

Who Pays for the “Welfare” in the Welfare State? A Multicountry Study

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I. Introduction

THERE was a time, not so long ago, when the welfare state was viewed as a proud social accomplishment. But recently it has been under considerable attack. At the heart of this attack has been the claim that during its heyday, from the 1950s to the 1970s, the social benefit expenditures of the welfare state led to subsequent economic stagnation and persistent unemployment throughout the advanced world. This paper brings to bear the empirical evidence from a multicountry set of studies. I outline the issues involved, discuss the methodology behind the empirical studies of six major Organization for Economic Cooperation and Development (OECD) countries (Australia, Canada, Germany, Sweden, the United Kingdom, and the United States), and present the main findings. My central finding is that social benefit expenditures were financed out of the taxes paid by recipients of these very expenditures: in other words, by and large, social welfare expenditures were *self-financed*, and could not have been a source of fiscal deficits or a drag on growth.

1. The Rise and Fall of the Welfare State

The growth of welfare states is one of the characteristic features of modern capitalist democracies. European welfare

states began with pension and social insurance programs in the late nineteenth and early twentieth centuries and then grew into comprehensive systems of social support between the 1930s and the 1950s. In the United States, it took the Great Depression to spark similar initiatives in the form of New Deal programs on social security, state-based unemployment insurance, and limited federally subsidized public assistance (which Americans call “welfare”) for the elderly poor, dependent children, and the blind.

After World War II, the role of the state expanded rapidly. From 1960 to 1988, in the OECD countries the average government share in gross domestic product (GDP) rose by over one-half (from 27 percent to 42 percent), while the average government share in total employment rose by about two-thirds (from 11 percent to 18 percent). Alongside this came a shift in the types of government spending, away from traditional expenditures on defense, public administration, and general economic services and toward social welfare expenditures on health, education, and transfer payments (social security and social assistance payments, business subsidies, and interest on government debt). By the 1980s, transfer payments had become the single largest category of economic expenditure in most countries (OECD, 1985: 16).

But the rise in government expenditure was only one side of the story. Taxes also rose sharply, and their composition shifted from traditional sources, such as indirect business taxes, to social security and personal income taxes (OECD, 1985: 16-17). Thus on the whole, both government expenditures and the tax structure changed in very similar ways.

The early part of the postwar period was the zenith of the welfare state as the industrialized world grew at a rate of almost 5 percent annually. However, by the mid-1970s the long underlying expansion had peaked and by the late-1970s the average growth rate of the industrialized world had fallen to half its previous level. By 1983, the OECD countries as a whole were barely grow-

ing (OECD, 1991). In this period of growth slowdown and eventual stagnation came rising unemployment and poverty, which led to greater demands on social expenditures.

In the United States, the postwar boom peaked in 1968-1969. The economy moved into a phase of (initially inflationary) stagnation. A major change took place in all major economic patterns at this point. In the boom decades from 1947 to 1968, growth was strong, unemployment averaged 4.8 percent, real wages grew almost 50 percent, and the average annual federal budget deficit was a mere \$1.7 billion.¹ In the subsequent two decades between 1969 and 1989, unemployment rose to an average of 6.6 percent, real wages *declined* by 14 percent, and the average budget deficit rose almost fiftyfold to \$82.4 billion (*ERP*, 1996). By 1980, eligibility for public assistance had been restricted, and for those who did receive aid, real benefits were 20 percent lower than what they had been in 1970.

From 1980 to 1988, the Reagan administration carried out a far-reaching and systematic policy of attacking workers and the poor. It undermined unions and cut back on the level and duration of unemployment benefits. Union membership declined rapidly during this period, from about a quarter of the labor force to less than a sixth. Real wages fell and worker concessions and givebacks became commonplace. The number of people in low-wage jobs rose sharply: in 1970 only 20 percent of workers earned a real income of less than \$7,000 (in 1984 dollars); between 1979 and 1984 some 60 percent of new jobs were in this category (Rosenberg, 1987). Military spending increased dramatically even as social spending was slashed, so that budget deficits continued to rise to new highs. Throughout all of this, the rhetoric of the period was dominated by the notion of "tax relief" for an overburdened population (a most familiar phrase once again). Corporations did receive substantial tax relief, which added to the benefits of a declining real wage. But as we shall see, for workers the situation was different, since their tax rate continued to rise (see figure 1 on page 1211).

TABLE 1: AVERAGE REAL GDP GROWTH RATES
(EXCLUDING 1973 OIL SHOCK)

	1961-1972	1975-1982	1983-1991
Europe	4.68%	2.23%	2.66%
United States	3.83%	1.97%	2.85%

The phase change outlined for the United States economy mirrored a pattern evident across all advanced capitalist countries as the decades of high growth gave way to decades of sluggish growth, inflation, rising unemployment, and an attendant “fiscal crisis of the welfare state” (Skocpol, 1987: 36). The European and United States growth rates of real GDP are depicted in table 1, in which the “oil shock” period from 1973 to 1974 is excluded to avoid biasing the comparison across periods. The corresponding patterns for unemployment rates are depicted in table 2.

In the light of these events, which were unfolding across the advanced world, it is not surprising that there arose a claim that the welfare state was to blame. Mainstream economists in particular argued that its “social policy [led to] . . . an over-expansion of the government, which [was] . . . a principal cause of the economic slowdown and rising inflation of the 1970s (Buchanan and Flowers, 1980, chap. 6, cited in Fazeli, 1996: 37). Thus the welfare state was “a drag on economic activity and [had] . . . reduced economic performance” (Moudud and Zacharias, 2000: 7). Cutbacks in social expenditures, particularly unemployment insurance and income support for the poor and the elderly, were deemed necessary to restore growth and reduce unemployment (Atkinson, 1999). And indeed, such cutbacks began to spread across the developed world.

Many different mechanisms have been proposed as the sources of the putative negative effects of the welfare state. Within orthodox economics, two are particularly important. The first of these arises from the claim that the welfare state

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TABLE 2: AVERAGE UNEMPLOYMENT RATES
(EXCLUDING 1973 OIL SHOCK)

	1961-1972	1975-1982	1983-1991
Europe	2.59%	5.41%	9.51%
United States	4.94%	7.01%	6.74%

gives rise to budget deficits in order to finance its social expenditures. These deficits are said to stimulate consumption and reduce the household savings rate, which in turn lowers the long-term growth rate of the economy. A similar claim also arose on the left, in the form of the “fiscal crisis of the state” identified by O’Connor (1973), and in the claim by Bowles and Gintis (1982) that over the postwar period the state induced a “substantial redistribution from capital to labor,” resulting in a “citizen wage” that grew so rapidly that by the 1970s it played “a critical role in producing and prolonging” the economic crisis of the 1970s and 1980s (Bowles and Gintis, 1982: 69, 84-85). In all of these arguments, the welfare state tends to reduce and undermine growth over the long run, which at some point gives rise to stagnation and unemployment (Fazeli, 1996, chap. 2; Moudud and Zacharias, 2000: 8-14).

The second criticism is that the welfare state perpetuates the very unemployment it creates. Orthodox economic theory says that unemployment would be self-correcting as long as workers lowered their real wages whenever there is any unemployment. But the various social protection mechanisms of the welfare state are said to create “labor market distortions” that interfere in this automatic adjustment process. Unemployment insurance and income support reduces the incentive of unemployed workers to accept lower wages and worse working conditions, while payroll taxes and employee protections reduce the wages that firms are willing to offer to workers. As Krugman puts it, the relatively greater social protections in Europe mean that “an unemployed European does not need to search for employment with the desperation of his

American counterpart” (Krugman, 1994: 22). Thus the welfare state tends to prevent the elimination of unemployment.

In the end we are told that the welfare state tends to undermine growth and give rise to unemployment because it helps give rise to budget deficits. At the same time it “distorts” labor markets by making workers less desperate in the face of unemployment, which tends to make unemployment persistent (Pear, 1995). In both cases, the appropriate solution is to reduce the extent of the welfare state.

As far as the “labor distortions” argument is concerned, even Krugman admits that this argument is unable to explain why the socially conscious “European countries [were] able to achieve such low unemployment rates before 1970” (23). Detailed micro- and macroeconomic studies also indicate only a weak link between benefits, labor market regulations, and unemployment (Bean, 1994: 594-595, 600-603). Most recently, a recent detailed cross-country study finds no real empirical support for the view that the welfare state’s labor market institutions and policies played a key role in the European unemployment crisis of the 1980s and 1990s (Baker, Glyn, Howell, and Schmitt, 2002: 2-4, 54-57). Finally, it is a striking fact that precisely during the period when the welfare state is supposed to have most inhibited economic performance, from 1975 to 1993, per capita gross national product (GNP) in the OECD countries increased by 314 percent, while per capita GNP in the United States rose by only 234 percent.²

But might it not be still possible that in the heyday of the welfare state, social spending, particularly social spending directed to labor, was financed by government deficits, which in turn were large enough to cause the subsequent slowdown of growth all over the advanced world? We turn to this issue next.

2. Who Paid For Social Expenditures?

The notion that the welfare state was deficit financed relies on a series of implicit claims. First, that the beneficiaries of the social

spending received more than they themselves paid in taxes. Second, that this difference was largely financed by government deficits, rather than transfers from other groups in society. And third, that the resulting deficits were large enough to initiate a slowdown in economic growth.

It is striking how little consistent empirical evidence has been advanced for such claims. Individual country studies do not provide much guidance for generalizations about the welfare state (Marmor, 1993). On the other hand, cross-national studies that analyze only expenditures,³ or only taxes, are equally inadequate because what matters is the *net balance* between the two. For instance, if the taxes paid by some group matched the social expenditures directed toward it, then these social expenditures were *self-financed*, and could not have been a source of fiscal deficits or a drag on growth.

The question thus becomes: who pays for the welfare spending of the welfare state? In addressing this issue, we focus on the relations between the state and labor (defined here as wage and salary earners, excluding top management such as CEOs). This focus arises out of the claim that it was the social support of labor in particular that eventually undermined the welfare state.⁴

3. Our Principal Findings

Our findings are based on a series of cross-national studies of the welfare state, conducted over the 1980s and 1990s. The framework used, which is outlined in section two, was originally applied to the United States (Shaikh and Tonak, 1987, 1994, 2000), and subsequently to Australia, Canada, Germany, Sweden, and the United Kingdom, over various intervals (Tonak, 1984; Bakker, 1986; McGill, 1989; Fazeli, 1992, 1996; Maniatis 1992).

The principal finding of these studies is that the taxes paid by wage and salary earners closely parallel the social expenditures directed toward them: for the estimated average of the advanced countries between 1960 and 1987, the difference between the value of total social benefits received and total taxes directly paid (the *net*

social wage) remains between 1 and 2 percent of GDP (3 to 5 percent of total wages and salaries) in almost every year. Since this is positive, it implies that wage and salary earners received more than they paid. But this overall net subsidy is clearly small. And as we shall see, while it is generally positive in the five OECD countries studied, it is generally negative (that is, a net tax) in the United States.

The small size of this average net social wage ratio (net social wage relative to GDP) does not support the claim that social benefit expenditures hurt economic growth in the advanced world. Indeed, what it instead shows is that the principle effect of net transfer flows is to recirculate income among wage and salary earners as a whole. But even here, the evidence indicates that any such intraclass redistributive effect is quite limited. Detailed studies across household income classes in various OECD countries seem to indicate that redistributive effects concentrate on the lowest and highest income ranges, so that the bulk of the income ranges are not much affected by the net government intervention (OECD, 1985, chap. 7, sec. B).

There are, of course, differences among countries, but even these are not necessarily what one might have expected. For instance, in the boom years the net social wage was negative in the United States, which meant that wage and salary earner paid out *more* in taxes than they received—they helped *reduce* any existing fiscal deficit. Over the same interval in Sweden, the net social wage was roughly zero, indicating that its generous social welfare expenditures were actually self-financed. In neither the United States nor Sweden, therefore, can welfare expenditures be indicted as the cause of fiscal deficits or consequent economic stagnation. However, in Germany the net social wage was generally positive in the boom years, on the order of 4 percent of GDP. And even this modest proportion is one of the highest in our sample. Here at least we can say that the net social wage did have a substantial impact on government finances: from 1950 to 1973, it accounted for roughly 42 percent of the government deficit, which was itself about 7 percent of GDP. Yet Germany's growth

rate was *higher* than that of either Sweden or the United States in every subperiod (OECD, 1991). In fact, in every period there is a *positive* correlation between the size of the net social wage and economic growth: Germany has the highest growth rate, Sweden is in the middle, and the United States has the lowest.

II. Methodology of the Net Social Wage

Our concerns require us to identify the different parts of total taxes that flow out of the aggregate wage bill, and the various social benefits that flow back to the working population through the medium of government expenditures; this will allow us to assess their net balance (the net social wage). The category of “working population” is not defined here in sociological or political terms, but rather in terms of all those who earn wages and salaries, with the exception of CEOs and other top management. This is in part because wages play a central role in most economic processes, but also because it allows us to get consistent results across countries. We use national economic accounts and other sources to estimate and track the net social wage in six advanced countries: the United States, Canada, the United Kingdom, Germany, Sweden, and Australia.

The net social wage consists of the difference between social expenditures directed toward the working population (“labor”) and the taxes directly levied on this same group. On the side of social expenditures, we count all welfare expenditures (health, education, welfare, housing, transportation, parks and recreation, transfer payments to workers, etc.). We divide such expenditures into two subsets. Expenditure Group I, which we assume is entirely received by workers, and consists of items such as Labor Training and Services, Housing and Community services, and Income Support, Social Security, and Welfare (except the small items called Military Disability and Military Retirement, which we treat as a cost of war). And Expenditure Group II, which is

directed toward workers and nonworkers alike and comprises items such as Education, Health and Hospitals, Recreational and Cultural Activities, Energy, Natural Resources, Passenger Transportation, and Postal Services. The workers' share in this is estimated by multiplying the group total by the labor share in personal income (Shaikh and Tonak, 1987, 1994).

On the side of taxes levied directly on the working population are income taxes, social security taxes, property and other taxes. The primary monetary flow from which the taxes are deducted is total Employee Compensation, which is the total cost of workers to their employers. We consider this to be the gross wage of workers, comprising wages and salaries as well as benefits such as Employers Contributions for Social Insurance and Other Labor Income. The total taxes to be considered then fall into two groups: Tax Group I, which comes entirely out of gross wages, and consists of all deductions for social security (that is, the sum of Employee and Employer Contributions), and the more general Tax Group II, which consists of Personal Income Taxes, Motor Vehicle Licenses, Personal Property Taxes (primarily on homes), and Other Taxes and Non-taxes (a very small category that includes passport fees and fines), and is allocated between labor and nonlabor using the share of labor income in personal income.

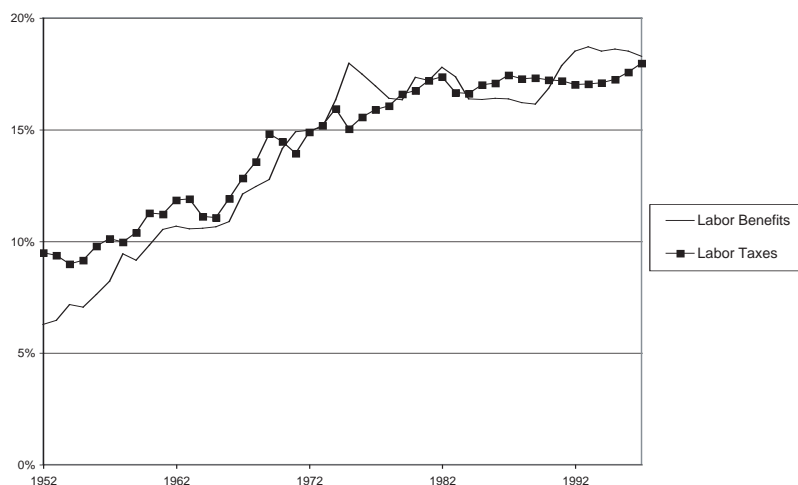
Comparing the expenditures on labor and the taxes paid by labor then gives us the net social wage, defined as benefits received by workers *minus* taxes paid (see Shaikh and Tonak, 1987, 1994, 2000, for further details). The net social wage ratio then refers to its size relative to GDP.

III. Empirical Results

1. The United States

We begin with our results for the United States, with data taken from Shaikh and Tonak (2000). Figure 1 depicts the benefit rate

Figure 1: US Labor Taxes and Benefits Relative to GDP

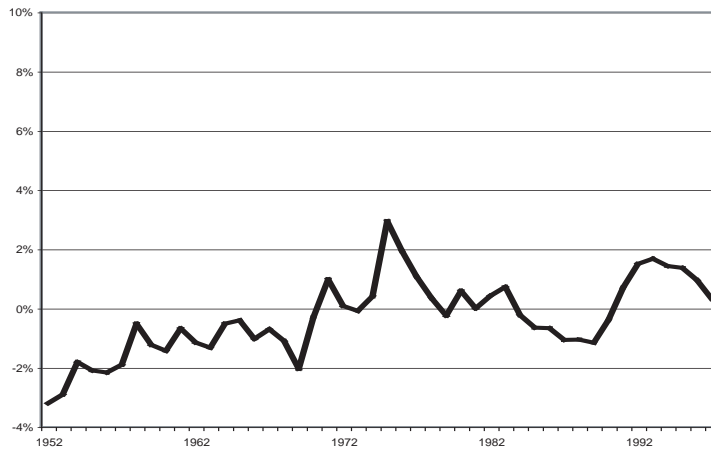


of labor (total social expenditures directed towards labor relative to GDP) and the tax rate of labor (total labor taxes relative to GDP).⁵ It is clear that both rise sharply over the postwar period. But what is particularly striking is that in the United States, during the long boom from the end of World War II to the late 1960s, the benefit rate is always below the tax rate. Thus during the long boom the net social wage is *negative*—that is, it is a net tax on labor. Rather than dragging down the rest of the economy in this interval, United States workers were subsidizing it.

It is only after the boom runs out in the early 1970s and the unemployment rate rises sharply that the benefit rate overtakes the tax rate and the net social wage become positive. This is simply because increased numbers of unemployed and impoverished people become eligible for payments, while at the same time their decreased incomes reduce the taxes they pay. This same effect also raises the government deficit. Thus a positive net social wage becomes associated with a rise in the government deficit *during* the growth slowdown, giving rise to the mistaken impression that the observed correlation between the two was causal.

But the correlation did serve an important ideological purpose, because it became fodder for the attack on the welfare state. By

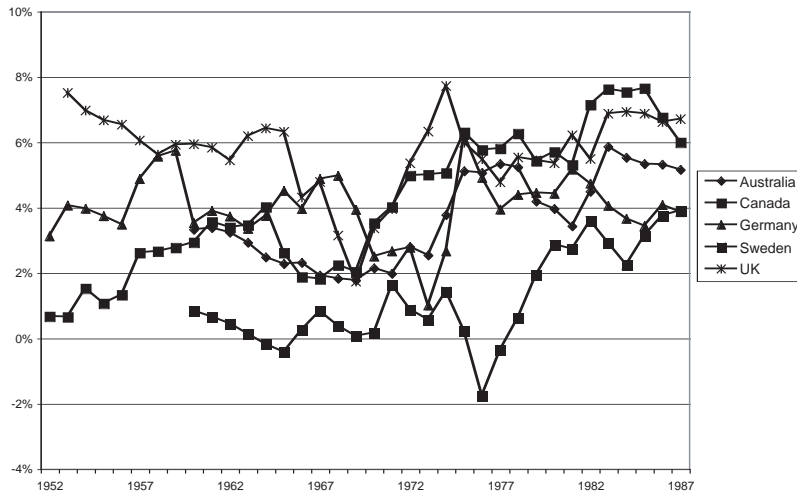
Figure 2: U.S. Net Social Wage Relative to GDP



the 1980s, beginning with Reagan and continuing after his administration, this assault succeeded in dismantling the safety net and sharply reducing the strength of workers' organizations (Amott, 1987: 51). Even the sharp rise in the unemployment rate at the beginning of the Reagan-Bush era (see table 2) barely changes the benefit rate because benefit and eligibility cutbacks compensate for the greater numbers of unemployed. A second surge of unemployment at the end of this era raises the benefit rate once again because total benefits accelerate in the face of greater unemployment while total employee compensation slows down for the same reason and their ratio actually rise. Under the Clinton administration it remains stable, but the tax rate rises, so that the gap closes once more.

Figure 2 shows these same movements from the point of view of the United States net social wage ratio (net social wage as a percentage of GDP), which is simply the difference between the benefit and tax rates depicted earlier. Over the entire postwar period, from 1952 to 1997, the average net social wage ratio in the United States is a mere -0.33 percent. In effect, workers paid for their own social benefits.⁶

Figure 3: Net Social Wage Ratio of Five Countries

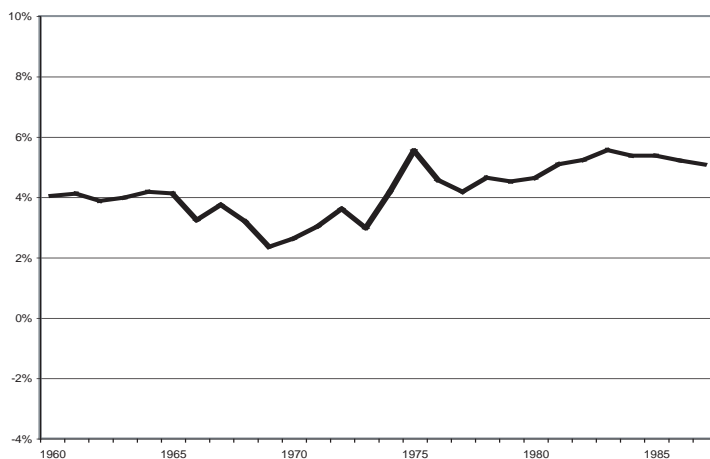


2. Five OECD Countries

A similar analysis was undertaken for the other five countries in this study (Canada, Germany, the United Kingdom, Australia, and Sweden). Because of data limitations, starting dates for the series range from the early 1950s for the first three countries, to the early 1960s for the last two. Ending dates also vary, since the country studies were undertaken by various people over different interval in the 1980s and early 1990s. For this reason, it was only possible to create comparable data for all countries for the period from 1960 to 1987.⁷ For our purposes this is sufficient to address the question of whether or not, in Europe at least, the welfare state might have caused the slowdown of growth that began in the 1970s.

Figure 3 depicts the net social wage ratio in each of the five OECD countries. Several concerns are immediately apparent. First, unlike the United States, the other OECD countries had generally positive net social wage ratios. Germany and the United Kingdom had the highest ratios, though even they averaged only about 5 percent of GDP and about 8 percent of total wages. Second, Sweden, the very paradigm of a welfare state, had an average net social wage around zero over the boom period,

Figure 4: Overall Net Social Wage of Five Countries



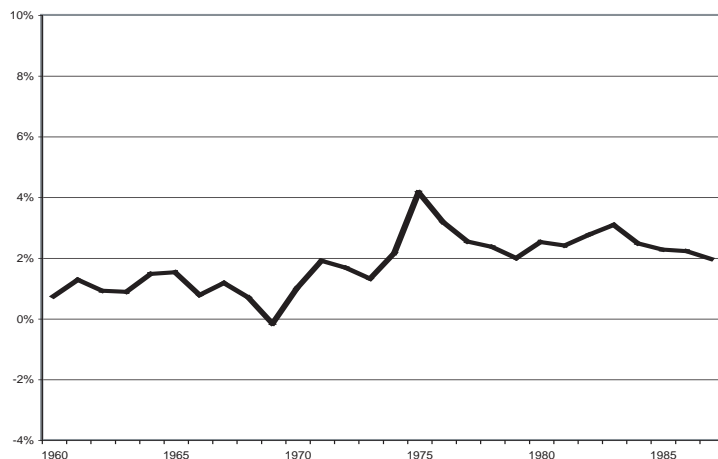
and it climbed above zero only in response to the stagnation in growth.

A third finding is that from 1960 to 1972, prior to the growth slowdown in the mid-1970s, the net social wage ratio ranged between 0 and -2 percent in the United States (figure 2), and between 2 percent and 4 percent in the other five countries combined (figure 4).⁸ Both these ratios rose substantially during the subsequent period of stagnation, but this was an effect of the stagnation itself. Since government deficits also rose for the same reasons, the rise in the net social wage is correlated with a rise in government deficits. This then gives rise to the mistaken belief that a rise in the social wage was fueled by a rise in budget deficits, which then caused the general decline in growth.

3. United States and Five OECD Countries Taken Together

Figure 5 depicts the estimated net social wage ratio of the advanced countries as a whole. To calculate this, the average net social wage ratio of the five OECD countries (Australia, Canada, Germany, Sweden, and the United Kingdom) was treated as a representative sample of that in Europe. It was then averaged with the United States ratio, using the respective shares of

Figure 5: Combined US and Europe Net Social Wage Ratio



Europe's and America's GDP in the sum of their GDPs, all expressed in United States dollars (OECD, 1991). We see that for the entire group, the net social wage ratio is roughly 1 percent for the boom period. It really rises above that, to around 3 percent, in the period of stagnation beginning in the early-1970s. Comparison of figure 3 and figure 5 makes it clear that *the average pattern is very similar to that of Sweden*. The Swedish welfare state, it seems, turns out to be paradigmatic in more ways than one.

IV. Summary and Conclusions

After the great postwar boom in the advanced world gave way to stagnation and inflation in the 1970s and 1980s, it became a commonplace on both the left and the right to attribute the disappearance of growth to the overexpansion of the state. It was claimed that that the welfare state gave rise to budget deficits in order to finance its social expenditures, and that these deficits in turned reduced growth and spurred inflation. Most often, these

claims were supported by pointing to the fact that social expenditures had risen as a share of GDP.

But a reference to the rising share of social expenditures is inadequate, because the share of taxes in GDP also rose equally rapidly. And when examined from this perspective, we find that the benefit and tax rates closely parallel each other in all six advanced countries studied here (Australia, Canada, Germany, Sweden, the United Kingdom, and the United States). The difference between the benefit and tax ratios, the net social wage ratio, is generally quite small.

In the United States from 1952 to 1997, the average net social wage ratio in the United States is a mere -0.33 percent. Thus during the entire postwar period, United States labor paid for its own social benefits. Indeed, in the boom years of the postwar period, from 1950 to 1972, the United States net social wage was *negative*, which meant that wage and salary earners paid out more in taxes than they received. Rather than dragging down the rest of the economy in this interval, United States workers actually subsidized it. It is only after the unemployment rate rises when the boom runs out in the early 1970s that the net social wage ratio turns positive. But this is because increased numbers of the unemployed and the poor led to increased benefit payments, while at the same time their decreased incomes reduced the taxes they pay. This same effect also raised the government deficit. Thus a positive net social wage became associated with a rise in the government deficit once the growth slowdown had begun, giving rise to the mistaken impression that the observed correlation between the two was causal.

In the other five OECD countries studied, over the long boom the average net social wage was about 3.5 percent of GDP. Here too the subsequent slowdown in growth raised the net social wage ratio to about 5 percent, just as it raised the budget deficit.

Yet in all cases these correlations are a consequence of the slowdowns in growth. On the deficit-as-drag argument, one would have to at least demonstrate that countries with higher positive net social wage ratios in the prior boom period have subsequently lower growth rates, and that countries with negative net social wage ratios have subsequently higher growth rates. But such a correlation does not hold. We find that net social wage ratios vary considerably across countries during the long boom, ranging from 5.5 percent in the United Kingdom, 4 percent in Germany, about 2.5 percent in Canada and Australia, a mere 0.4 percent in Sweden, to -1.2 percent in the United States. Yet all of these countries—even the United States with its negative net social wage—suffered a substantial slowdown in growth over the next two decades. The putative causal link between social expenditures and slowed growth simply does not hold up.

Notes

¹Real wages are average annual earnings of nonagricultural workers deflated by the consumer price index, both series taken from *ERP* (1996), tables B-42 and B-56, respectively.

²The data are in United States dollars, Atlas methodology, from the “World Tables” of the World Bank.

³For instance, Pampel and Williamson (1989) place a great deal of emphasis on the demands placed on social expenditures by interest groups such as the middle classes (“contradictory class locations”), ascriptive groups (gender, race, ethnicity based), and the aged (xiii-xiv), yet they seldom mention taxes at all. They thus end up giving the false impression that social expenditures account for what they call the “crisis” of the welfare state in the 1970s and 1980s (28).

⁴This claim is explicit in Bowles and Gintis (1982). But this is disputed by Shaikh and Tonak (1987, 1994, 2000) and Miller (1988, 1989).

⁵Since we are concerned with their impact on the economy as a whole, we measure benefit and tax rates relative to GDP. But if we are interested in their impact on the standard of living of workers, then we should scale them relative to the gross income of labor—that is, relative to employee compensation, as in Shaikh and Tonak (1987).

⁶In terms of gross labor income, the net social wage in the United States from 1952 to 1997 averaged a mere -0.60 percent (Shaikh and Tonak, 2000: 252). This is not only tiny, but also negative (i.e., a net tax on labor).

⁷It was necessary to extrapolate benefit and tax ratios for certain initial and final years (Australia, 1960, 1984-1987; Canada, 1987; Germany, 1987; Sweden, 1986-1987; United Kingdom, 1987).

⁸The combined ratio was calculated by converting all the net social wages in each country in each year into United States dollars through each year's exchange rate, summing them, and then dividing them by the similarly converted total GDP of the five countries. This is equivalent to taking a weighted average of the individual country net social wage ratios, using the share of each country's converted GDP in total converted GDP.

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