Israel Economic Review Vol. 11, No. 1 (2014), 145–148

REVIEW OF "MIGRATION AND THE WELFARE STATE"

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OVERVIEW

This book deals with a very important question from an economic and political perspective: immigration and the future of the Welfare State. While its focus is mostly theoretical, the theory is flexible enough to accommodate variants and extensions of a benchmark model that allow for dealing with specific contexts and increasingly complex issues. The book is very well structured—each chapter clearly builds on the previous ones (which themselves build on previous work by the authors) and proceeds gradually. It starts with a basic set-up which is enriched sequentially with new ingredients (e.g., allowing for more heterogeneity in migrants' skills, in the type of welfare state considered—Europe v. the United States, moving from a static to a dynamic framework).

The book has three main parts. Part 1 develops a series of static models of immigration and the welfare state, starting with immigration as a determinant of the welfare state, following with reverse effects (the "welfare magnet" hypothesis) and, finally, ending with joint determination. Part 2 extends these models along the time dimension using overlapping-generations models. This is particularly welcome as this allows for an analysis of intergenerational effect, which nicely complements the intragenerational effects emphasized in the static analysis. These models also allow for introducing political economy considerations such as strategic voting, which is dealt with in a separate chapter. Lastly, Part 3 deals with the specific measurement of fiscal benefits and costs of (unskilled) immigration and considers how host countries (and later also source countries such as EU accession countries) can change their fiscal and migration policies when they compete to attract a larger pool of potential migrants.

PART I

Chapter 2 develops a first workhorse model that illustrates the basic dynamics of the models contained in the book. The model builds on a standard Cobb-Douglas function with two labor inputs (skilled, unskilled). Labor complementarities arise not within the same skill category, but across them (naturally, the wage of a skilled native increases as the relative supply of unskilled labor increases). The generosity of the welfare state is captured by the tax rate. Not surprisingly, skilled labor is a net contributor to the welfare state and unskilled labor a net recipient. Policy is set by in a median voter framework (throughout the book). Immigration affects the utility function of skilled and unskilled natives via its skill composition: Relatively more skilled immigrants increase the overall labor productivity and thus contribute to the financing of the welfare state, but they also decrease (increase) wages of skilled (unskilled) natives.

Two main predictions for the "quality" or skill composition of immigration (captured by the ratio of skilled over unskilled immigrants) are verified empirically using a bilateral data set of immigration to the OECD member countries:

1) In the case of unrestricted migration policy (e.g., between two EU countries), immigrants' quality decreases together with an increase in the generosity of the welfare state since skilled immigrants will now prefer to migrate to countries with a lower fiscal burden.
2) In the case of restricted immigration policy (e.g., between an EU and an EU accession country), immigrants' quality increases together with an increase in the generosity of the welfare state (relative to the free migration case), since a skilled median voter will demand more skilled immigrants to support the welfare state and immigration policy will accordingly change endogenously.

Chapters 3 and 4 extend the above model by endogenizing welfare state generosity (chapter 3) and by jointly determining both welfare state generosity and the immigrant skill composition (chapter 4).

The parsimonious model in Chapter 3 predicts two very natural results that are empirically tested.

1) Skilled natives generally want less redistribution than unskilled natives
2) Skilled natives and unskilled natives want more redistribution if immigration is more highly skilled (since these immigrants are net contributors to the welfare state).

When testing these predictions, one finds a strong empirical endogeneity between the skill composition of immigration and the generosity of the welfare state (e.g., the extent of transfers). The authors thus employ a 2SLS model using predicted immigration stocks and then find their predictions to hold for a sample of 16 OECD countries.

Chapter 4 jointly endogenizes the welfare state and immigration policy. Two cases are distinguished. In a first case—"the free migration regime"—the native-born vote only on the extent of welfare state generosity. In a second case—"the policy-restricted regime"—they also vote on immigration policy. The same regime distinction was previously made in chapter 2. In both cases, the skill level of the median voter is decisive for the outcome. If the median voter is skilled, he/she will prefer less redistribution than an unskilled worker would have chosen (see Chapter 3) but would also restrict the inflow of skilled immigrants due to labor market competition concerns. An unskilled median voter, however, would allow only skilled workers to immigrate, since those contribute more to the welfare state and do not compete with him/her in the labor market. When introducing free migration (thus relaxing the migration policy constraint), different dynamics arise. When the median voter is a skilled native-born, immigration becomes relatively more skilled, and relatively more unskilled otherwise. Furthermore, with unrestricted immigration, welfare generosity generally falls since redistribution becomes more costly to natives due to "fiscal leakage effects"—more funds need to be redistributed (to natives and immigrants) in order to reach a desired level of redistribution for natives.

PART II

The following chapters extend the basic models via the introduction of a time dimension. This allows for analysis of inter-generation distribution schemes in Chapter 5. The set up follows a standard two-period overlapping generations model, where natives (and natives only) vote in the first and second period on the extent of an old-age (Pay as you go, PAYGO) intergenerational redistribution scheme. Simply speaking, it is in the interest of the young to pay as little as possible (or nothing) and to consume out of public redistribution when old. The model then explains the conditions under which a welfare state may exist (rather than the conditions for the relative generosity of the welfare state).

The standard model with positive population growth implies that the young always outnumber the old, and no intergenerational redistribution ever takes place. In the case of negative population growth, the intertemporally optimal level of redistribution is positive and set by the median voter. When migration is introduced, it affects the prevailing welfare equilibrium only in one case: if the population growth of natives is negative (in other words, if there is a welfare state) and the combined population growth of natives and immigrants (the latter is assumed to be strictly larger than the former) is positive. In that case only, migration can affect, and threaten, the sustainability of the welfare state, since more immigrants (and their more populous offspring) shift voting power in favor of the young. The current young are thus at risk of losing their retirement in the following period, and thus will set immigration at a positive level that trades off the benefits of immigration (a larger pie) with the risk of being in the minority when old. The model thus predicts that young natives will set an intermediary level of immigration in the first period that guarantees them to be (barely) in the majority when old in the next period. In that period, redistribution will be decided by the old, who will maximize redistribution (set the tax rate at the Laffer rate) and also allow a high number of immigrants in to increase overall GDP. As a result, the young will again outnumber the old in the next period, and the model is back to the implications of the first period. This process will then proceed in this cyclical fashion.

Chapter 6 introduces the concept of strategic voting, whereby voters do not simply choose their preferred policy but their preferred policy among those likely to be chosen anyway. This very brief chapter merely serves as a basis for a full model of intergenerational and intragenerational redistribution in Chapter 7, where multiple equilibria are created resulting from the interaction of the skill and age dimensions of immigration.

Chapter 7 sets up the richest model in the book. The tax rate (a measure for welfare state generosity), and the number and the skill composition of immigrants are determined endogenously on the basis of an overlapping generations model with two skill groups and two age groups (thus resulting in four combinations of age and skill). Young and skilled contribute to the welfare state, all others (including young and unskilled) benefit from it. The model predictions crucially depend on the relative sizes of these groups:

- If the group of the old retirees (skilled and unskilled) is in the majority, it will set the tax rate at the Laffer optimum, increase the number of immigrants and restrict immigration to skilled immigrants, since all these policy choices maximize their pension benefits.

- If the group of unskilled workers is in the majority, they will set a positive tax rate but a lower one than that of the retirees, since these unskilled workers still pay positive taxes. Furthermore, they want immigration of skilled immigrants only, since those contribute to the welfare state. Lastly, the unskilled will maximize immigrant inflow, but only up to the point that the continuation of the welfare state in the next period (and a subsequent majority of old people) is ensured.
- The group of skilled workers, the only contributors to the welfare state, abolishes the welfare state if it is the largest group majority. Interestingly, this group will tend to restrict immigration quantitatively (and to skilled immigrants) to ensure that the group remains in the majority when old (otherwise the population growth in the young cohort would be too high due to higher fertility of immigrants). In a last interesting twist, when the group of skilled immigrants is very large, it needs more immigrants, and more unskilled immigrants to ensure some continuation of the welfare state in the following period – assuming that the unskilled workers will then vote strategically along with them for a positive level of redistribution.

PART III

Chapters 8-10 focus on more specific politico-economic issues of immigration. Chapter 8 briefly sketches a dynamic model to illustrate that the net fiscal burden of (unskilled immigrants)—a key assumption in the previous models—is an insufficient measure for the gains from migration, since, as this model shows, even a net fiscal burden can go hand in hand with pareto-improvements of the native population. Chapter 9 sets up a multi-country model with one host and one source country that both set their tax (benefit) rates individually. The objective is to test if similar predictions from the literature on capital mobility that tend to predict a "race-to-the-bottom" also hold for liberalization of labor. The authors find some limited evidence for such dynamics, but only for the case where unskilled workers are in the majority in both countries. When skilled workers are in the majority, the effect of immigration on welfare state generosity is actually positive (this is in contrast to results of the capital mobility literature). This result is obtained from numerical simulations, but the authors provide little-to-no intuition for this somewhat surprising finding. Chapter 10 extends the model to the case of two host and two source countries, all of which may coordinate or compete on taxes and on immigrant labor supply. Also in this model, tax competition may—quite counter-intuitively—lead to higher taxes.

The book ends with an epilogue that briefly discusses a limitation of the analysis, namely, the fact that the analysis focuses on majority-voting political economy models at the expense of interest group models, while the latter have recently received renewed attention in the political economy literature. This being said, the book provides a very useful framework to think about the complex relationships between immigration and the Welfare State and the economic and political forces that will determine their joint evolution.