

INEQUALITY AND THE POLITICAL ECONOMY OF EUROSCLEROSIS

Paul Krugman

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Centre for Economic Policy Research
25-28 Old Burlington Street
London W1X 1LB
Tel: (44 71) 734 9110

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ABSTRACT

Inequality and the Political Economy of Eurosclerosis*

Before the early 1970s generous welfare states seemed to be consistent with high employment. Since then, there has been growing concern over disincentive effects of social insurance. This paper suggests that the problem may have arisen in part because European nations were in effect trying to fight market tendencies toward increased inequality. In the United States, with its much more limited welfare state, there has been a striking rise in inequality; a stylized model suggests that the response of redistributive states to these same market forces could have led to a considerable fall in employment.

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Paul Krugman
Department of Economics
MIT
Cambridge MA 02139
USA
Tel: (1 617) 253 2655

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Twenty years ago, many advanced nations seemed to have achieved a workable blend of efficiency and equity. Western Europe, in particular, had been highly successful in applying the principle of the welfare state -- an economy in which market forces dictate the allocation of resources, but in which a redistributive tax-and-transfer system softens the extremes of wealth and poverty. Until the early 1970s, the judicious pursuit of social justice seemed to be consistent with sustained economic growth and high levels of employment.

Since 1973, however, the welfare state economies of Western Europe have performed far less well. Unemployment, in particular, has shown a strong secular upward trend: the unemployment rate in the European Community was less than 3 percent in 1973, but had reached 11 percent by 1993.

Many European economists have blamed "Eurosclerosis", the secular upward trend in unemployment rates, on the adverse impact of the welfare state on incentives. They argue that generous income support reduces both the pressure on unemployed "outsiders" to seek work and the constraints on the wage demands of employed "insiders". They also argue that measures designed to protect the interests of the employed, including both restrictions on firing and required contributions by employers, reduce the demand for labor.

Critics of the European welfare state often point to the example of the United States, which intervenes much less in the distribution of income, and has been much more successful than the European nations in increasing employment. Yet the US has its own

problems. Its income distribution is much less equal than that of European nations, and income inequality has worsened sharply over the past two decades. Indeed, the proportion of families below the poverty line in the United States has increased considerably since 1973, even though average family income has risen substantially.

Those who blame the welfare state for Eurosclerosis also face the problem of explaining why a system that seemed to work quite well during the 1950s and 1960s has gotten into so much difficulty since then.

This paper offers a simple, if perhaps oversimplified, answer. It suggests that the growth in inequality in the United States, and the rise in unemployment in Europe, can be viewed as the responses of two different institutional systems to a common shock. I argue that both Europe and the United States have been confronted by market forces that push toward a sharp widening of income inequality. The United States has essentially let these market forces have their way, maintaining a favorable employment performance but allowing poverty to worsen even as the rich get richer. The welfare states of Europe, by contrast, have "leaned against" the market forces pushing for greater inequality. This response has cushioned the poor from the impact of declining earnings -- but it has also led to growing unemployment.

This argument is not entirely new. What is new about about the paper, however, is that I present the argument in the context of a fully specified, if highly stylized model. The model explicitly treats the tradeoff between equity and efficiency. More unusually,

NON-TECHNICAL SUMMARY

Since the early 1970s European economies have seen a large rise in unemployment, while the United States has not. On the other hand, the United States has seen a much larger increase in income inequality. This paper argues that these two experiences may represent the response of different institutional systems to a common shock: technological changes that have pushed towards greater earnings inequality. A simple model contrasts the response of a relatively laissez-faire economy (i.e. the United States) to growing inequality with that of a redistributionist state (i.e. a European nation) that maximizes the welfare of the median voter. The redistributive state leans against the inequality, but in so doing increasingly distorts incentives.

it makes the choice of tax-and-transfer policy endogenous, offering a simplified positive theory of the political economy of the welfare state. In the context of this model I can show that a welfare state will indeed respond to an increase in the underlying market inequality of incomes with policies that tend to reduce aggregate employment.

The remainder of the paper is in four parts. Part 1 lays out the basic model. Part 2 shows how the size of the tax-and-transfer system and the level of employment are jointly determined. Part 3 then shows how an increase in market inequality leads, through channels that include the endogenous response of policy, to lower employment. Finally, part 4 illustrates the argument with a semi-realistic numerical example.

1. A model of the welfare state

In order to tell a clear story about the political economy of the welfare state, a model must contain several elements. First, it must offer some representation of welfare-state policies, preferably in a way that allows us to define in an unambiguous way the generosity of those policies. Second, it must embody somehow the tradeoff between equity and efficiency that is the central dilemma of welfare states. Finally, it must offer a political choice mechanism that allows us to predict how policies will change when the environment changes.

This paper offers a highly stylized model that may be regarded

as a special case of the political economy model introduced by Meltzer and Richard (1981). The Meltzer-Richard model satisfies all three criteria. In their model, individuals are assumed to have inherently different earning ability; in the present model this is assumed to take the form of exogenously given hourly real wage rates. These real wages are the only source of income other than transfers from the government. The welfare state is represented as a frankly redistributionist entity that collects taxes on earned income and hands the revenue out as transfer payments. It is assumed, however, that the redistributionist tools available to the state are blunt: the only possible policy is a proportional tax on income that is redistributed as a flat per capita transfer. This assumption rules out both progressive taxation and means-testing of benefits, but it has the compensating advantage of allowing the modeler to reduce policy determination to the choice of a single variable, the tax rate.

Choosing the tax rate involves a tradeoff between redistribution and efficiency, because a higher tax rate-cum-transfer will discourage work effort. Indeed, the model economy will actually exhibit a "Laffer curve", with the transfer falling if the tax rate is raised too high, although a rational government will never put the tax rate into that range. Representing the employment effect of the welfare state purely as a matter of voluntary reduction in work effort is, of course, not very realistic. In reality, most of Europe's unemployed would be happy to get jobs at prevailing wage rates. However, an increase in both

the tax rate and the generosity of income support makes the unemployed less desperate to get jobs, and the employed less afraid of losing them; in a variety of models this leads to lower employment.¹ Rather than try to be realistic in modeling the channels through which this effect occurs, I use a simple response of labor supply as a convenient if rough proxy.

Finally, the political economy of the welfare state is represented by the Downs (1957) model: political competition is assumed to lead to an outcome that maximizes the welfare of the median voter.² It is a familiar point that the median-voter approach only works under very special conditions -- issues must be one-dimensional, and voters must have single-peaked preferences. Luckily, this model satisfies those conditions. Policy reduces simply to the choice of tax rate; and the higher the earning ability of an individual, the lower the tax rate she prefers.

Imagine, then, an economy with a large number of individuals (which we will treat as a continuum), whom we array along the unit interval in order of their earning ability. We let w_z be the hourly real earnings of the individual at point z , $0 < z < 1$. By construction, w_z is increasing in z .

¹See, for example, the models described in Lindbeck and Snower (1988).

² Lindbeck (1993) emphasizes that welfare states in fact redistribute income in a variety of directions, both vertically from well-off to less well-off and between various socioeconomic groups. He argues forcefully that these elaborate redistributions cannot plausibly be said to maximize the welfare of the median voter. Thus the political and economic equilibrium described in this paper must be viewed as at best a crude sketch.

All individuals share the same tastes for consumption and leisure, with C_z the consumption of the individual at z and N_z the number of hours she chooses to work out of her fixed available time:

$$U_z = \frac{1}{1-\theta} [C_z^{1-\lambda} (\bar{N}-N_z)^\lambda]^{1-\theta} \quad (1)$$

Two points should be made about (1). First, the parameter R , which may be interpreted as the degree of relative risk aversion, plays no role in the positive analysis. It matters only when we ask whether the welfare state with its distortion of incentives is better or worse than a laissez-faire economy with its greater inequality. In effect, R should be seen as a parameter reflecting the social critic's preferences rather than those of the population.

Second, the assumption of a Cobb-Douglas form for (1), while it greatly simplifies the analysis below, is not innocent. It implies that in the absence of transfers the labor supply curve, both from any individual and for the economy as a whole, would be vertical. More generally, the assumption implies (as will be shown below) that changing all wage rates w_z in the same proportion would have no effect on the equilibrium level of taxation or employment; only changes in the distribution of wages matter.

All individuals face a proportional tax rate t on their earned income, and receive a transfer payment T from the government. There is no saving or investment in this model, so the budget constraint

faced by an individual is simply

$$C_z = w_z(1-t) + T \quad (2)$$

The government also faces a budget constraint, that transfer payments equal the total revenue collected in taxes:

$$T = \tau \int_0^1 w_z N_z dz \quad (3)$$

Finally, we define the government's objective, which is to maximize the welfare of the median voter. Let M be the position of that voter. Then the government simply chooses t to maximize U_M . In the simplest case, we may think of M as the median earner. The model can be stretched, however, to allow for a situation in which low-income adults are less likely to vote, and in which the median voter may therefore earn substantially more than the median individual. (Meltzer and Richard (1981) regard the idea that broader franchises will pursue more redistribution as the most important prediction of their model. Indeed, this is one way of interpreting the difference between Europe and the United States: perhaps the United States has so niggardly a welfare state as a consequence of its notoriously low voter participation).

It may be worth pointing out that this is a fairly cynical model of the welfare state. The most encouraging thing about welfare states in practice is the way that they help the poorest, the safety net that they provide against real misery. In this type of model, however, although the poorest have the most to gain from

an extensive welfare state, their gains are in fact an unintended byproduct of policies aimed at satisfying the middle class. A related, ironic, point is that changes in the generosity of the welfare state are decided by the interests of those who are least affected. Because the tax rate is set to maximize the welfare of the median voter, changes in that rate have only a second-order effect on the median voter's welfare. Yet a rise in t (and T) is unambiguously good for low earners and bad for high earners.

This line of thought is highly suggestive as a way of understanding the politics of economic ideology; but we will return to that point after showing how equilibrium is determined.

2. Economic and political equilibrium

Taxes, transfers, and labor input are all determined simultaneously in this model. Given a distribution of hourly wage rates w_i and a tax rate t , the per capita transfer T that the government can afford depends on the labor supply decisions N_i , but these decisions in turn depend on T . Furthermore, the tax rate itself is determined endogenously so as to maximize U_μ , taking into account both the direct impact on the median voter's tax payments and the indirect effect on the transfer she receives.

As a first step toward solving for the economic and political equilibrium, we express labor supply as a function of the tax and transfer rates. For the individual at z , the labor supply is

$$N_z = (1-\lambda)\bar{N} - \frac{\lambda}{1-\tau} \frac{T}{w_z} \quad (4)$$

Note that with a given per capita transfer, labor supply is less for workers with lower hourly wage rates. Indeed, as written it could imply a negative labor supply. We should be careful to impose a non-negativity constraint, but for this analytical exercise that constraint will be ignored (it is respected in the numerical examples in part 4).

This labor supply response may be substituted into the government budget constraint to yield the result

$$T = \tau(1-\lambda)\bar{N} \int_0^1 w_z dz - \frac{\lambda \tau}{1-\tau} T \quad (5)$$

or, rearranging and relabelling,

$$T = \frac{(1-\lambda)\bar{N}\tau(1-\tau)}{1-(1-\lambda)\tau} \bar{w} = g(\tau)\bar{w} \quad (6)$$

Notice that for any given tax rate the transfer is proportional to the average wage (where this average is weighted by individuals, not by hours worked; the average hourly wage rate will be higher, because higher-wage individuals work longer hours, and will also depend on policy, whereas this average wage is exogenous).

Equation (6) defines the economic equilibrium given the tax rate τ . Now we endogenize τ by embedding this economic equilibrium in a political equilibrium. The government sets τ to maximize U_g . Rather than write this maximization problem out in full, we note that as a consequence of utility maximization it must be true that

$$\frac{dU_M}{dt} = \frac{\partial U_M}{\partial T} \left[-N_M w_M - \frac{\partial T}{\partial t} \right] \quad (7)$$

That is, an increase in the tax rate hurts the median voter directly, but helps him indirectly via an increased transfer payment.

Will the median voter favor any welfare state? There is a simple criterion: if the average pre-tax wage exceeds that of the median voter, that voter will gain from at least some redistribution -- basically, the rich will give more to the middle class than the middle class gives to the poor. We can confirm this by evaluating (7) at $t=0$, to find that

$$\frac{dU_M}{dt} = \frac{\partial U_M}{\partial T} (1-\lambda) \bar{N} [\bar{w} - w_M] > 0 \quad (8)$$

Thus there will be at least some welfare state as long as mean income in the absence of a redistributive policy will exceed median income. In principle this need not be the case. In practice, the distribution of income is always skewed to the right, so that in fact in all observed cases mean income does exceed median; thus there is always a gain to the median individual from at least some redistribution.

But how far should this redistribution go? As the tax rate is increased, the disincentive effects of higher tax-and-transfer policies become increasingly important. The median voter will get less compensation for her own higher taxes in the form of an increased transfer. Thus there will be a tax rate that maximizes

her welfare at a level that is positive but less than 100 percent.

We may define this politically optimal tax rate implicitly by noting that

$$\frac{dU_M/dt}{\partial U_M/\partial T} = -w_M \bar{N} + \frac{\lambda}{1-t} g(t) \bar{w} + g'(t) \bar{w} \quad (9)$$

Setting $dU_M/dt=0$ therefore implies the first-order condition

$$\bar{N}(1-\lambda) = \left[\frac{\lambda}{1-t} g(t) + g'(t) \right] \frac{\bar{w}}{w_M} \quad (10)$$

which implicitly defines the politically optimal t .

We note that this equilibrium tax rate depends on the distribution (though not the level) of income. Specifically, it is an increasing function of the ratio of mean to median income. This should not be surprising, since we have already seen that it is the excess of mean over median income that makes the median voter want at least some income redistribution in the first place.

In the next part of the paper we will consider how the political-economic equilibrium is affected by a change in the market distribution of incomes. At this point, however, it may be worth stepping slightly outside the model to think about some of its political implications.

As already pointed out, in equilibrium a small change in the tax rate has a negligible impact on the welfare of the median voter. This is not because average and median income have been equalized, but because any possible gains to the median voter from

further redistribution are exactly offset by the disincentive effects of higher taxes and transfers. That is, the political process is assumed to choose that point on the equity-efficiency tradeoff that is best for the median voter.

Individuals with above-median income would, however, prefer a lower tax rate, while those with below-median income would prefer a higher rate. One might therefore expect political representatives of the upper and lower class respectively to try to convince the middle class that it should expand or contract the welfare state.

How might they do this? In the model it is assumed that everyone understands the effects of alternative tax rates on work effort and hence output. In reality, of course, such incentive effects are the subject of bitter dispute. And this bitter dispute is no accident: it is in the interest of the rich and their agents to convince the middle class that the incentive effects of taxes are large; it is in the interest of the poor and their supporters to deny significant incentive effects.

As a Marxist might say, it is no accident that liberals tend to be skeptical about the importance of economic incentives, while conservatives tend to be wildly optimistic about the response to tax cuts. And it is also no accident that liberal economists, who no matter how great their compassion for the poor do believe that incentives matter, often find themselves regarded as poor allies by their political bedfellows.

But let us return to the model, and ask how a welfare state will respond to a difficult shock: an increase in the underlying

inequality of earnings.

3. Responding to increased inequality

Over the past 15 years there has been a sharp increase in earnings inequality in the United States, with a substantial increase in the real hourly earnings of high-skill workers and a considerable fall in the real earnings of the less skilled. The reasons for this increase in inequality have been the subject of extensive debate. It is conventional wisdom that international competition, especially in the form of imports from developing countries, has driven down real wages for less skilled workers. In fact this seems to be untrue on the basis of the evidence (Katz 1993, Lawrence and Slaughter 1993), suggesting that the origins of increased inequality lie in technological factors rather than trade. Whatever the reasons for increased inequality, however, it is clear that there has been a dramatic shift.

For the purposes of this paper I will simply take an increase in inequality of pre-tax earnings as a given. Specifically, I will assume that the wage rates w_2 are replaced by a new set of wages w_2' , with w_2'/w_2 strictly increasing in z . (This allows for the possibility that low-paid workers may see their real wages actually fall).

In a laissez-faire economy this increase in inequality would be reflected in a corresponding change in incomes, with no change in labor supply. What we will show is that a welfare state will

tend to mitigate the growth in inequality. But in that state the total labor input -- the number of hours worked in the economy as a whole -- will decline. That is, the effort to limit rising inequality will be reflected in declining employment.

It is useful to make the argument in two stages. First we ask what would happen given the change in the wage structure if the tax rate were kept unchanged. We can show that even in this case employment would fall. Then we show that the political response will be to raise taxes, which will further reduce employment.

Suppose, then, that the tax rate were held constant. Then from (5) we immediately see that tax revenue rises in proportion to the average wage,

$$\frac{dT}{T} = \frac{d\bar{w}}{\bar{w}} = \gamma \quad (11)$$

Does this imply that there is no change in labor supply? No, because not everyone's wage rises by the same proportion. Those workers whose wage rates rise more than the average wage will increase their labor supply, while those whose wages rise less will reduce their working hours.

There is a simple intuitive argument that immediately suggests that the net effect of these changes must be a reduction in the total number of hours worked. If tax revenue rises in proportion to the average wage, then the increased work effort by some must just outweigh the reduced work effort by others. But by assumption,

those whose work effort rises are paid more per hour than those whose work effort falls. In effect, weighted hours remain unchanged, but the hours that go up have heavier weights than those that go down. Thus the number of unweighted hours must have fallen.

This seems obvious. Proving it is slightly more troublesome. We proceed by stages.

First, partition the growth of each individual's wage into the growth in the average wage and the deviation from that growth:

$$\frac{dw_z}{w_z} = \frac{d\bar{w}}{\bar{w}} + \left(\frac{dw_z}{w_z} - \frac{d\bar{w}}{\bar{w}} \right) = \gamma + \epsilon_z \quad (12)$$

Also, label that individual whose wage increase exactly matches the average as individual A.

Next, write the change in the income of the economy as a whole:

$$dY = \int_0^1 N_z (dw_z) dz + \int_0^1 w_z (dN_z) dz \quad (13)$$

We can show that

$$\int_0^1 N_z (dw_z) dz = \int_0^1 w_z N_z \left(\frac{dw_z}{w_z} \right) dz = \gamma Y + \int_0^1 w_z N_z \epsilon_z dz \quad (14)$$

But since tax revenues are proportional to national income, it must be the case that

$$dY = \gamma Y$$

It therefore follows that

$$\int_0^1 w_z (dN_z) dz = -\int_0^1 w_z N_z \epsilon_z dz \quad (16)$$

We now do a trick involving the labor supply of the individual

A:

$$\int_0^1 w_z N_z \epsilon_z dz = \int_0^1 (w_z N_z - w_z N_A) \epsilon_z dz + N_A \int_0^1 w_z \epsilon_z dz \quad (17)$$

where the second term on the right hand side of (17) can be shown to equal 0 by construction.

We use a similar trick involving the wage rate of individual A:

$$\int_0^1 w_z (dN_z) dz = w_A \int_0^1 (dN_z) dz + \int_0^1 (w_z - w_A) (dN_z) dz \quad (18)$$

Finally, we write an expression for the change in the number of hours worked in the economy as a whole:

$$\int_0^1 (dN_z) dz = -\frac{1}{w_A} \left[\int_0^1 (w_z N_z - w_z N_A) \epsilon_z dz + \int_0^1 (w_z - w_A) (dN_z) dz \right] \quad (19)$$

But the two terms inside brackets are both positive. The first term is positive because all individuals who have wages above w_A also supply more labor than A, and conversely. The second term is positive because workers who have wages above w_A increase their labor input, and conversely. It follows that with a constant tax rate, total employment will fall when pre-tax inequality rises.

To complete the argument, we now note that the political

equilibrium tax rate depends only on the ratio of the average to the median wage, and will actually rise if the average wage rate rises more rapidly than the median rate. We have already noted that in practice average incomes always exceed median; it is also true that when inequality rises, the ratio of average to median income invariably rises as well. Thus the political equilibrium will involve a rise in t . This will reinforce the tendency to lower employment.

4. A numerical illustration

The fairly lengthy derivations of Part 3 of this paper may have somewhat distracted attention from the essential simplicity of the argument. The basic point, once again, is that a redistributive welfare state tends to respond to an increase in underlying inequality in a way that reduces employment. Redistribution from well-off taxpayers to less productive workers increases; this reduces the incentive to work, and thus leads to a reduction in labor supply.

To illustrate this argument, and to suggest that it may be quantitatively important, I conclude this paper with a numerical example that is intended to make at least a slight gesture toward realism. I take as a starting point the actual levels of hourly earnings by quintile in the US in 1979 and 1989; these are shown in Table 1. Several points should be noticed about these data. First, in both years the mean exceeds the median (which in this case is

simply the wage of the middle quintile), which as we have seen is the necessary condition for the median voter to support at least some redistribution. Second, earnings inequality clearly increased from 1979 to 1989, almost but not quite satisfying the assumption that the percentage increase be increasing in the initial level. Finally, the mean did rise faster than the median, providing an incentive for the median voter to support higher taxes.

From this point on the numbers are all made up. Specifically, we need values of λ , the leisure share in consumption, and R , the coefficient of relative risk aversion. I assume $\lambda=.5$ -- households would spend half their time working in the absence of a welfare state -- and $R=2$, a conventional value.

Given these parameters, we may compute mean and median welfare as a function of the tax rate. Figure 1 shows how welfare varies as a function of t given the 1989 distribution of hourly earnings. Both mean and median welfare show the expected inverted "U" shape. rising at first because of the benefits of redistribution, then falling as the disincentive effects of higher taxes and transfers become dominant.

The welfare of the median household is maximized for $t=.25$. At this level of taxation the disincentive effects on work effort are substantial: the number of hours worked in the economy as a whole is only 83 percent of what it would be at zero taxes. (This disincentive effect is, however, concentrated on low-productivity workers; output is 86 percent of its laissez-faire level). One should not conclude from this, however, that the welfare state is

Table 1: US hourly earnings by quintile

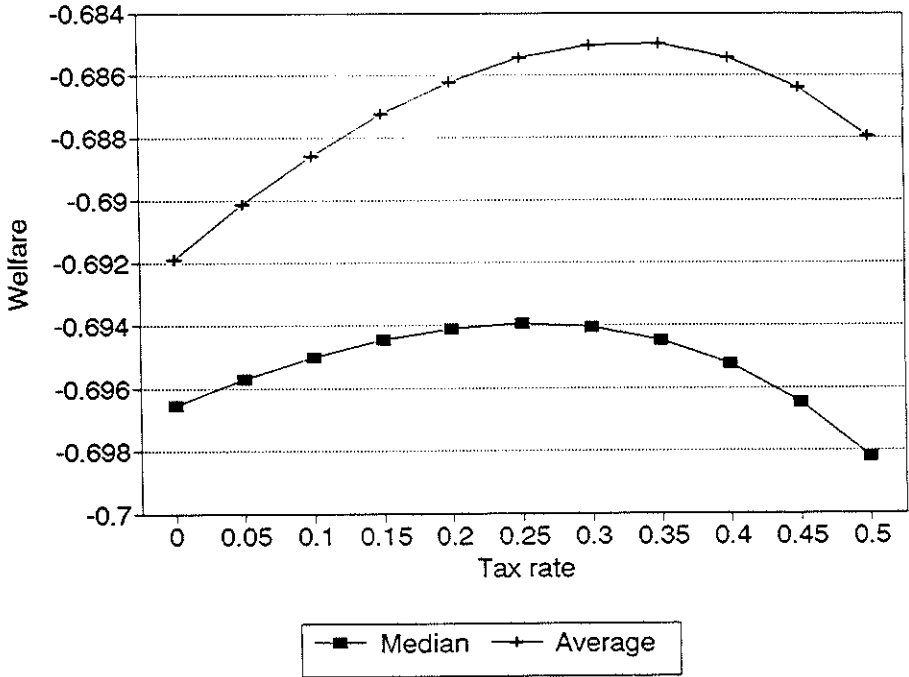
(% of poverty line X 1000)

		1979	1989	% change
Quintile	1	62.0	60.3	-2.6
	2	90.3	87.1	-3.6
	3	105.1	106.2	1.0
	4	125.3	134.5	7.3
	5	180.1	206.1	14.4
	Average			

Table 2: Political and economic equilibrium

	1979	1989
Tax rate	0.17	0.25
Employment rate:		
Quintile 1	83.1	71.8
2	88.4	80.5
3	90.5	84.0
4	91.6	87.2
5	94.2	91.8
Average	89.0	83.1

FIGURE 1



a bad thing. As the figure also shows, given the assumed risk aversion, the redistribution of income from well-off to poor raises average welfare. Indeed, the tax rate that maximizes average welfare is considerably higher than that which maximizes median welfare, $t=.32$.

Finally, we ask how such a welfare state would respond to an increase in wage inequality. Table 2 summarizes the behavior of an economy with a government that maximizes median welfare facing 1979 and 1989 wage distributions respectively. Such a government facing the 1979 distribution would levy a 17 percent tax, and as a result have employment at 89 percent of the laissez-faire level. The growth in inequality from 1979 to 1989 would lead to an increase in the tax rate to 25 percent, and largely as a result to a decline in employment to 83 percent of the laissez-faire level. Among the lowest-paid workers the decline is much steeper: the employment rate among the bottom quintile falls 11 percentage points.

One would not want to take this example too seriously. It does suggest, however, that the line of causation that runs from increased inequality, through the redistributionist response of governments, to lower employment, is not on the face of it unimportant. Indeed, it could well be large enough to explain a significant part of the problem of Euroclerosis.

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