have tried to buy out seniors by subsidizing early retirement of workers in the 50-64 age range. The implicit tax on staying at work peaked at the start of the 1990s. Italy is in particularly deep trouble here, yet Italian politics has thus far produced only timid and partial roll-backs of the subsidies to early retirement.
Asking for trouble with overall government deficits. The budget pressures that can crush social programs need not relate to aging or to retirement policy alone. They can come from any source. Whatever raises the overall government deficit and national debt relative to annual GDP can force a country to cut back on any kind of spending, including pensions and other social transfers. Even if pensions were ostensibly protected in a special lock-box fund, a desperate government could always raid the lock box. The OECD country subject to the most pressure from its overall budget deficit is Japan, where the deficit has been about 6-8 percent of GDP for over a decade. The United States has suddenly vaulted into second place in the deficit/GDP ranks since 2002, thanks to its mixture of spending jumps and tax cuts.

These pressure points will cause more pain in some countries than in others. Perhaps the top victims will be Italy and Japan on the pension front, and the United States on the health insurance front.

Basic Perspectives on OECD Pension Solutions

PAYGO is Sustainable

When the population gets older, something has to give. Annual pension benefits simply cannot continue to keep up with annual incomes of the employed.

Most public pension systems are now on a pay-as-you-go (PAYGO) basis. In the aggregate, the current generation of workers pays for the retirement of the currently elderly, and not for its own retirement. Given that PAYGO is the prevailing current system, many have slipped into thinking that PAYGO is doomed and must be replaced with a funded or defined-contribution system.

This is incorrect, however. No pension whatsoever is immune to the need to adjust to longevity. Suppose that the only pillar of your retirement were your individual savings. If you work and save for Q years, and draw on savings for an estimated R years of retirement, you must set your annual savings and retirement benefits so that the accumulated value of your savings just covers your retirement needs. For any given rate of return you get on your savings, you cannot enjoy more retirement (raise the ratio R/Q) without cutting your retirement consumption relative to your earlier wage. The same holds if you add a second private pillar, getting your employer to share your retirement costs, presumably by accepting a lower rate of straight pay. You and your employer are still subject to the same actuarial logic as you would be by yourself. Nor is the third pillar any different: A public system, like a private pension plan, must adjust the relative retirement benefit to the ratio of years spent in the two phases of adult life.

But just as aging is a problem in any pension system, so too there is some parametric adjustment in any system that can fix the problem. Making the pension system sustainable is no more difficult under a PAYGO public system than under any other. There are two ways to avoid raising the tax rate and still balance the pension budget, even though we live longer:

1. Slow down the rise of retired/working ratio, by raising retirement age (or fertility or immigration), and
2. Make benefits rise more slowly than the average income of the employed.
Yet real benefits need not be cut, as long as income grows. Suppose that over a half-century the elderly share doubles, as it threatens to do for Italy and Japan. If real incomes continue to double every half-century, as in the past, the country could leave its real benefits and its retirement age and its tax rate the same forever. Real benefits per retiree could even go on rising as long as the aging is less severe than in Italy or Japan, or the full-benefit retirement age is raised, or both.

The Implied OECD Solutions of the 1980s and 1990s

Keeping PAYGO in equilibrium is not purely hypothetical. In fact, several countries of Northern Europe did much of the necessary adjusting in the 1980s and 1990s. It is instructive to see which adjustments their political systems tended to make. By drawing on the underlying econometric estimates of what determines social budgets, we can forecast the likely non-linear effects of population aging on taxes and transfers (Lindert 2004, Chs. 7, 8 and appendices). Figure 1 gives the revealed policy response to aging, holding other things equal. When the over-65 share of the population rose from 14 percent to 18 percent (a rise of 29 percent), there was no change in the shares of pensions or other social transfers in GDP. The cost to taxpayers of all social transfers, including pensions, therefore rose hardly at all (a statistically insignificant 0.5 percent of GDP). Essentially the full burden of the adjustment fell on the elderly themselves. The crude pension support ratio, measured as the ratio of (pensions per elderly) to (GDP per capita), dropped 18 percent, other things equal. It did not show up as a real drop on pension benefits because GDP per capita was growing. Some countries achieved this by encouraging later retirement, other by indexing pensions to something that grew more slowly than the growth of earnings. In principle, this kind of adjustment in tax-based pensions could continue forever. In the 1980s and 1990s it was part of a larger set of social transfers that did not bring any loss of GDP to those high-budget countries of Northern Europe.

How are Funded and Private Systems Different?

Even though the long-run equilibrium requirements for different private and public pension systems are analogous, there is still the widespread belief that switching from PAYGO to a funded (defined contribution) system or a more private system would bring benefits, and that these benefits somehow relate to the aging problem. While the proposals are complex and varied, a core feature is that individual earners take their paycheck contributions out of the public PAYGO system. Despite the “privatization” label, government compulsion is involved: Even those whose set-asides are voluntary are compelled to keep their extra private savings locked away until retirement.

Compelling households to save more allegedly serves four goals: (1) bringing government deficits under control, (2) promoting national saving, (3) improving the rate of return on investments in retirement, and (4) building in a political pre-commitment to a fixed set of rules. Yet it is not clear that any of these four goals is well served by what are often called “reforms” of the public pension system.

Higher budget deficits. Government budget deficits will be raised. Honoring the implicit pension promises to those currently in middle age or older means that pension budgets cannot be cut for a quarter century. The general taxpayers must offset each dollar that is withdrawn from the public pension system and shifted to personal private
accounts. The extra burden on general taxpayers is as immediate as the exit of savings into personal private accounts. As we shall see, Chile’s experience dramatized this new burden on the general taxpayers.

The distant rise in national savings. Eventually, if the system stays in place beyond the quarter century in which the government compensates the earlier cohorts, continued compulsory savings would indeed raise the national savings rate. But that is a quarter century off, and we still await clear evidence that the nations in question are under-saving. A simpler way to address the savings issue is to switch from the current income tax systems that double-tax saving.

A better rate of return? In the American debate, at least, one hears that switching from social security contributions to private (forced) savings gives investors a better rate of return, by letting them choose something other than the government bonds that social security implicitly or explicitly buys. This is questionable. Private financial markets already equilibrate between bonds and other assets, so that differences in rates of return tend to reflect differences in risk. Inducing some investors to shift out of bonds and into, say, stocks raises the rate of return on bonds and lowers the rate of return on stocks. If any rate-of-return gap had actually existed, the rate of return could not go up as much as that gap would imply. Even the existence of a gap in favor of holding stocks, as implied by the literature on “the equity premium,” is in doubt, both for the past and especially for the future. That past equity premium was based on measurements that may not have adjusted correctly for risk or for survivor bias in the stock indices. Believing that there will be an equity premium in the future implies that investors will be persistently and systematically mistaken about stocks versus bonds -- a strange support for the belief that they will make the right choices when investing their privatized retirement funds.

Furthermore, making it profitable or compulsory to shift from government bonds to other assets means a greater government debt service burden, simply because this portfolio shift and the greater government deficit will raise interest rates on those bonds.

History doubts that reforms bring political pre-commitment. There is no reason to believe that starting a defined-contribution plan has any more permanence that a PAYGO set of benefits. Most countries with PAYGO pensions today had defined-contribution plans earlier, but overthrew them. Consider three famous examples. The original Bismarck social security innovations of the 1880s started as defined-contribution plans, but began shifting within a few years to more PAYGO, and more burdens on general taxpayers. The US Social Security Act of 1935 set up a funded system, not PAYGO. The system was defined-contribution at the aggregate cohort level, though it gave low earners a better rate of return than high earners. Yet political forces gradually abandoned the funded system in favor of PAYGO, under pressure from the powerful elderly lobby (Miron and Weil 1998). Finally, Margaret Thatcher’s famous privatization of Britain’s public pensions still exists, but with important modifications drifting back toward progressive redistribution and PAYGO. While the Blair government has retained much of the defined-contribution features of the Thatcher era, it has raised minimum income guarantees for pensioners significantly, at the expense of the general taxpayers (Blundell and Johnson 1999; Disney, Emmerson, and Smith 2004). The political tendency is clear: Democracy finds it at least as easy to switch out of funded defined-contribution systems toward PAYGO as vice versa. All pension “reforms” reflect temporary and reversible shifts in political mood.
Meanwhile, the reforms are regressive. In the process of switching to defined contribution and privatized plans two kinds of elderly poor fall behind -- those whose lower lifetime earnings yield less pension support under the less progressive reform designs, and those whose retirement investments turned out worse. Furthermore, the financial service sector gets a windfall gain if government has compelled households to buy its services. Of all the effects of such compulsory private savings, this is perhaps the clearest. As we shall see, the same might have been true of Chile’s famous pension privatization, once some offsetting effects are weighed.

Will Developing Countries Become Welfare States?

History versus Today’s Global View

If the welfare state package is ever exported to other countries, it will probably be carried by the same forces that delivered it to some countries and not others in the past. We now know what those forces are, thanks to more than a century of experience in twenty-one OECD countries. The rise of the social transfer share is driven by these three forces, in order of century-long importance: (1) the rise of full-voice democracy, (2) population aging, and (3) income growth. At any given moment in history, the stark international differences in commitment to social transfers are driven by these same three forces, plus two others: the commitment to an open economy, and social affinity toward different income classes and income groups. So says an extensive historical and econometric literature. So we should expect the arrival of the welfare state in countries that are democratizing, aging, prospering, open to trade, and relatively homogenous.\(^{10}\)

To begin the search for likely future welfare states around the globe, let us first gather clues on the two more measurable of the three key forces, namely population aging and income level, leaving democratization for later. Comparing the age shares and income levels of the past and today’s developing countries yields a striking perspective, as illustrated in Figures 2 and 3. Today’s developing countries spend more on social transfers, including pensions, than the advanced OECD countries spent historically at similar age shares and income levels. For example, back in 1930 Sweden spent only 2.6 percent of GDP on social transfers, at a time when it had a relatively aged population (8 percent were over the age of 65). Compared to the Sweden of 1930, many countries today exceed that 2.6 percent, despite having younger and poorer populations. Such elevated transfers shown up in recent data from many countries in Eastern and Central Europe, and also for Costa Rica, Panama, Tunisia, Sri Lanka, Egypt, and Bolivia, among others.

Which developing countries will continue on the path toward being perennial welfare states? The leaders will almost surely be countries of Central and Eastern Europe, given their elderly populations, their fair growth prospects, their shift from elite democracy to fuller democracy, and their history of safety nets under communism. While their social transfer shares of GDP have dropped since the depression of the early and mid-1990s, they are still above other countries’ historic patterns.

Outside of Europe, two large regions seem to spend more than others. Latin America, and the Middle East to a lesser extent, generally spends more on the elderly, the disabled, the unemployed, and the poor than do Africa, South Asia, and East Asia. Among countries that were never part of the Soviet bloc, the early leaders are Israel, Uruguay, and Chile.
Before we can identify the developing countries likely to become welfare states, however, we must look behind the numbers on their social transfers. Who is actually getting those transfers, and who is paying for them? The behavior of many low- and middle-income countries differs from that of the high-income and transition countries.

Robin Hood in Reverse

The social expenditure systems of many developing countries fail to be progressive at all, and some are clearly regressive. That is, given the distribution of the tax burdens that pay for them, some of the social expenditures raise income inequality.

To discover which social programs are regressive, one must start by recognizing that the usual available figures are biased on opposing ways. Some views of the international data on social spending overstate regressivity, and others hide regressivity. On the one hand, casual looks at the distribution of benefits from contributory programs can overstate regressivity. The benefits from pensions, public health, and even unemployment often accrue to higher income classes, because they participate heavily in the formal and governmental sectors. Yet if they, as an income group, are paying for their own insurance, no serious social redistribution is occurring.

The opposite, or optimistic, biases also show up in the way we often view developing-country data on social transfers. Some may mistakenly assume that a social program redistributes progressively just because it comes in welfare-state packaging. Another trap awaits those who uncritically accept figures on “coverage” as showing how widely the benefits of social programs are dispersed. In many cases, data showing that 80 percent of the population is “covered” by a social transfer program hide the fact that most of the covered population receives a pittance while a wealthy minority gets generous gifts from taxpayers. Obvious examples arise in public education (poor rural primary schools do not equal top universities), public health (rural inoculations are not the same as capital-city hospitals), and pensions (a subsistence pension is not a civil service pension).

Fortunately, researchers have begun to distill more accurate indicators of who is paying for whose social programs through the tax and transfer system in developing countries. In this recent research, World Bank staff economists and consultants have played a pioneering role. Let us turn to some of the best-documented illustrations of the larger problem of regressive social programs in developing countries.

Latin American pensions. Regressivity is all too common a feature of social transfers in the region best known for economic inequality today. Latin America’s most consistent offender is its set of public pension systems. My first illustration is the best-documented case, the public pension system of Brazil. In its defense, one can say that Brazil’s system has recently begun to provide pensions for the poorest groups. Yet these safety nets support less than $1000 a year even for those poor who receive them. By contrast, Brazil’s civil servants get a huge subsidy. Here are some parameters of the civil service system:

(a) It is paid out of general taxes, and not by contributions from the civil servants themselves or even from their employing units. The subsidy from the general budget was 100 percent of these pensions until 1998, when it was slightly lowered to 89 percent. The general budget revenues come largely from the sales and excise taxes paid by people further down the income ranks.
(b) A retiring civil servant can count all his years of work, even in the private sector, as service years. He need work only one year as a civil servant to get pensions based on his high civil service salary.

(c) Before 1998, he could retire this way at age 53, get benefits near the peak salary, and still take another job. Only in 1998 was that retirement age raised to 60 for men and 55 for women.

This system is not easily reformed. The valiant efforts of Presidents Cardoso and Lula have been restrained by the 1988 Constitution’s legal protection of civil service and military pensions.

Elsewhere in Latin America, the regressivity is just as bad, even in countries under supposedly left-center regimes, as in Uruguay. The easiest way to see the regressivity is to note that the system typically fails to cover the poor who spent their careers in the countryside or in the informal service sector. They get no pensions, or get negligible pensions, throughout the region (Sala-i-Martin 1996). Even Mexico’s effective anti-poverty program Oportunidades (formerly Progresa) does not yet cover the elderly. So for Latin America a first requirement of establishing progressive welfare-state pensions will be to take money away from the powerfully defended pension subsidies to the public-sector elite.

**Myths about Chile’s “Privatization” of Social Security.** Chile’s pension system is world-famous as a model of privatization. In 1981 the Pinochet dictatorship supposedly abolished social security pensions that were a soaring public budget burden, and replaced them with compulsory forced saving by private individuals. Taken at face value, this consensus story shows that Chile’s privatized system transfers nothing to the poor, restores the old inequalities, and raises national saving.

The consensus story is wrong, as one can discover by reading the works of Carmelo Mesa-Lago and others, including World Bank economists, who have analyzed Chilean pension history in detail.13

The first correction in the consensus story is to note that Pinochet did not abolish Chile’s social security system, because Chile did not have a social security system in the first place. As in other Latin American countries, Chile’s pension system covered only those occupational groups holding power and privilege. In Chile’s case, this extended down toward the middle ranks, including not only the military and government elite but also the most powerful labor unions. Even Allende did little to rock this boat. While issuing lofty proclamations about supporting the whole society someday, he extended pension coverage only to small groups of self-employed merchants. Most of Chile’s high-end occupational pensions were paid out of contributions by the employees and their direct employers, but the system had indeed begun to leak in the 1970s. Through cheating on returns, a rising share of those in the privileged occupations began to get their pensions at the expense of the general government budget. This was the element of rising costs that Pinochet did fix.

What specifically did his pension reforms of 1979-1981 do, aside from stemming the cheating on pay records? First, Pinochet left the generous military pensions alone, and they remain untouched to this day. Second, he used general tax funds to buy out the employers’ contributions to the occupational pensions. This was a gift to the employers at the expense of the general taxpayers. Finally, he gave the elderly poor of the countryside and the informal sector their first pension safety net. Not a generous safety net, but the first of its kind in Chile.
Knowing this makes it easier to brace for the shock that may come when looking at the
time series on Chile’s budget deficits and expenditures on behalf of social security programs.
Since 1981 -- that is, since the “privatization” of Chile’s pensions -- the social security budget
deficit has slowly risen to about 4.5 percent of GDP. Chile’s total social security expenditures
under Pinochet became the second highest in Latin America, second only to Castro’s Cuba.

Why does the consensus story of Chilean “privatization” depart so radically from the
facts delivered by the experts? Perhaps because the consensus story is so convenient for both
the right and the left. The right can applaud Chile’s privatization, and the left can deplore it --
even though it has not happened yet.

The true relevance of Chile’s experience for today’s privatization debate is quite
different. Pinochet’s Chile, like Thatcher’s Britain, found that the budgetary cost of the
transition to privatization in any form turns out to be large. It causes government to dis-save a
sizeable share of GDP, in the name of promoting national savings.

In the end, the main justification for privatization of pensions in certain developing
countries might be an extreme second-best argument. It could be that privatization brings
equity and efficiency gains in cases where the only alternative to privatization was an even
worse elite-pension system. Chile’s historical choice vaguely hinted at such a choice of evils,
which might be clearer for other developing countries. This second-best argument, however,
does not apply to OECD democracies.

**Indian health and education.** The next case of regressive transfers arises in a
surprising place. Surely the world’s greatest democracy should have egalitarian social
transfers. Yet India’s health and education policies transfer from poor to rich. Let us
focus on health care here.¹⁴

On the health front, the World Bank has put it bluntly. India’s “publicly financed
curative care services are unambiguously pro-rich” (Peters et al. 2002, 218; see also
Misra, Chatterjee, and Rao 2003; World Bank 2003.) For efficiency, it would be good to
distribute public aid to health care so as to maximize national life expectancy. An
eclectic abundance of evidence shows that the actual distribution of expenditures departs
from this by under-investing in the health of the poor, even more so in India than in the
United States. In either country, an extra tax dollar put into basic rudimentary care saves
more years of life than an extra tax dollar put into high-end care. This would probably be
true even if the same amount were spent on each poor person as on each rich person. But
the amounts are not the same, especially not in India.

Here are some clues that the Indian public health system is inefficient and
inequitable:

(a) In hospitals, the rich get more frequent and higher-quality care than the poor,
in the public facilities as well as in the private.

(b) So weak are the public hospital offerings to the poor that 39% of poor patients
pay the 8-times-higher private hospital rates rather than entering the public hospitals
available to them. Such imbalances are not restricted to hospital care, though that is the
illustration chosen here.

(c) These imbalances are greatest in the states of India that have the greatest
poverty and inequality. They are greatest in the poor heartland states, like Bihar and UP.
The more efficient and equitable states also happen to be the richer ones, like Kerala,
Tamil Nadu, Gujarat, and Punjab.
Political Voice is Crucial

What would change the politics of developing countries so as to reduce the frequency of regressive tax-transfer systems, and possibly even breed some new welfare states? The history of the OECD countries suggests that the key driving forces behind the rise of social transfers are income growth, population aging, the rise of democracy, and social unity (Lindert 2003; Lindert 2004, Ch. 7). To eliminate the most egregious cases of regressive systems like those featured here, the latter two forces are probably crucial.

Fullness of political voice seems crucial to the shift toward more egalitarian fiscal systems. The key step is not the shift from a dictatorship to a democracy (Mulligan, Gil, and Sala-i-Martin 2002), but the spread of voting and lobbying power down the ranks within democracies. Various institutional changes may help, such as shifts from presidential to parliamentary systems and shifts to proportional voting. While one cannot be sanguine about having, say, all of India deliver egalitarian full-voice democracy, the inter-regional patterns within India do suggest that policy can respond to voice. In the more progressive rim states (such as Kerala, Tamil Nadu, Gujarat, and Punjab) voice has long been more equal and caste has played less role than in the poorer and more hierarchical heartland states (such as Bihar and Uttar Pradesh). Those rim states were the ones that led in developing developed primary schooling, better basic health care, lower fertility, and higher incomes. Thus even within the Indian setting, the cross-sectional pattern suggests changes that time could bring to the heartland. I grant that voice and social unity are not easy policy handles, but pressure for change can succeed slowly.

The current patterns of social spending in developing counties support both pessimism and optimism about the prospects of newly emerging welfare states, ones that get the incentives as right as they seem to be in parts of Europe. Pessimism, because we have seen how powerfully the regressive social transfers are defended, even in what look like full democracies. Optimism, because the regressive transfers are there in the budgets as place-holders. As political voice spreads down the ranks the way it did in Europe, democracies can gradually replace the privileged transfers with true egalitarian safety nets -- without greatly raising tax rates.
Figure 1. How Population Aging Affected Pensions and other Social Transfers in the OECD, 1978 - 1995

Percent of GDP or (for pension support ratio) percent of GDP per capita, relative to a country with 14% elderly

- ○ - public pensions / GDP
- × - pension support ratio *
- ▲ - public pensions + health / GDP
- ▼ - total social transfers / GDP

*Pension support ratio = (public pensions/elderly) / (GDP/capita)

(Source = Lindert (2004). Appendix Table E3, equations without full fixed effects.)
ENDNOTES

1 It is desirable to exclude the contributory amounts paid by one’s self or one’s employer. They are not a controversial redistribution of resources, but rather just part of one’s employment contract. It is not easy, however, to remove all employer and employee contributions from the expenditure data. As a smaller step toward isolating non-contributory payments, I have tried to exclude government-employee, and military, pensions from the OECD measures used here.

2 The underlying data sets do not permit us to add “tax expenditures” (tax reductions) to the social transfers.

3 As of 1995, the welfare states, ranked by the share of total social transfers in GDP, included Sweden, Finland, Denmark, Norway, Belgium, France, Netherlands, Germany, and Italy. Also included for 1995, but only slightly above the 20-percent line, were the United Kingdom, Austria, and Spain (Lindert 2004, vol. 1, 177).

4 It is not clear why OECD data show such a strong rise in Swiss pensions and health expenditures, as a percent of GDP, since the early 1990s. The elderly share of the population has not risen much, and is low by OECD standards. One might have suspected a role for relatively sluggish growth of the GDP denominator, but Switzerland’s growth has been relatively poor since 1975, well before the rise in the shares of pensions and health care in GDP.

5 The literature is rich, even when we focus just on studies explaining the determinants of GDP per capita, and set aside the determinants of employment. Much of the literature is surveyed in Slemrod (1995), Atkinson (1999), and Lindert (2004, vol. 2, Chapters 18 and 19). Perhaps the most plausibly specified set of econometric tests finding a significant and sizeable cost of larger government is Fölster and Henrekson (1999, with a rebuttal by Agell, Jonas, T. Lindh, and H. Ohlsson. 1999). Its relevance to the issue of social transfers is limited, however, by its focus on the effects of total taxes. These taxes go to finance all government consumption and investment, not just social transfers.

6 This fiscal mis-match also shows up in the literature on global growth econometrics, which shows negative GDP effects of wasteful non-social government consumption. For example, the Barro-Lee (1993, Barro 1997) measure of government consumption excludes the social transfers that are the expenditures of interest here. A further mis-match between the global econometrics studies and the issue of welfare-state programs arises from their including kleptocratic governments in the global sample, a choice that supports no conclusions about the growth effects of a rich-country welfare state.

7 Lindert (2004, Chapters 7, 16, and 17) and, for similar perspectives on international differences, Alesina and Glaeser 2004.

8 For an overview of the rich earlier literature, see Meyer 1995, Nickell 1997, and Blanchard and Wolfers 2000. For the new tests, see Allard 2003; Lindert 2004, Vol. 2, Ch. 19; and Allard and Lindert, in progress.

9 The effective rate of unemployment compensation here means Gayle Allard’s “net reservation wage” (Allard 2003, with updates on her web site).

10 Lindert 2004 (Chapters 7, 16, and 17) and, for similar perspectives on international differences, Alesina and Glaeser 2004.

12 On Brazil’s runaway public-sector pensions, see Wall Street Journal, 9 September 1999, 1; Paes de Barros and Foguel 2000; DeFerranti et al. 2004, Ch. 9; Medici 2004, and World Bank (2004). On the restrictive coverage of public pensions around the globe, see Sala-i-Martin (1996, 281-6).


14 On the regressivity of Indian education policy, especially in the poorer heartland states, see Lindert 2003, Lindert 2004 (Ch. 15), and the studies cited there.
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