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# Renewing the American Social Contract

*A New Vision for Improving Economic Security*

With Contributions From:

Greg Anrig | Steven Attewell | Dean Baker | Bruce Bartlett | Lauren Damme  
Joshua Freedman | Steven Hill | Robert Hiltonsmith | Mike Konczal | Robert Kuttner  
Michael Lind | Peter Lindert | Jeff Madrick | Steven Teles | Bruce Stokes | Ron Unz



Economic Growth Program  
*Next Social Contract Initiative*

NEW AMERICA FOUNDATION

## About the Project

The Next Social Contract Initiative aims to rethink our inherited social contract, the system of institutions and policies designed to empower and support citizens from childhood through work and retirement. Inspired by the premise that economic security and opportunity are mutually reinforcing, a new social contract should foster innovation and openness, encourage long-term growth and broadly shared prosperity, and engage individuals and families not only as participants in the economy but also as citizens.

## About the Series

Renewing the American Social Contract is a series of major policy papers outlining bold proposals from leading thinkers for reforming American social policy in areas from wages and job creation to taxation and the welfare state. Representing diverse perspectives from across the political spectrum, the contributors to the series share a commitment to questioning orthodoxy and enlarging the boundaries of debate.

These papers were previously published at New America and are [available online individually here](#).

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# Contents

<b>Introduction</b> by Michael Lind and Joshua Freedman	v
<b>Complexity vs. Efficiency: Rethinking the American Social Contract</b>	
<b>Kludgeocracy: The American Way of Policy</b> by Steven Teles	2
<b>No Discount: Comparing the Public Option to the Coupon Welfare State</b> by Mike Konczal	12
<b>Competing Visions of the Past: Lessons from History for the Future of Social Policy</b> by Steven Attewell	21
<b>Good Jobs and Good Wages: The High Road to Shared Prosperity</b>	
<b>The Case for Wage-Led Growth</b> by Jeff Madrick	36
<b>Raising American Wages...by Raising American Wages</b> by Ron Unz	59
<b>Economic Recovery and Social Investment: A Strategy to Create Good Jobs in the Service Sector</b> by Robert Kuttner	67
<b>Independence Through Interdependence: Lifelong Economic Security</b>	
<b>Expanded Social Security: A Plan to Increase Retirement Security for All Americans</b> by Michael Lind, Steven Hill, Robert Hiltonsmith, and Joshua Freedman	78
<b>The Next Priority for Health Care: Federalize Medicaid</b> by Greg Anrig	100
<b>Front Line of Defense: Building a New Unemployment Insurance System</b> by Steven Attewell	114
<b>Paid Family Leave</b> by Lauren Damme	120
<b>Paying for The Next Social Contract</b>	
<b>Debt, Deficits, and Demographics: Why We Can Afford the Social Contract</b> by Dean Baker	135
<b>Tax Reform That Works: Building a Solid Fiscal Foundation with a VAT</b> by Bruce Bartlett	155
<b>Social Contract Budgeting: Prescriptions from Economics and History</b> by Peter Lindert	167
<b>Appendices</b>	
<b>Public Attitudes Toward the Next Social Contract</b> by Bruce Stokes	186
<b>Further Resources on the Next Social Contract</b>	198

# Introduction

America's social contract needs to be reinvented for the twenty-first century. Our inherited social contract — the overall system of economic security for individuals as children, working adults and retirees — was mainly built during the New Deal era. In the years since, long-term economic and demographic changes have eroded its foundations, even before the crisis of the Great Recession further tested its strength.

Some elements of the social contract, like Social Security and unemployment insurance, have held up well, and deserve to be preserved or perhaps expanded. Other parts have fallen away, like disappearing employer defined benefit pensions, and need to be replaced by programs that fit the needs of today's workers and economic structure. Meanwhile, arrangements like individual reliance on tax-favored private savings accounts have failed in their objectives and should be reconsidered.

The current political environment has raised additional questions about the social contract. In an era of constrained budgets and the shifting of power from labor to capital, there has been a concerted effort to shrink or eliminate many of the cornerstone public elements of the social contract. The repeated refrain that “we cannot afford” these programs has tended to dominate public debate, at the price of shutting down discussion about how to realize the underlying principles of the social contract in today's conditions.

It is to promote that public discussion that we have commissioned leading thinkers to propose ideas for the next social contract in America. The essays in this collection come from authors of many different backgrounds, ideologies, and experiences, and as a result their solutions do not always align. But taken together, the essays in this collection share certain themes.

The most important theme is that the next social contract should be broader, simpler, and more inclusive. Instead of layering small programs on top of previous small programs, it would be better to consolidate complex existing policies into fewer programs that are more transparent and whose benefits and burdens are more equitably shared.

Much of the existing social contract was designed to achieve goals through opaque, indirect methods that would allay political opposition to “big government.” The complexity of the sys-

tem is compounded by the fact that the social contract has been created in spurts of reform through piecemeal programs run by a dispersed set of actors at different levels of government. This method of policymaking, dubbed “kludgeocracy” by Steven Teles ([Kludgeocracy: The American Way of Policy, Page 2](#)), has not served Americans well. Steven Attewell details how this system came to be and explains the shortcomings of the employer-based system on which we have come to depend ([Competing Visions of the Past, Page 20](#)).

The American social contract can achieve its goal of an inclusive economy only if the middle class is able to grow along with the economy. Yet American wages have been stagnant for more than a generation, and wages in the service industries that are gaining the most jobs in a changing economy are often insufficient to ensure a decent standard of living. Jeff Madrick argues that the current low-wage regime across the globe – part of an economic strategy focused on mercantilism – has been a key factor in creating an unstable world economy. The only sustainable path to prosperity is through wage-led growth ([The Case for Wage-Led Growth, Page 36](#)).

In a demand-strapped economy, higher wages would allow more people to meet their needs and increase consumption of basic goods and services that improve standards of living and contribute to a stronger economy. Robert Kuttner exposes the dangers of the current weak economic recovery and proposes a strategy to combat weak economic growth with public investment in the service sector that will increase wages, create better jobs, and boost the economy ([Economic Recovery and Social Investment, Page 67](#)). Ron Unz lays out the case for a higher minimum wage in the United States ([Raising American Wages...by Raising American Wages, Page 59](#)).

But higher wages alone are not enough. As an advanced nation, we have a moral obligation and an economic interest in creating

a social contract that will adequately and ably support its citizens when they cannot work, because they are ill, disabled, young or elderly. When it comes to the delivery of benefits to citizens, the fashionable trend toward combining private provision with publicly-subsidized vouchers needs critical examination. Mike Konczal examines the pros and cons of public provision versus vouchers and when it makes sense to have public programs rather than vouchers ([No Discount: Comparing the Public Option to the Coupon Welfare State, Page 11](#)).

Perhaps the most common rebuttal of an expanded vision of the social contract is the alleged need to cut back due to the aging of the population. But America's demographic changes do not, and should not, preclude the possibility of a stronger social contract. In his essay, "[Debt, Deficits, and Demographics](#)" ([Page 135](#)), Dean Baker explains the true nature of our changing demographic picture and why we can afford better policies even as the baby boom generation retires.

If we want to guarantee a decent retirement for the nation's seniors – a goal that has not been met through other avenues – we need to be reinforcing and expanding, rather than contracting, Social Security. Steven Hill, Robert Hiltonsmith, Joshua Freedman and Michael Lind propose an expanded version of Social Security that uses a two-tier combination of a universal flat benefit with an income-based component to move the country back toward a more stable system of retirement security ([Expanded Social Security, Page 78](#)). Aside from Social Security and Medicare, many of our current social programs suffer from an overly-complicated design that divides power, responsibility, and oversight among the federal and state governments. When it comes to large pieces of our social insurance puzzle a single, national program would be better able to address the flaws of the system. Greg Anrig proposes the nationalization of Medicaid ([The Next Priority: Federalize Medicaid, Page 100](#)) and Steven Attewell does the same for unemployment insurance ([Front Line of Defense, Page 114](#)).

The next American social contract should also correct a major failing of today's arrangements by ensuring adequate care for the young and their parents. The United States is the only developed country in the world that does not provide basic paid leave for its workers, and paid family leave policies have proven successful at a state level within the U.S. Lauren Damme proposes to cor-

rect this flaw by ensuring paid family leave for all workers ([Paid Family Leave, Page 120](#)).

Implementing broader public programs in some cases would require more revenue, but it is possible to create stable, sustainable, and fair funding mechanisms that need not undermine economic growth. A value-added tax (VAT), as Bruce Bartlett notes, has successfully formed the basis of social contract financing across the developed world and used to be widely popular among conservatives in the United States ([Tax Reform that Works, Page 155](#)). A VAT need not be regressive in its impact if it is used to finance progressive social programs. In a thorough overview of the design of modern social contracts, Peter Lindert shows that a flatter tax used to fund progressive spending can be both sustainable and progressive without harming growth ([Social Contract Budgeting, Page 167](#)).

As Lindert explains, historical data show that higher social spending has not hurt economic growth or competitiveness while raising the quality of life. A reformed social contract that lifts people out of poverty and sustains the middle class would be an economic boon, and more stability and support over the course of a lifetime will allow increased entrepreneurial risk-taking and innovation.

In fact, the public does not see a tradeoff between a stronger social contract and a better economic future. Bruce Stokes analyzes public opinion research and finds support for the types of broad, universal programs described in many of these papers ([Public Attitudes Toward the Next Social Contract, Page 186](#)).

The purpose of the ideas and policy proposals in this series is less to provide definitive answers than to ask the right questions about the challenges facing American workers and families. Even if they disagree on other issues, most of the contributors to this symposium reject the conventional wisdom which holds that the next social contract must be flimsier or narrower, and that there must be painful tradeoffs between either government supports and economic growth or between the old and the young. And even if, in some cases, it requires more government regulation or spending, the authors in this series tend to agree that rather than continue to create increasingly complex and opaque programs, we need to build a social contract that is simpler, fairer, and more efficient.

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*Joshua Freedman is a policy analyst in the Economic Growth Program at the New America Foundation and the lead editor of this paper series. Michael Lind is the policy director of the Economic Growth Program and the Next Social Contract Initiative at the New America Foundation and a cofounder of the organization.*

**ONE**

**Complexity vs. Efficiency:  
Rethinking the American  
Social Contract**

**Steven Teles  
Mike Konczal  
Steven Attewell**

# Kludgeocracy: The American Way of Policy

Steven M. Teles, Associate Professor of Political Science, Johns Hopkins University

The last thirty years of American history have witnessed, at least rhetorically, a battle over the size of government.<sup>1</sup> Yet that is not what the history books will say the next thirty years of American politics were about. With the frontiers of the state roughly fixed, the issues that will dominate American politics going forward will concern the complexity of government, rather than its sheer size.

The next decade of American politics will see greater attention placed on the substantial amount of government action that redistributes resources upward to the wealthy and the organized, to the disadvantage of the poorer and less organized. Connected to this, greater attention will be placed on the rickety, complicated and self-defeating complexity of public policy across multiple, seemingly unrelated areas of government activity.

Conservatives over the last few years have increasingly claimed that America is, in Hayek's terms, on the road to serfdom. This is ridiculous, for it ascribes vastly greater coherence to American government than we have ever achieved. If anything, we have arrived at a form of government with no ideological justification whatsoever.

You can't solve a problem until you can name it. We have names for one axis of our politics — right vs. left, big versus small government. But voters and politicians have no name for what should be an equally important set of questions that cuts straight through those ideological divisions, which is complexity versus simplicity. The name, for a lack of a better alternative, is *kludgeocracy*.

The dictionary tells us that a kludge is “an ill-assorted collection of parts assembled to fulfill a particular purpose... a clumsy but temporarily effective solution to a particular fault or problem.” The term comes out of the world of computer programming, where a kludge is an inelegant patch put in place to be backward compatible with the rest of a system. When you add up enough kludges, you get a very

complicated program, one that is hard to understand and subject to crashes. In other words, Windows.

“Clumsy but temporarily effective” also describes much of American public policy. For any particular problem we have arrived at the most gerry-rigged, opaque and complicated response. From the mind-numbing complexity of the health care system (which has only gotten more complicated, if also more just, after the passage of Obamacare), our Byzantine system of funding higher education, and our bewildering federal-state system of governing everything from the welfare state to environmental regulation, America has chosen more indirect and incoherent policy mechanisms than any comparable country.

The great agenda of the next four years of the Obama administration, and probably the nation's next thirty, is coming to grips with kludgeocracy. But to understand how to treat our government's ailment, we first need to understand what the side effects of complexity are, and why American government is so chronically sick in the first place.

## The Costs of Complexity

The most insidious feature of kludgeocracy is the hidden, indirect and frequently corrupt distribution of its costs. But those costs are real even if they are out of sight.

The price paid by ordinary citizens to comply with programmatic complexity is the most obvious downside of kludgeocracy. One of the often overlooked benefits of Social Security, for example, is that recipients silently have taxes taken out of their paycheck and then, without any effort on their part, checks begin to magically appear upon retirement.

By contrast, 401(k)s, IRAs, 529 plans and the rest of our crazy quilt of savings incentives (for retirement as well as other purposes like higher education) require enormous investments of time, effort and stress. Just for a start, equity mutual funds charge an annual fee of around one percent of assets — compounded until retirement, this reduces savings by around twenty percent.<sup>2</sup> Including items beyond the management fee (like transaction costs and the reduced returns that come from having to hold cash to deal with redemptions), can push that number up considerably.

But that's the tip of the iceberg. While Americans should just put their savings into a balanced, indexed portfolio, most do not, and in an effort to try to invest intelligently are increasingly devoting more time (and corresponding stress) to the gyrations of the markets. Entire networks like CNBC, the financial planning industry, and a small army of financial publications have sprouted up to profit off the public's confusion — and to waste time that would be better spent on almost anything else.

If anything, the transaction costs of the tax code are even more impressive. The American tax code is almost certainly the most complicated in the Western world, both on the individual and the corporate side. The IRS's taxpayer advocate estimates that the direct and indirect costs of complying with all this complexity costs Americans \$163 billion each year.<sup>3</sup> Included in that cost is the remarkable 6.1 billion hours a year that American individuals and businesses spend complying with the filing requirements of the tax code. The web of deductions and credits also pushes up marginal tax rates for everyone: the Bowles-Simpson commission estimated that eliminating all tax deductions other than the EITC and child tax credit would allow marginal rates on middle-income taxpayers to be cut by half, and those on the top earners by about a third, without costing more money.<sup>4</sup> Getting to anything like that level of tax simplicity is exceedingly unlikely, but it does show how much of a cost in higher marginal rates we are paying to preserve

our kludgy tax system.

The compliance costs that kludgeocracy imposes on governments are just as impressive as those that face private citizens. The complexity of our grant-in-aid system makes the actual business of governing difficult and wasteful, sometimes with tragic results. As Melissa Junge and Sheara Krvaric argue in a recent report, the multiple, overlapping, bewildering different federal programs for K-12 education create a “compliance mentality” among school leaders, pushing them to focus on staying on the right side of the rules and making them shy of dramatic innovations in organizing schooling.<sup>5</sup>

Similarly, Martha Derthick shows that the confused joint administration of the flood protection system of New Orleans played a vital role in the system's failure during Hurricane Katrina.<sup>6</sup> Derthick quotes Sen. Susan Collins as having found that there was “confusion about the basic question of who is in charge of the levees,” an inherent problem given our pervasive, kludgy interweaving of federal and state responsibilities. Because administering programs through intergovernmental cooperation introduces pervasive coordination problems into even rather simple governmental functions, the odds that programs with shared rather than solo responsibility will have unintended consequences and sluggish administration are, inevitably, high.

Kludgeocracy is also a significant threat to the quality of our democracy. The complexity that makes so much of American public policy vexing and wasteful for ordinary citizens and governments, however, is also what makes it so easy for organized interests to profit off the state's largesse. The power of organized interests varies in direct proportion to the visibility of the issue. As Mark Smith argues in *American Business and Political Power*, corporations are most likely to get their way when political issues are out of the public gaze.<sup>7</sup> It is when the “zone of conflict” expands that the power of organized interests is easiest to challenge. That is why business invests so much money in politics — to keep issues off the agenda.

Policy complexity is valuable for those seeking to extract rents from government because it muddies the waters, making it hard to see just who is benefitting and how, and so obscuring the actual mechanism of political action that it is difficult to mobilize against it. That's why business

prefers its benefits in the tax code, or in obscure regulatory advantages, rather than in straightforward handouts from the state. Politicians may posture against “corporate welfare,” but kludgeocracy makes it hard for the public to focus on the various handouts to business, and thus to effectively target their anger. The consequence is that anger diffuses onto our system of government as a whole, leading to a loss of trust and cynicism at the possibility that the public sector can be an efficient instrument of the public good.

Policy complexity also benefits interests other than business. For example, the federal government has become increasingly involved in funding K-12 education over the last fifty years. But instead of just handing over a big check to school districts on the basis of need, the federal government showers the states with dozens of different, small programs. There is not much evidence that federal funding has improved the quality of schooling, and yet the morass of federal grant programs in primary and secondary schooling survives, year after year. Why? Complexity makes it easier to organize a supportive coalition for federal education funding, by segmenting it into individual grants targeted around specific constituencies that form groups around them. The complicated structure of federal education policy has created an army of Lilliputians, who then lock in the multitude of grants even though it makes it harder to actually run school districts. Kludgeocracy ensures that what Chester Finn has called the “Blob” of education interests win, but the ability of the federal government to actually drive equality of educational opportunity loses.

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### Policy complexity is valuable for those seeking to extract rents from government.

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Neither party is immune from the costs of policy complexity: the interests of both liberals and conservatives are ill-served by kludgeocracy. As Suzanne Mettler argues in her important recent book *The Submerged State*, our complex, hidden welfare state conceals the presence of government action, leading citizens to mistake as “private” market structures those programs that are in fact pervasively shaped by government.<sup>8</sup> Mettler’s research shows that Americans

who benefit from educational savings programs through the tax code (like 529 plans) do not experience them as government at all, despite the fact that they redistribute huge sums of money. The same is true for the deduction for employer-provided health care, and a variety of other pieces of the welfare state hidden in the tax and regulatory codes. This facilitates the myth of independence and rugged individualism upon which modern conservatism is based, while also creating the impression that only other, less deserving people, are able to draw upon government largesse.

Kludgeocracy is also bad for liberalism by creating both the reality and image that government is incompetent and/or corrupt. The complexity of the tax code, for instance, facilitates tax cheating and creative accounting, and along with it the impression that tax compliance is actually lower than it is. Much of the legitimacy of the law, and the willingness of citizens to contribute to public goods, rests on the perception that others are doing their share. Complexity helps eat away at that perception, which is crucial to support the expansion of beneficial state activity.

The habit of finding sneaky ways to advance public goals in a political environment suspicious of government has also had a corrosive impact on liberalism. Searching for obscure mechanisms to plant public activism in rocky institutional and cultural soil, liberals have developed a habit of dishonesty and evasiveness rather than openly making the argument for a muscular role for government. This is why so few of liberalism’s successes build a platform for new rounds of reform.

Conservatives, too, have reasons to be worried about the political costs of kludgeocracy. Pursuing public goals through regulation and litigation doesn’t eliminate the costs of government, but it does make it hard for citizens to see the costs of public action, which appear in the prices of goods and services rather than on the government’s books. While cutting their friends in on the action might seem like a reasonable pound of flesh to extract in exchange for permitting new areas of government activity, the real effect is to turn private actors into part of the lobby for entrenching government activity.

While liberals are harmed by the opacity of kludgeocracy’s successes, conservatives are hurt by the lack of traceability of its failures. The fact that so much of our welfare state

is jointly administered — either inter-governmentally or through contracting with private agents — makes it hard for Americans to attribute responsibility when things go wrong, thus leading blame to be spread over government in general, rather than affixed precisely, where such blame could do some good. The consequence of complexity, then, is diffuse cynicism, which is the opposite of the habit needed for good democratic citizenship.

## The Causes of Kludgeocracy

The costs of kludgeocracy, therefore, are considerable. To do something about it, however, requires that we understand why American politics turns to kludgey solutions so regularly.

A condition as chronic as kludgeocracy is inherently multi-causal, but the key interlocking causes of kludgeocracy are the structure of American institutions, the desire to preserve the fiction of small government while also addressing public problems, and the emergence of a “kludge industry” that supplies a constant stream of complicated, roundabout solutions. I will address each in turn.

We were all taught in school that American institutions were designed to constrain the growth of government. This is, of course, why those on the right tend to defend our founding institutional heritage, while many liberals as far back as the Progressive Era have voiced considerable skepticism. But there are reasons to be skeptical of the idea that federalism and the separation of powers limit the growth of government, since a huge pile of political science scholarship shows that when we look beyond spending and taxation and focus on policy tools that the United States has historically relied on more heavily, such as regulation, litigation, and tax expenditures, the activity of the American state is not starkly different than other industrial countries.

American institutions do, in fact, serve to constrain the most direct forms of government taxing and spending. But having done so, they do not dry up popular or special interest demands for government action, nor do they eliminate the desire of politicians to claim credit for new government activity. Public demand, when prevented from flowing directly, does not disappear. Instead, it spreads out

in complicated, unpredictable ways.

The most obvious reason why American institutions generate policy complexity is our numerous veto points for action. Separation of powers means that any proposal must generate agreement at three different stages — each house of Congress and the president. But veto points turn out to be more extensive than the simple text of the constitution would imply. Most legislation has to pass through separate subcommittee and committee stages, each of which presents opportunities for legislators to stymie action. Even worse, many ambitious proposals are considered by Congress under “multiple referrals,” in which more than a single committee is given jurisdiction. This multiplies the number of veto points, as in the recently passed health care reform bill, which had to pass through five separate committees in Congress. Finally, the super-majority requirement for breaking a filibuster in the Senate, combined with the intense partisanship that accompanies most major policy reform, means that any single member of the majority party can stall the progress of legislation.

A superficial analysis would predict that this proliferation of veto points would lead to inaction, generating a systematic libertarian bias. But in practice, every veto point functions more like a toll booth, with the toll-taker able to extract a price in exchange for his or her willingness to allow legislation to keep moving. Most obviously, the toll-taker gets to gobble up pork-barrel projects for an individual district in exchange for letting legislation move onto the next step. This increases the cost of legislation, but as John Ellwood and Eric Patashnik argue, it might be a reasonable price to pay for greasing the wheels of a very complicated legislative machine.<sup>9</sup>

Unfortunately, the price of multiple veto points is much larger than an accounting of pork barrel projects would suggest. First, many of our legislative toll-takers have a vested interest in the status quo. In exchange for their willingness to allow action to proceed, they often require that legislation hold their favored programs harmless. Consequently, new ideas have to be layered over old programs, rather than replacing them — the textbook definition of a policy kludge. Second, the need to generate consent from so many actors makes attaining any degree of policy coherence difficult, at best. Finally, the enormous number of veto points that legislation must now pass through gives legislative strategists a strong incentive to pour everything

they can into giant omnibus legislation. The multiplication of veto points, therefore, does not necessarily stop legislation from happening, but it does considerably raise its cost and, more importantly, its complexity.

America's federal system of government also does its part to add to policy complexity. In a purely federal system, in which governmental functions were clearly differentiated between the national and state governments, that would not be the case. But that is not American federalism as currently practiced. Many of our major social programs were created when the South, and to a lesser degree urban political machines, exercised a veto over extensions of the federal government that didn't leave administration to them.<sup>10</sup> That decentralization was gradually eaten away through an accumulation of thousands of federal rules and regulations, many imposed by the courts, which were layered on top of rather than substituting for programs' federal structure.

Even as the government expanded in the 1960s and 1970s, from environment to education to health care, the federal and state governments continued to be pervasively intertwined. While states and localities actually administer all of these programs, the federal government is deeply involved as a funder, regulator, standard-setter and evaluator. The consequence is the complicated "marble-cake federalism" structure that characterizes almost all domestic policy in the United States, and which makes clear lines of responsibility (as we have learned in the Katrina disaster and the BP oil spill) hard to establish.

American political culture and ideology have also, in sometimes obscure ways, contributed to kludgeocracy. One of the strongest findings in the study of American public opinion is that Americans are ideological conservatives and operational liberals. That is, they want to believe in the myth of small government while making demands on government to address pressing public problems, including poverty, retirement security, environmental protection and social mobility.

This ambivalence in public opinion creates a durable bias in the actual outputs of American government. The easiest way to satisfy both halves of the American political mind is to create programs that hide the hand of government, whether it is through tax preferences, regulation or litigation, rather than through the more transparent means of

direct taxing and spending.

Where our government does spend, it increasingly does so indirectly. The myth of what Michael Greve calls "our federalism" creates a bias toward sending the money to the states, even though the cash always comes attached to a huge mass of regulations and programmatic requirements (as in dozens of grants-in-aid that go to the states to support primary and second education).<sup>11</sup> And the myth of the superiority of private business has been supported by funneling government money through contractors in the military and consultants throughout government, and government supported enterprises like Fannie Mae and Sallie Mae (which, while off-the-books, turned out to have major on-the-books consequences).

Abetting and to some degree contributing to this bias in public opinion have been the strategic decisions of conservatives over the last fifty years. A half-century ago, conservatives were unable to stop the growth of the federal government's role in education. But, as Patrick McGuinn shows, what they were able to do was to force that funding to come in the form of multiple different small programs, on the theory that these would be less likely to grow than a simple, clean handover of cash to poor districts.<sup>12</sup> They turned out to be wrong — targeting funding helped facilitate the growth of supportive interest groups, which has made it virtually impossible to streamline our ineffective web of federal education programs.

More recently, Republicans have faced a similar question of how to deal with an irrepressible public demand for government action, and in many cases made a decision to fold on the condition that the growth of government cut their allies in on the action. In the George W. Bush administration, Republicans sued for peace over the popular cry for a prescription drug benefit for the elderly, but had enough power to ensure that the program would not be administered through standard Medicare. Instead, as Andrea Campbell and Kim Morgan show in *The Delegated Welfare State*, conservatives insisted as a condition of their cooperation the administration of the program through privately run plans.<sup>13</sup>

This was more than just a payoff to business interests. Republicans hoped that avoiding Medicare administration would cut the traceability chain between citizens and government, leading the elderly to associate the improvement

in their standard of living with private providers, instead of government. If they couldn't stop the program entirely, then programmatic complexity would make it difficult for Democrats to take credit for it, or for the program to influence citizens' support for government overall.

Similar stories could be told in a variety of other policy areas, where liberals got bigger government, but conservatives funneled benefits to business while keeping liberals from reaping political credit. The conclusion of the last three decades of ideological trench warfare is that the American public got a more active, but also incoherent and frequently ineffective, state.

Finally, kludgeocracy turns out to be self-generating through the "kludge industry" that feeds off of the system's appetite for complexity. In the name of markets and innovation, and driven by increasingly strict (as well as arbitrary) limits on government personnel, the United States has created what public administrators call a "hollow state," in which core functions of government have been hived off to private contractors, operating under the oversight of increasingly overwhelmed civil servants. Christopher McKenna, in his magnificent book *The World's Newest Profession*, shows that, for over half a century management consultants brought in to advise governments have — surprise! — regularly recommended a greater role for consultants and contractors.<sup>14</sup>

This army of consultants and contractors then became a lobby for even greater transfer of governmental functions — including, as Janine Weidel shows in *Shadow Elite*, such core roles as formulating policy recommendations and overseeing contractors.<sup>15</sup> This "kludge industry," having pulled the fundamental knowledge needed for government out of the state and into the private sector, thus becomes nearly indispensable. And with their large, generally non-competitive profits, the kludge industry has significant resources to invest to ensure that government programs maintain their complexity, and hence the need to purchase their services.

As vital as the material interests of consultants and contractors have been in encouraging policy complexity, an equally important role has been played by the army of think tank analysts, including those who claim to be liberals. As the institutional and cultural incentives reinforcing kludgeocracy have gotten ever tighter, the suppliers of policy ideas

have generally adapted to kludgeocracy rather than resisting it. For example, instead of repeatedly making the case for the fairly simple and direct mechanisms of social insurance, writers in think tanks have pushed for often bewilderingly complicated policies to increase savings under the banner of "assets strategies." Much of the preference for complexity comes from trying to get the equivalent of two dollars in social benefit out of one dollar (or less) in governmental effort, which has seemed increasingly vital in an era of tightened budgets. But some of it comes from a preference for the perception of what is clever, interesting or innovative, which relatively simple, direct uses of governmental brute force are not. In any case, the "suppliers" of policy ideas have tended to reinforce the bias toward complexity, when one could argue their higher obligation is to resist it.

## The Cure for Kludgeocracy

Kludgeocracy is not an accident — it is a predictable consequence of deep features of the American regime. It would be facile, therefore, to pretend that its baleful effects can be reduced without major (and extremely unlikely) changes in our larger system of government and dominant values. But institutions can be changed at the margins, values can shift incrementally, and in any case knowing what one would do to reverse the problem is necessary if only to know how to keep it from getting any worse.

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**Any attempt to chip away at policy complexity must involve reducing the number of veto points in our system.**

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The deepest cause of kludgeocracy is the structure of American institutions, and the incentives that they provide for individual politicians. Any attempt to chip away at policy complexity must involve reducing the number of veto points in our system. None of those I have in mind are actually features of our basic constitutional design, but are barnacles built up over time. If anything, removing them would lead to institutions truer to our founding design.

First, eliminate or radically reduce the filibuster in the Senate, which increases the number of members who can demand changes in legislation as the price of their vote. Second, reduce multiple referrals to Congressional committees, which create extra opportunities for rent seeking and produce policies with fundamentally divergent logics that need to be reconciled with each other (before they even reach a House-Senate conference).

Public policies would become less kludgy if Congress shifted the power over the “micro-design” of policies away from Congress and toward the agencies that will actually have to administer them once they are passed.<sup>16</sup> This is not a plea for greater delegation of Congressional power to the executive: in some ways, it is the opposite. Congress often avoids actually making law that is worthy of the name — a general, abstract statement of authoritative values and basic policy design — and instead passes a wave of specific measures unconnected by any general logic. It does too much of what the executive is best equipped to do, and too little of what only it can command the authority. Giving the people who will actually have to administer policies greater power over their design would likely increase their simplicity.

We should also substantially reconsider of our system of federal grants to the states. Michael Greve recently suggested that we adopt a norm of “one problem, one government.” In other words, whether it is education or health care, either give the problem to the federal government or give it to the states, but don’t give it to both. If the federal government wants to expand access to health care, it should pay the bill and administer the program itself, either by creating “Medicare for All” or building a system of national exchanges and subsidies. In education, either we should considerably nationalize education (by, for example, creating a national voucher paid for out of tax funds that would go directly to individuals, and would preempt local funding through property taxes) or cut the complicated web of education finance and regulation altogether. Conceivably we could do both, relieving states of the costs of Medicaid entirely and sending education — lock, stock and barrel — back to the states.

This is an area where the conservative majority on the Supreme Court might actually generate greater pure nationalism, by establishing rules that make it harder for Democrats to expand federally-supported state-level wel-

fare state programs (like Medicaid). Democrats will scream in the short term, but over the long term constitutional standards like these might actually serve the interests of liberalism better than the law of anything goes.

Significant institutional reform is, at best, a longshot. A more plausible target is an attack on the kludge industry, given that it both lives off of and helps create demand for policy complexity. The best place to start could be the Department of Defense, where the growth of the private military over the last few decades has been explosive, and where deficit reduction is putting the Pentagon’s budget in Congress’ crosshairs. Increasing the salaries of high-level federal workers throughout the federal government and reducing caps on their numbers could also go hand in hand with cutting the budgets that agencies have to spend on management consultants.

Perhaps the most important tool against policy complexity is a change not in institutions, interests and rules, but in ideas. All of the suggestions I have laid out in this last section will have only marginal effects unless policymakers come to be embarrassed to be associated with kludginess.

The only viable way to do so is to increase the visibility of policy complexity’s costs, so that more publicly-spirited politicians seek to minimize them, while their more electorally-minded colleagues are made to worry about being held responsible for them. As the late Sen. Moynihan argued, what counts is what’s counted. While CBO deficit scoring powerfully influences the alternatives politicians consider, the large compliance costs associated with kludgeocracy are uncounted, and thus invisible. Requiring that CBO issue an estimate of governmental and private compliance costs along with its deficit score would reduce somewhat the incentives to lower deficit estimates by substituting more complicated alternatives.

Few of the reforms sketched out above have much of a chance, since the institutions and practices they propose to alter are too deeply dug in to uproot. But there are levers for change short of major institutional reform, the most important of which is a shift in “problem definition.” Feminism, for example, didn’t become a top-shelf public problem until writers and agitators gave their grievances a publicly recognizable name. The quality of the air, water, public lands, and toxic waste were all thought of as discrete issues until writers and a nascent movement made “the

environment” a problem that politicians thought of holistically. There are no natural “problems” in politics — it is through research, discussion, deliberation, and argument that we piece together the pieces of a complex world that we come to recognize as stable problems. It is often very difficult to get the political system to recognize a new problem, but once it has, and once that recognition has been entrenched through new rules and practices, it can be very sticky, with considerable implications for policy outcomes.

Making kludgeocracy into a recognized public problem will be an uphill battle. First, ordinary citizens need to be helped to see the problem, to recognize its manifestations in their ordinary lives. When they get frustrated trying to figure their way through federal education aid programs, or flustered trying to understand their taxes, or perplexed at the complications of our civil litigation system, they

need to recognize their problem as a part of a larger system that connects up to other, seemingly unconnected grievances. This is, quintessentially, the work of public intellectuals, bloggers, researchers, and entrepreneurial politicians. Only the shapers of public debate can help the public recognize that the source of the insider dealing and special interest politics they detest is the policy complexity that their own ideological incoherence helps to create. Only intellectuals can help the public see that the ineffectiveness that they detest is a product, in part, of institutions and cultural values they mistakenly believe protect them against government.

Only, in short, when Americans give a name to their pain — kludgeocracy — are we likely to get a government that is simpler, more effective, and better for democracy.

## Notes

1. This paper was a product of the New America Foundation from start to finish. A few years ago, when I was a NAF fellow, Andrés Martínez suggested that the neologism I threw out over coffee — “kludgeocracy” — could be made into a serious essay. I also owe Bernard Schwartz a debt of gratitude for his generous funding of the Fellows program. I started writing this essay soon after talking to Andrés but ran out of gas. This fall, Mike Lind convinced me to dust the idea off and finally get it into print. Finally, Mike Tomasky read an earlier, and much windier, version of this and provided excellent comments.
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3. IRS Taxpayer Advocate Service, [2010 Annual Report to Congress](#), Volume One.
4. The National Commission on Fiscal Responsibility and Reform, [“The Moment of Truth,”](#) December 2010.
5. Melissa Junge and Sheara Krvaric, [“Federal Compliance Works Against Education Policy Goals,”](#) *AEI Education Outlook* No. 6, July 2011.
6. Martha Derthick, “Where Federalism Didn’t Fail,” *Public Administration Review*, December 2007, pp. 36-47.
7. Mark Smith, *American Business and Political Power: Public Opinion, Elections and Democracy* (Chicago: University of Chicago Press, 2000).
8. Suzanne Mettler, *The Submerged State: How Invisible Government Policies Undermine American Democracy* (Chicago: University of Chicago Press, 2011).
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11. Michael Greve, *The Upside Down Constitution* (Cambridge: Harvard University Press, 2012).
12. Patrick McGuinn, “Education Policy from the Great Society to 1980: The Expansion and Institutionalization of the Federal Role in Schools,” in Brian Glenn and Steven Teles, eds., *Conservatism and American Political Development* (Oxford: Oxford University Press, 2009).
13. Kimberly Morgan and Andrea Campbell, *The Delegated Welfare State: Medicare, Markets and the Governance of Social Policy* (Oxford: Oxford University Press, 2011).
14. Christopher McKenna, *The World’s Newest Profession: Management Consultants in the Twentieth Century* (Cambridge: Cambridge University Press, 2006).
15. Janine Wedel, *Shadow Elite: How the World’s New Power Brokers Undermine Democracy, Government and the Free Market* (New York: Basic, 2009).
16. Something similar was proposed by Alan Blinder in “Is Government Too Political?,” *Foreign Affairs*, November/December 1997, pp. 115-126.

# No Discount: Comparing the Public Option to the Coupon Welfare State

*Mike Konczal, Fellow, Roosevelt Institute*

The fundamental ideological conflict surrounding the Welfare State in the U.S. is no longer over the scope of government, but instead how the government carries out its responsibilities and delivers services. The conservative and neoliberal vision is one of a government that provides a comparable range of benefits as conventional liberals, but rather than designing and delivering the services directly, it provides coupons for citizens. Coupons – whether by that name or more anodyne terms such as “vouchers” or “premium support” or tax subsidies – could then be used to purchase the services in the private market. Whenever neoliberals have sought to expand the scope of the welfare state or conservatives have tried to fundamentally shrink it, both have come bearing coupons.

This is a vision of the government as a giant coupon machine, whose primary responsibility is passing out coupons to discount and subsidize private education, health-care, old-age pensions and a wide variety of other primary goods. Over the past 30 years, efforts to privatize what government does and replace it with vouchers have taken hold in elite policy circles. But recent popular pushback against the privatization of Social Security, the use of private military contractors, and the voucher-ization of Medicare in Paul Ryan’s budget shows that the proper method of provisioning of government services is still a point of contention.

Beyond that, there’s an increased realization that public options are capable of creating better outcomes while taking advantage of both democracy and markets when used under the right circumstances. But when should public options be used? What guidelines should be used to understand when the state should provide a good directly versus subsidizing the private market through subsidies?

There have not been many clear guides on which is a more

preferable outcome for goods the government wants to provide: public allocation or public subsidies for private allocation. This paper seeks to outline a theory of when public provisioning of goods is a superior solution to the approach of subsidizing private goods with vouchers.

There are many advantages that the government has when it comes to providing goods itself, especially when vouchers prove problematic. When the government itself produces a good it can contain costs in markets where supply is constrained, standardize products to solve information problems, ensure basic levels of quality and use scale and compulsion to efficiently provide social insurance. Publicly produced goods move choices in the marketplace to choices democratically made, emphasizing democratic accountability and access. This can give it an advantage over many problems with vouchers, including distributional effects, visibility and control over intermediation.

**Table 1** outlines the two different approaches of vouchers and public provisioning.<sup>1</sup> Direct public provisioning is when the government directly administers and allocates

Table 1: Public Provision versus Vouchers

	Public Provision	Vouchers
Explanation	Provide good directly through either transfer or production.	Encourage the private provision or purchase of a good through subsidies and inducements.
Common Instruments	Government production, cash payments.	Tax breaks, subsidized credit, vouchers, cash payment.
Examples	Social Security, Veterans Health System.	Tax exclusion of fringe benefits, food stamps.

the good in question. The government chooses both the quality and quantity of the good in question. It handles the production, administration and supervision of the good in question.

Vouchers can refer to many different things, but in general a voucher is a subsidy that grants an individual limited purchasing power for a specific range of goods and services in private markets. In this sense it provides a medium level of choice by both prescribing and proscribing the good in question. A voucher places restrictions on the types of goods and services that can be provided but allows for a large amount of choice within these goods. Beyond choice, vouchers are flexible in design. The subsidy they provide can be given to the consumer or the provider, and it can take the form of an expenditure or a tax subsidy.

Of course, the contrast should not be overstated. The relationship between direct, public provisioning and vouchers should be thought of as existing along a continuum. Many programs of direct provisioning already involve private contracts, outsourcing and public-private partnerships. And public provisioning has many distinctions, ranging from where the public monopolizes the good or service, like defense, to public options that are in competition with private options, such as K-12 schools and universities. (This paper will focus more on the public option than a single public provider, though distinctions will be discussed when necessary.) However, there is an ultimate distinct split between public provision and vouchers.

## Advantages of Vouchers

The advantages associated with vouchers are ones of choice,

efficiency, competition, budget control and incentive management. In allowing individuals to choose among market competitors, they can best satisfy their own preferences, elevating the best products. In return, competitive markets respond by increasing the quality and quantity of a good for a given price, bringing efficiency to bear on the product. This unleashes the full advantages of market competition while still allowing the government a role in helping with the allocation of certain goods.

Since the commitment of a voucher isn't open-ended, but instead capped by the amount of the voucher itself, it can allow for better budget control by the state than a publicly provisioned program based on need. The capped nature of vouchers manages incentives: there is an incentive to spend the full voucher but the marginal cost beyond it is transferred to the person in question. Vouchers can also be easily targeted to those most in need of a good, giving them equitable and distributional potentials as well.<sup>2</sup>

## What are the Problems with Vouchers?

Though there are advantages to using vouchers to provide government services, there are also drawbacks. As the political scientist Jacob Hacker notes, we shouldn't think of private provisioning as a "mere substitute" to public production, but instead note that there are three big differences: "distribution, visibility and control."<sup>3</sup>

The distributional impacts of vouchers will often skew upward. Using vouchers requires having the information and resources to find and utilize them. For instance, the benefits of vouchers as public policy are often delivered through the tax code. People get certain deductions for the

specific practices that the government wants to support, from housing to health care savings accounts. However, deductions for taxes disproportionately benefit those with higher incomes.<sup>4</sup> Taxes are higher up the income ladder under progressive taxation, so the richest have the most to gain from tax deductions. People with more income are also more likely and more able to put additional resources towards taking advantage of all the hidden welfare state mechanisms like tax deductions. If fully utilizing the private welfare state requires a team of tax attorneys, only people who can afford a team of tax attorneys will take advantage. The private welfare system is thus less progressive in its redistribution than the normal mechanisms of the traditional, public welfare state.

Privately provisioned aid programs are frequently less visible than publicly provided programs. A private welfare state hides the mechanisms of choices and distribution. As Cornell University professor Suzanne Mettler has shown, a large number of people who take advantage of the vouchered, or what she refers to as the “submerged,” welfare state, don’t believe they are using a government resource. For example, over 60% of those who use college tuition subsidies and over 50% of those who claim a mortgage interest deduction or take out a student loan don’t see themselves as using a government program.<sup>5</sup> This creates the impression that private provisioning is more “natural” while hiding the public nature and government role in setting up these markets. It also leads to under-provision of goods and services because people do not want to pay for the programs that they do not realize they are benefiting from.

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## A private welfare state hides the mechanisms of choices and distribution.

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Beyond citizens, it isn’t clear that lawmakers always see deductions in the tax code as part of a private welfare system or fully understand the mechanisms at play. Thus a private welfare system can be even less subject to democratic control and accountability, either from citizens or lawmakers.

Meanwhile, control over the allocation of these public goods is in the hands of private intermediaries who actually produce the goods. As a result of providing public goods

through vouchers, new political coalitions will be created. Some argue that using vouchers will reduce the size of the government. Libertarians such as Milton Friedman have been aggressive in arguing that vouchers are a good first step in reducing the size of the government, while others like Stuart Butler have argued that privatization more broadly will break up “public spending coalitions” that advocate for a larger government. However, both of these thinkers miss that a private welfare state will create new coalitions of business interests, providers, middlemen and conservatives to defend this welfare state with just as much vigor.<sup>6</sup>

Vouchers can create spending coalitions that are difficult to change. The fact that public authority and resources are being used to validate the private provisioning of the state gives these coalitions even more power than they would normally have as a lobbying group.

To take one example, many commentators have argued that the home mortgage interest deduction, a tax code subsidy voucher that is nominally designed to encourage homeownership, should be phased out. However, this voucher brings together realtors, construction companies, the financial industry and homeowners themselves as a new coalition group in a way that public housing never did. Homeowners don’t see the tax deduction as part of the welfare state and do not engage with it as a form of “welfare” as they normally would. And the mortgage-interest tax deduction is highly regressive, mostly benefitting people making well over six figures, and only those that itemize their returns.<sup>7</sup>

## Democratic Choice and Market Choice

Those are obvious problems with running public goods through a private system. But it is important to critically discuss what is considered the best benefit of vouchers – the notion of “choice.” Most proponents of vouchers say that it will expand choices. Instead of citizens relying on a single option provided by the government, there would be many options in a competitive marketplace. But what vouchers really do is replace one set of choices, made through democratic action, with another set of choices, made through the market.

In a democracy, governmental actions are responsive to

citizens through voting. Vouchers take citizens democratically finding solutions to problems and turn them into consumers bidding on goods in a market. Finding solutions in a public space emphasizes accountability, voice, transparency, rules and claims through reasoning that goes beyond the self. The private market emphasizes cost-benefit thinking, exit, closed proprietary profit-seeking strategies, bargaining and the satiation of individual wants. The locus of government action moves away from providing for the commonwealth towards encouraging entrepreneurial activities. Instead of a role in directly providing certain goods or a baseline of security – economic or otherwise – in a voucher system, the role of the government is to provide a baseline of market participation. Though the limits of and strains on the democratic process are well known, that does not negate the clear limits of the marketplace. The democratic problems are simply turned into a new set of constraints in the market.

The solutions for these constraints are also different. Democracy enables citizens to demand accountability and agitate for change through action and expressing their voices. But the equivalent form of action in a market for consumers is either spending or not spending. This turns democratic action into something where agency and votes are conditional on income, and thus fundamentally unequal. Vouchers encourage what the economist Albert

O. Hirschman called “exit,” as vouchers can only be spent or not spent, while public options encourage “voice.”

A public option amplifies private options. It provides cost-control in cases where firms have monopolistic price-setting powers. It helps reduce informational problems, by creating a long-term, stable baseline for private providers to innovate and expand against. In some markets, notably insurance ones, it is more efficient because of compulsion and size.

More generally, public options working with private-market vouchers combine the strengths and weaknesses of democracy and market-based capitalism. Democracy and accountability are essential to the social goods the government provides, as the items we want the government to ensure citizens have, from education to health care to retirement in old age, aren’t just narrow consumer goods but the basis of our civic society and form the promise to the future of our country.<sup>8</sup>

This element of democratic accountability will shape the provisioning of public goods, with citizens arguing for more or less of a good, and with the possibility of exit to the private market making the voice of the democratic process more effective. In turn, if consumers feel a lack of accountability or voice in the private market, or if they feel

Table 2: When Public Provision is Preferable

	Advantages to Public Provisioning	Concerns about Coupon Government
Choice	Democratic choices as citizens encourage accountability, voice, transparency, rules and claims through reasoning that goes beyond the self.	Market choices as consumers encourage cost-benefit thinking, exit, closed proprietary profit-seeking strategies, bargaining and the satiation of individual wants.
When Markets Fail, and Providers Have Pricing Power	Full allocation goes towards the good in question, while also reducing costs and rent-seeking powers of private providers.	Private providers can capture subsidies. Increased demand raises prices for all consumers.
When Standardization and a Baseline of Quality is at Stake	Public options can function as check and balance by providing baseline quality of a good. Reduces need for subsequent regulation. Encourages competition on price and higher quality.	Often difficult to tell the difference between efficiency gains and lower quality of a good. Very important when baseline quality is important for the good in question.
Providing Social Insurance	Compulsion, scale, long timeframe, strong negotiations make government provisioning of insurance efficient.	Cream skimming and market segmentation. Vouchers work poorly when needs is very unequal.

private providers are exploiting them, they are more likely to return to the public option. This in turn makes private providers more accountable to the democratic process.

Beyond allowing citizens to have a democratic say, what are the other advantages of public allocation? What characteristics of goods make it more attractive for them to be provided by the government, and are these features generalizable? Table 2 gives an overview of when public allocation has an edge over the coupon government, and the rest of the paper will expand on these.

### Uncompetitive Markets: Firms that Don't Lower Prices in Response to Demand

Given that the case for vouchers relies on theories of economics in which markets are functioning well, what happens when markets don't behave perfectly? What about situations where firms won't increase supply in response to demand, either because they are monopolists, oligopolists or otherwise have market power to set prices?

In these cases, incumbent firms are likely to capture a large part of the value of a voucher through increasing prices on the services they deliver. Vouchers are designed to increase demand, which, if not met with an appropriate amount of increase in supply, will raise the price. Not only will this blunt how much beneficiaries from vouchers will benefit, it will also raise the price for consumers not benefiting from the voucher. If the firm has market power, this effect will allow them to capture part of the voucher in profits.

But what if the state, instead of providing vouchers for private firms, uses those resources to reduce the cost of the good by providing it themselves? First, all those resources will directly go to the services necessary to be funded. Second, a dollar spent producing the good doesn't just lower the cost for the direct consumer. It also lowers costs from private providers, who have to compete with the public option.

In these cases, vouchers get less bang-for-the-buck than public options directly funded with the same amount of resources. Vouchers, in the presence of firms with market power, will be partially captured and prices will increase for all. With public options, the resources will be adequately allocated and prices will decline for all.<sup>9</sup>

Take the example of higher education. Since the 1970s the government has created several voucher mechanisms to fund access to private colleges and universities, including Pell Grants, government-subsidized student loans and tax-subsidized savings vehicles. Meanwhile, public funding is being lowered and tuition raised at the equivalent public option, state public colleges and universities.<sup>10</sup>

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Vouchers, in the presence of firms with market power, will be partially captured and prices will increase for all. With public options, the resources will be adequately allocated and prices will decline for all.

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There's a set of arguments stating that private institutions of higher education largely capture these vouchers by raising tuition in order to compensate for the extra demand vouchers produce.<sup>11</sup> If this logic is flipped, directly reducing the price of a college degree through public education will also reduce the tuition costs at the private institutions, as they are forced to reduce margins in order to compete. So in these instances, money spent on providing cheaper public options will amplify their effect throughout the market, while money spent through vouchers is simply captured by incumbent institutions and prices rise across the board.

### When Standardization and Quality Are an Issue

A public option also standardizes a product, which is especially important for markets where there are information inequalities between buyers and sellers. This not only gives consumers an advantage in expecting what they'll get, but it also allows competitors to more explicitly compete on both quality and price. This is necessary when the government requires that a bare minimum of a good be allocated to each citizen.

A major problem with providing vouchers for a good is that it can be difficult for the government to completely monitor the quality of goods that qualify for vouchers when the private market produces them. If consumers themselves

also have difficulty monitoring or understanding the full variety of goods, the market can lead to stratification and competition on reducing quality. If prices are lowered, it can be difficult for the government and citizens to tell if it is because market innovations have allowed for lower cost production or because they are providing services of a cheaper quality. When there is a baseline quality necessary for the good this becomes very important.<sup>12</sup>

This extends to situations in which there is already a large market for private goods. Public options can set standards against which private plans can compete. The private market is then more incentivized to provide new benefit options and offer greater flexibility. Public options thus provide an institutional check and balance, which encourages private plans to have higher standards of quality and affordability.

This is true in the case of consumer finance. A 30-year, prepay-able fixed-rate mortgage with a down payment is, in part, a creation of Fannie Mae and Freddie Mac of the immediate post-War era. Consumers know what they are getting with these mortgages, and because they are standardized banks are able to compete on rates without deterring quality. The standardized nature of these mortgages created a large secondary market. Many states and academics have pushed for additional so-called “vanilla option” packages to be mandated for sale by banks or officials, ranging from a checking account with no hidden fees to a system of banking accounts to be run by the postal service.

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It is worth noting that these vanilla options reduce the need for excessive regulation of private options that come with subsidies. For instance, private prisons have extensive regulations associated with them, because the baseline of what should be done to prisoners shouldn't be left to market forces. These private systems can lead to an increase in the importance of regulations, because monitoring of

private agents can become quite costly. Rather than creating regulations to try and mold a basic quality level, the government creates, runs, and subsidizes such an option and lets the private market innovate in response to it.

## Social Insurance

In many cases, especially in regards to social insurance, the government will be a more efficient provider of services than the private market. For markets where adverse selection plays a major role, the unique ability of the government to use compulsion to require purchase of a service makes public options more effective. People can choose not to spend vouchers, but being required to take advantage of a program can't be easily avoided. This allows insurance to work best through expanding risk pools and distributing risks more widely. This particular bargaining leverage gives the government the ability to gain volume discounts and restrain total spending.

As public options can often innovate and do research that acts as a public good, improvements in the system can be spread more widely. And due to the timeframe of the government relative to private firms, public options are better incentivized to make long-term investments in their clients that deliver benefits further down the road.

The lack of a profit margin and the scale at which governments can perform help explain these cost-control advantages, especially in the insurance markets. Information is a public good that private firms have no desire to share, yet it directly impacts quality control, improvements and costs. The size of the government gives it an advantage as a negotiator, and lower administrative overhead contributes to these cost-control advantages. We see this when the good is health care, as public insurance has proven more stable and capable of controlling costs, especially for the most vulnerable populations.

To take one example, public health insurance has been shown, through a range of studies, to be better at providing a given level of benefits for less than it would cost on the private market. Comparisons between Medicare and private insurance spending show that Medicare spending per enrollee has grown substantially slower than private plan spending.<sup>13</sup>

Social insurance is particularly important because needs aren't equally distributed among people or known in advance. Vouchers particularly work well when needs are roughly equal across people. People need roughly the same amount of food to survive, so food stamps allow individuals to buy the food bundles best suited to their needs. In these cases, giving people coupons to purchase the specific good that best suits their preferences is sufficient.

However, there are many situations in which needs vary greatly among people for reasons outside their control. In these cases, needs are unequally distributed and thus having equal access to a subsidy won't be enough for people who need the good the most. This is most obvious in health issues, where pre-existing conditions and the randomness of brute luck can cause people to need a large amount of health care.<sup>14</sup>

Indeed, "cream-skimming" and other forms of adverse selection, in which providers pick the most advantageous clients and leave other potential clients on the sidelines, are problems that can only be solved with compulsion available with certain types of public options. Both health care and Social Security can be available to those that would normally be denied it by creating a single-risk pool.

A form of social insurance that it is worth spotlighting is income maintenance. The government has shown itself to be particularly capable of supporting incomes for populations during specific age spans or life circumstances. As with health care, because of its size and lack of profit motive the government can lower administrative costs. Cash transfer programs where income is taken in through taxes and then sent out to targeted individuals is highly efficient as a technical matter: Social Security's administrative costs are in the range of less than 1%.<sup>15</sup> Beyond this, the long, intergenerational timeframe of the government's horizon allows for efficient, long-term insurance.

Providing people a level of income X under conditions Y is something the government has turned out to be very efficient at doing. Determining both the level of income and the circumstances of income maintenance requires a democratic debate, but once determined the government is well-positioned to carry these actions out.

Social insurance combines with the priority of providing for a bare minimum. Many social insurance goods are

designed to compensate for bad luck, keep people out of hunger or poverty, or prevent certain undesirable states from being reached. Because these goals are part of the core of the welfare state, they should not be contingent on a relative lack of success in marketplace transactions. Preserving social insurance policy outside of the market emphasizes the importance of this minimum.

## Case Study: Unemployment Insurance Accounts

With the broad outlines provided here it might be helpful to use a specific example to illustrate these principles in practice. Let's look at the example of unemployment insurance. Several commentators and policymakers have suggested replacing the unemployment insurance program, created in law as part of the 1935 Social Security Act, with a system of private, personal accounts for unemployment insurance. Former presidential candidate Mitt Romney told an Iowa debate in 2011 that he "would far rather see a reform of our unemployment system, to allow people to have a personal account which they're able to draw from as opposed to having endless unemployment benefits....if I were president right now, I would go to Congress with a new system for unemployment, which would have specific accounts from which people could withdraw their own funds."<sup>16</sup>

Under this private system, instead of contributing to a public trust fund for unemployment insurance, employees would create a savings account while working that has money automatically channeled into it tax-free that could then be drawn down during periods of unemployment. How does this system stack up against traditional unemployment insurance?

Unemployment insurance is strong all the advantages that we've outlined above and also manages to have the disadvantages of the private sector welfare state. To start, unemployment insurance falls under the broad definition of income maintenance and social insurance. It is easy for the government to provide people with a stipend of money under the conditions that they've been unemployed for a certain period of time and meet a few other obligations. The innovation and competition that comes from the market won't further this in the way it does for many other

industries.

Between compulsion and the spreading of risks unemployment insurance also falls into social insurance, playing to the strengths of the government as a provider. Unemployment insurance savings accounts aren't actually social insurance – there's no risk pooling or sharing risks among large populations in order to take advantages of the traditional benefits of insurance. With individual savings accounts isolated, atomized individuals absorb the entirety of their unemployment risks by themselves.

The base minimum that comes with standardization is also key for unemployment benefits. Unemployment benefits are easy to scale up in difficult times like recessions. Unemployment savings accounts would be difficult to expand, thus taking a crucial “automatic stabilizer” of macroeconomic policy out of commission. Publicly-provided unemployment insurance is not isolated from choice, either – the expansion and contraction is subject to a democratic process, making the expansion in rough times visible and thus accountable.

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## The public allocation of goods has many advantages that are unique to the government itself.

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Unemployment insurance savings accounts also encounter many of the pitfalls of a private welfare state. Redistribution in this private welfare state is quietly upwards, towards the richest, instead of toward those in need. Like any welfare spending through the tax system, unemployment insurance savings accounts benefit those who pay the most in

taxes and those who have the ability and means to take advantage through disposable income and tax sophistication.

Unemployment insurance, like the best of social insurance, is something that works well in the background. People pay into it during good times automatically and then withdraw from it in bad. An unemployment insurance savings account transfers the risk from the public to the household, but it also transfers the management and execution to the individual as well. It is even more likely that citizens see that “submerged” welfare benefit not as a government executed item but as something they do themselves.

## Conclusion

In the wake of the Great Recession, people from across the ideological spectrum are looking to remake the welfare state. As a result of the deregulation and privatization of the past 30 years, the default stance for many policy intellectuals is to support using private means to carry out the government's responsibilities as an end in and of itself.

This should be resisted. The public allocation of goods has many advantages that are unique to the government itself. These include compulsion, standardization, democratic input and rectification of market imperfections. Meanwhile, the private allocation of goods has additional problems that often amplify generic concerns about the government, ranging from distributional to control concerns. Reexamining the role of the government with these guidelines in mind will shed new light on where the market tends to fail and where the government can provide better by itself.

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# Competing Visions of the Past

## Learning from History for the Future of American Social Policy

*Steven Attewell, PhD Student in Policy History, University of California - Santa Barbara*

In his 2012 nomination acceptance speech in Charlotte, President Obama argued that this election represented “a choice between two fundamentally different visions for the future.” It is also true to say that we faced a choice between two fundamentally different visions of the past. And despite Obama’s reelection, the debate rages on in a closely-divided electorate and in Washington. Underneath disagreements over Obamacare, Medicare advantage cuts and Medicare vouchers, and individual retirement accounts, there is an argument about which model of social policy is best for the country.

Broadly speaking, the current debate revolves around three models of providing support to our citizens – employer-based benefits, individual accounts, and social insurance – that have been tested in the past, and yet there has been very little attention paid to our historical experience. When history can tell us which of them worked and which didn’t, we should pay more attention to these lessons. By learning from this history, we can determine how to craft better social policy for the future.

### The Rise and Fall of Employer-Based Benefits

Whether we look at defined benefit pensions, employer-subsidized health insurance, or paid leave and vacation time, American social policy depends on the existence of employer-based benefits so axiomatically that it’s easy to forget how historically recent and fragile our uniquely private social insurance system is.

As Sanford Jacoby and other historians have shown, “welfare capitalism” originated at the turn of the 20th century for the specific purpose of warding off outside influences that might interfere with their employees’ loyalty and

dependence on their employers. On the one hand, employers had to contend with “friendly societies” run by unions or other associations that offered funeral benefits, widows’ pensions, sickness and unemployment insurance, and banking and credit services.<sup>1</sup> Comprising some five million members by 1920, these welfare funds offered workers some limited economic independence from their employers, and in the case of trade union friendly societies, a powerful incentive to join unions. On the other, the rising Progressive movement had thrust European-inspired social insurance onto the national agenda. In 1905, the formation of the American Association for Labor Legislation brought together Progressive academics and public intellectuals into a sophisticated lobbying organization that fought for model social insurance legislation on a state-by-state basis, introducing bills for sickness insurance in three state legislatures in 1916 and eleven more in 1917.<sup>2</sup> The 1912 Progressive Party platform endorsed national social insurance for the sick, the elderly, and the unemployed – bringing the issue to a level of prominence it had never before enjoyed.

In order to ward off these threats to their dominance over their workforce, a group of employers began to offer benefits to their workforce as a voluntary “Third Way,” part of a larger “American system” that also included the intro-

duction of company unions, personnel departments, and other seemingly benevolent measures. By 1914, 2,500 firms offered some form of limited benefits – cafeterias, employee housing, athletic leagues, and types of profit-sharing in the first wave, with retirement pensions and unemployment benefits becoming more prevalent later on.<sup>3</sup> These firms were hardly typical; early adopters of welfare capitalism tended to be large industrial corporations, especially founder-owned companies, with heavy concentrations in the railroad, locomotive manufacturing, steel production, and tire industries.<sup>4</sup> The benefit programs they offered were specifically designed to give them the most discretion possible in which employees got benefits, and what level and form of benefits they would receive, which in turn maximized the need for employees to remain on good terms with their employers. Even within a single firm, programs weren't intended to be universal; rather, they were specifically targeted at skilled workers who were believed to be the most open to trade union organizing or to a competitor's job offer, and to make sure that those workers had every incentive to remain in their current jobs.

Welfare capitalism exploded during and immediately after World War I, as employers like Bethlehem Steel, Western Union, AT&T, DuPont, Westinghouse, and General Electric sought to preserve what they called “communal harmony” in the face of record levels of labor organizing, industrial strife and the intervention of the newly-minted War Labor Board by increasingly offering tangible benefits like pensions, insurance, and profit-sharing. Like earlier pioneers, employers who jumped on the welfare capitalist bandwagon during and immediately after the war tended to be concentrated in industries and firms that were capital-intensive with low labor costs, and especially those that enjoyed above-average levels of profit and steady demand for their product – which meant offering benefits was more affordable than in labor-intensive, low-margin industries.<sup>5</sup> As before, however, benefits remained limited, contingent gifts of the employer, with only 2% of the workforce covered by formalized group insurance plans by 1929.<sup>6</sup>

The Great Depression profoundly transformed the world of welfare capitalism and revealed the extremely weak financial foundations of employer-based benefit programs. With the collapse of 100,000 American employers between 1929-1933, many workers found the retirement and health care benefits they were relying on had disappeared along with their jobs. Many others whose employers didn't go

under saw their plans cancelled as employers sought to reduce costs by any means necessary.

Welfare capitalism didn't die, even as major firms like U.S Steel, Ford, Armour, and International Harvester jettisoned their programs.<sup>7</sup> Two factors preserved employer-based coverage: first, insurance companies began to offer group plans for disability, old age, and life insurance to employers, which lowered administrative overhead and allowed for a rationalization of costs of the long term.<sup>8</sup> Second, the traditional friendly societies that might have flooded in to compete had fractured under the same pressure of increasing benefit claims, declining numbers of payees, and underfunded reserves.<sup>9</sup>

Employer-based benefits did, however, face an intensified threat from the new industrial unions and the emerging New Deal state. As Jenn Klein notes in *For All These Rights: Business, Labor, and the Shaping of America's Public-Private Welfare State*, the emerging Congress of Industrial Organizations (CIO) didn't stop at endorsing the New Deal's social policies. Instead, inspired by union leaders with syndicalist tendencies like John L. Lewis and Sidney Hillman, the CIO also pursued a modernized version of friendly societies, founding union-owned insurance companies, banks, and housing cooperatives. In the field of health care, both CIO and AFL unions approached a strategy in which they simultaneously pushed for the addition of health insurance to Social Security and constructed a network of health centers and health plans, open to both union workers and unorganized members of the community. Unions negotiated with groups of doctors to agree on a set monthly fee for medical services, frequently offering both community rating to equalize premium levels and progressive dues set at a percentage of family income.<sup>10</sup> Their ultimate aim was to create a system of health provision independent of employers but friendly to the New Deal state, which they hoped would initially offer financing for construction of health centers or even subsidies for their health care plans as a foundation for national health insurance.

The high-water mark of this campaign came in 1946. John L. Lewis led the United Mine Workers out on strike to win a union-controlled Welfare and Retirement Fund offering a full suite of health care, retirement, and unemployment insurance through union dues and a mandatory employer contribution. The UAW, which had built up its own system

of union-run rehabilitation, unemployment, and old age benefits and had made contracts with doctors' groups for medical services coverage, demanded a flat 3% of payroll contribution from employers to run their social insurance system in the 1946 contract campaign.<sup>11</sup>

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**While pension and health insurance programs exploded both on the union and employer-based side, the ultimate question of who would control social provision would depend on the New Deal state.**

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Employers, especially in the steel, rubber, auto, electrical, and oil industries, fought back with a vengeance to preserve their position. One major strategy they arrived at was to unilaterally establish group insurance programs offered to them by commercial insurance companies and new health insurance organizations like Blue Cross, in order to preempt union-run plans and keep employee benefits under their control while still maintaining that employer-based benefits were a “gratuity” offered by the employer and thus not a subject of bargaining. Thus, while pension and health insurance programs exploded both on the union and employer-based side, the ultimate question of who would control social provision would depend on that other threat to employers, the New Deal state. If the New Deal state preferred either union-controlled or employer-controlled programs when it came to collective bargaining, tax subsidization, or incorporation with Social Security, that model of social provision would likely become dominant; if the New Deal state’s policies instead privileged state-based provision over either, the state might eclipse both.

Despite a brief period of cooperation during the first few years of the New Deal when the National Recovery Administration brought business and government together to stabilize prices and wages, employers came to view the federal government as a threat to their independence the moment that the Roosevelt Administration attempted to implement NRA codes empowering workers to form unions. The 1935 Social Security Act was seen as an even more dangerous threat. National old age insurance, paid for by a payroll tax levied on and collected by employers through withholding, threatened to make private pensions

obsolete and rob employers of one of their chief tools to keep workers (especially skilled workers) tied to the company for life. Unemployment Insurance further sought to interfere with “management prerogatives” by varying tax rates in order to penalize employers who relied on cyclical layoffs to keep down labor costs. Employers sought to ward off this threat, first by lobbying for an exception for employers who offered private pension and unemployment programs, and when that failed, by challenging the Social Security Act in court.

To an extent, taxation and regulation had always shaped the course of employer-based benefits. IRS decisions and Revenue Acts in the 1910s and 1920s had been useful for welfare capitalists (by excluding employer contributions to accident insurance, life insurance and pension payments to current retirees from corporate income taxes, as well as deferring taxes on pension trust assets until receipt of benefits), and corporate tax rates were low enough that employers didn’t really have to worry about the tax bill on their benefit systems.<sup>12</sup> However, once the higher corporate tax rates of the New Deal and World War II began to take more of a bite, finding some way to reconcile welfare capitalism with the New Deal’s social insurance system became paramount.

At the last minute, employers managed to avoid Social Security replacing their private pension programs outright as the rough outlines of a compromise emerged. The Revenue Act of 1942 allowed employers to “integrate” their private pensions with Social Security by counting workers’ Social Security benefits against what the employer would normally owe. When added to a 1939 law that allowed private pension income to be free of income and Social Security taxes, this dramatically reduced the cost of covering blue collar workers whose retirement income would be largely made up of Social Security with a supplemental benefit from their employer, while allowing employers to concentrate their own finances on larger pensions for their skilled, higher-paid workers.

In exchange for this, New Dealers extracted requirements that employers had to open up pension coverage to the bulk of their workforce instead of to a privileged few, requiring a minimum of 50% of the workforce covered in order for pensions to qualify for Social Security “integration.”<sup>13</sup> As a result, private pension coverage, which had been stuck at about 5% of the workforce from 1915-1930, dramatically

increased to about 40% of the workforce in 1965. A 1943 IRS decision to allow group health insurance contributions to be untaxed likewise lowered the costs of providing health insurance, and led to a similar expansion in private coverage.<sup>14</sup>

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### Employer-based benefits have always relied on public subsidies and regulations.

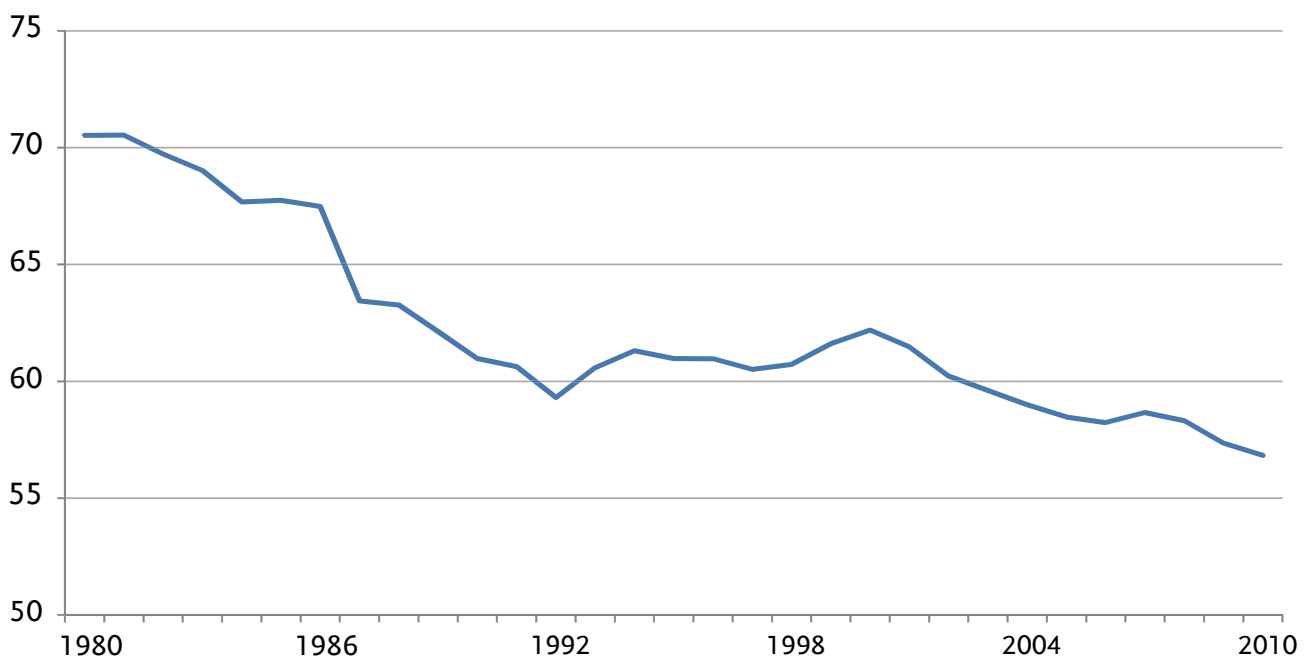
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Another compromise emerged when it came to the question of union plans versus employer plans. While the National Labor Relations Board (NLRB) and the National War Labor Board (NWLB) restricted employer power by empowering unions to organize and collectively bargain with employers over union recognition, wages, and grievance systems, the two trod a much more cautious path on “fringe benefits.” The National War Labor Board initially refused to impose mandatory insurance programs and instead guaranteed existing (largely employer-based) plans, while allowing employers to unilaterally impose pension and health care insurance.

It was only after 1943, when the NWLB excluded employer payments to insurance plans from the wage freeze (thus creating an enormous incentive for employers to add expanded benefits to collective bargaining in lieu of wage increases) and later mandated the inclusion of insurance in new agreements, that the principle was established that employer-based benefits would have to be negotiated with unions, creating something of a mix between the old welfare capitalism and union benefits. The hegemony of the new collectively-bargained private insurance system was cemented when the Taft-Hartley Act of 1947 banned retirement and welfare programs operated solely by unions, derailing the attempt of the UAW and UMW to create an independent social security system.<sup>15</sup>

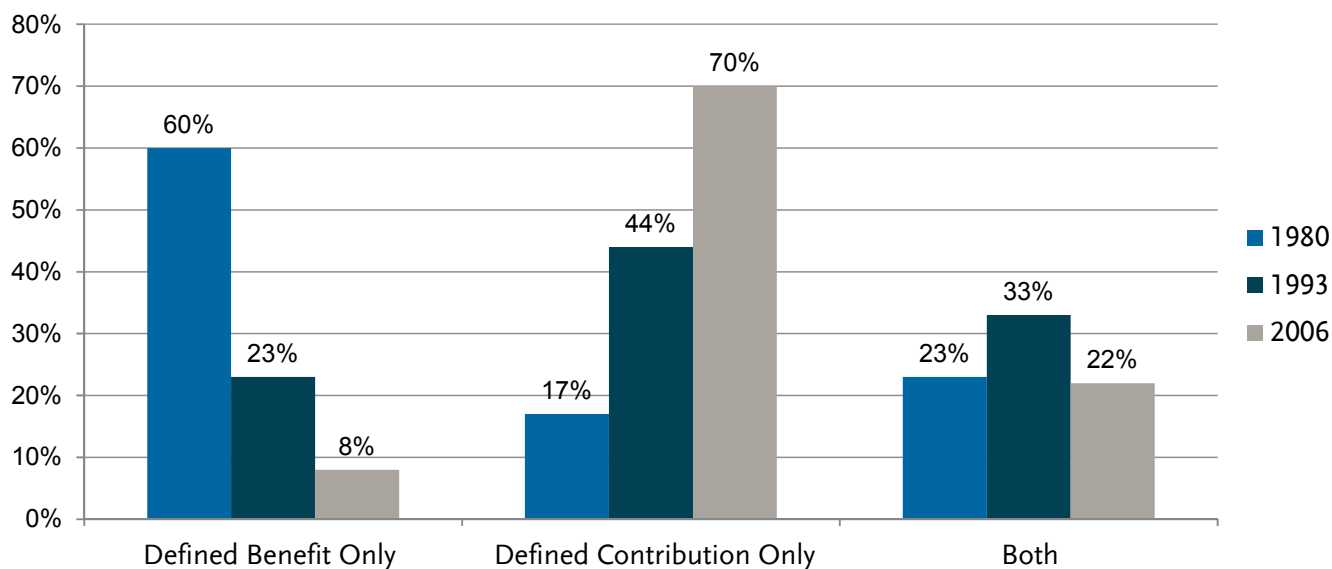
The larger point is this: employer-based benefits have always relied on public subsidies and regulations that give them access to tax subsidization and protection from being totally overwhelmed by either union-controlled plans or social insurance, and on a particular economic structure in which large employers, heavily based in manufacturing and industry, could afford to take on an additional economic burden in the name of maintaining employee loyalty and dependency.

Figure 1: Share of Workers with Employer-Provided Health Insurance, 1980-2010



Source: John Schmitt and Janelle Jones, Center for Economic and Policy Research

Figure 2: Private Sector Workers with Employer Pensions, By Type of Pension, 1980-2006



Source: Center for Retirement Research at Boston College

When that stopped being the case, a crisis in employer-based social provision was bound to occur.

### The Future of Employer-Based Benefits

As we can see from the charts below, employer-based social provision worked for a broad segment of the population once upon a time. In 1980, about 70% of people under age 65 had health insurance and about 60% defined benefit pensions through their employers. However, over the last 30 years, the shifting of the American labor market (along with decisions by employers to jettison employee benefits in the name of competitiveness) has led to a marked decline in coverage – in 2006, only 58% of people under 65 had employer-based health insurance and less than 30% had access to defined benefit pensions.<sup>16</sup>

Moreover, these figures show decline becoming more and more problematic. While remaining roughly steady between 1975 and 1986, and declining by 8.2 percentage points between 1986-1992, coverage mostly recovered during the 90’s boom. However, since 2000, employer-based health coverage has declined nearly every year, both in recessions and recoveries. It is possible that the ACA’s employer mandate may change this trend, but any reforms will be swimming against a strong current running in the

opposite direction. When we look at the ten occupations projected by the BLS to have the most new jobs through 2016, on average only 47% offer employer-based health insurance, and only 37% defined benefit pensions.<sup>17</sup> Recent research also shows that in the last decade alone, the percentage of workers without access to any employer-sponsored retirement plan rose 21%.<sup>18</sup>

And yet, most of our recent health care reform efforts of the last twenty years have been built around employer-based provision of health insurance. The failed Clinton health care reform was based on a joint individual and employer mandate along with subsidies. Ironically, much of the controversy over premium caps and mandatory participation of employers, insurers, and providers to participate in regional cooperatives (let alone the individual mandate) had little to do with coverage and more to do with the role of employers and whether they would continue to offer insurance if burdened with new regulations.

The Massachusetts health care reform passed under Governor Mitt Romney was similarly based on a “play-or-pay” mandate on employers with more than 10 employees (who had to either have an employee plan at least covering 25% of their full-time workforce or provide at least 33% of premium costs for outside insurance) and an individual mandate to purchase health insurance. A further “free

“rider” surcharge on firms that did not establish a payroll deduction system for health insurance (which in turn would make running an employee insurance program much easier) further illustrates how critical universalizing employer-based insurance was to “Romneycare.”

Finally, the Affordable Care Act follows much the same “moderate” blueprint in regards to private insurance. In addition to the more controversial individual mandate, firms with more than 50 workers will have to either provide health insurance to their workforce or pay a “shared responsibility” fee for every employee whose insurance the government had to subsidize; small businesses are offered subsidies to purchase insurance for their employees. Employer-sponsored plans and individual plans alike will face new regulations to ensure minimum standards of coverage and medical care per premium dollar, that preventative services (especially women’s health services and contraception) are provided without co-pays and deductibles, and that insurance provides a minimum level of services for premium dollars.

Despite this common thread, all of these attempts to grapple with American health care faced and continue to face the difficulty of sailing into a prevailing wind of the decline of employment-based health insurance.

This shouldn’t come as a surprise to anyone. If employment-based insurance has always depended on public subsidies and on a particular model of economic growth, long-term trends in the economy don’t bode well for its success. To begin with, we’ve seen a secular shift in the U.S labor market towards increased use of casual, part-time and temporary labor, as employers seek to offload economic risks on their employees. Given that most employment-based benefits require minimum tenure (both in terms of months of employment and hours per week), fewer employees will be covered even by employers who maintain health plans. Similarly, the long-term trend toward increasingly persistent and sharp recessions will increase demands on employer-based programs that spread costs over fewer and fewer workers.

All of this raises the question: given that employment-based coverage was designed to allay political opposition to changing the status quo and to provoke less controversy than government-provided health care, does the strategy still make sense if people with employer-based health

insurance will cease to be the majority of the electorate in a few years, and individual and employer mandates no longer have bipartisan appeal in the think-tank world, the Republican Congressional Caucus, or in the electorate?

Clearly not. Health care reform is not going to go away as a political issue, even after the last provisions of the ACA come into effect. Thanks in large part to the Supreme Court’s decision in *NFIB v. Sebelius* to allow states to opt out of Medicaid expansions, there will still be 31 million Americans (or 10% of the population) without health insurance. Policymakers will need to develop new plans to finally universalize health coverage, maintain quality of care, and reduce the growth of health care costs, which means they will have to move away from employer-based insurance.

## The Trouble With Individual Accounts

To the extent that a conservative model for social policy still exists following the collective decision of the right to demonize the individual mandate model originally drawn up by the Heritage Foundation in the 1990s, it’s the idea of individual accounts.

The argument for individual accounts as a model for social policy began in the early 1980s as a reaction to Reagan’s failure to muscle through cuts in Social Security and the successful effort of Tip O’Neill to ride the “third rail” to a working majority in the 1982 midterms. Recognizing that Reagan’s election hadn’t quite brought about the popular rejection of the welfare state that they had hoped, Peter Ferrara of the Cato Institute synthesized ideas coming from Arthur Laffer, Peter Drucker, and other conservative economists into a plan to replace traditional Social Security with private, individual savings accounts. Ferrara’s plan bent to pragmatic reality by retaining traditional retirement benefits for existing and soon-to-be retirees, while requiring younger workers to fund their own retirement accounts and purchase private disability and health insurance.

Stuart Butler and Peter Germanis of the Heritage Foundation took up the political side of Ferrara’s vision by proposing a generation-long “Leninist Strategy,” in which conservatives would divide the pro-Social Security coalition by protecting seniors while selling the young on individual

accounts. Meanwhile, they would eliminate as much as possible of Social Security's universal and redistributive elements. The next step, they argued, would be to build up a new anti-Social Security coalition explicitly financed by the financial services industry by bringing together movement conservatives together with protected seniors and "aspiring" young people.

Despite a sequence of failures to mobilize the supposedly more pro-market, individualist 80s Yuppies and 90s Generation Xers to vote for privatizing Social Security, advocates for individual accounts were buoyed by the growth of IRAs between 1982-86 (when an IRS decision allowed IRA participants to sock away more tax-free dollars), and the even more impressive explosion of 401(k)s starting in the late 80s, the decline of traditional defined benefit pensions, and the seemingly eternal rise of the stock market in the 90s. Even if Social Security was still untouchable, the cultural playing field seemed to be tipping in favor of establishing individual accounts as an explicit alternative to Social Security.

Interestingly, while corporate funding and funding from wealthy businessmen had been forthcoming from the beginning of the individual accounts movement, the financial services industry was slow to embrace privatization as a source of profits as opposed to an ideological commitment. Initially, the financial services industry was politically motivated by the fear of inflation and volatile interest rates, which financiers like Pete Peterson believed were the result of government spending. In order to preserve financial stability, bond marketeers wanted to maintain stagnant wages and balanced budgets while promoting increased rates of individual savings to power growth – and replacing Social Security with private accounts seemed an excellent way to achieve all of these goals simultaneously.

Gradual changes in the financial services industry opened the door to a self-interested embrace of privatization: the abolition of fixed commissions by the SEC in 1970s, with a resulting shift of profit centers from underwriting to fees-generation; and especially the expansion of IRAs and 401(k)s at the expense of Defined Benefit pensions, which resulted in dramatic growth in the mutual funds market from \$15 billion in 1975 to \$1.5 trillion in 1992.<sup>19</sup> The new financial services industry required a constant pipeline of financial transactions to generate fees off of, and given how extreme shifts in volume of stock trades could be,

Social Security seemed a uniquely steady source of revenue because of its public nature.

Thus, Wall Street was primed to respond to the entreaties of the Heritage Foundation, Cato's Project on Social Security Privatization, Peterson's Concord Coalition, and a whole host of accounts advocates, especially when the growth of the Social Security Trust Fund in the late 90s promised to bring in \$100 billion in new revenue (increasing the size of the mutual funds market by one-fourth to one-half). By charging 1.94% in administrative expenses (about 60% more than Social Security's administrative overhead) and tacking on additional fees for annuitization and other transactions, the financial services industry could extract \$12.5 billion a year in profits.

Beginning in the 1990s, individual retirement accounts surmounted a crucial barrier by moving from campaign rhetoric to bills introduced in Congress with the 1994 Kerrey-Danforth plan that emerged out of Clinton's Social Security Commission, and the 1995 Kerrey-Simpson Bill.<sup>20</sup> Both proposed increasing the retirement age to seventy, "adjusting" the CPI to slow cuts, reducing cost-of-living increases, and allowing workers to divert up to a third of their payroll tax into an individual retirement account. Despite opposition from the majority of the Democratic Party, Clinton remained a behind-the-scenes advocate of a bipartisan deal on Social Security and was willing to pay heed to individual accounts until 1998, when the Republican impeachment made Clinton reach for "Save Social Security first" and opposition to privatization as a popular club to beat his Congressional opponents.

The ascension of George W. Bush, an early and outspoken advocate of privatizing Social Security through individual accounts, to the presidency with Republican majorities in both houses of Congress brought the movement closest to passing individual retirement accounts into law. However, the drive was immediately complicated by the competing conservative drive to push for \$1.2 trillion in tax cuts, which ate much of the surplus that could have cushioned the enormous transition costs of establishing these accounts. As a result, the proposal for individual accounts promoted by Bush's 2001 Social Security Commission required benefit cuts of 48% and \$100 billion a year in transfers from the Social Security Trust Fund to make the numbers work, hardly the "free lunch" advocates had been describing for twenty years.

Combined with the 2001 stock market crash and the wave of corporate scandals that emerged after the fall of Enron, popular support for such a proposal was no longer in the offing and the plan was quietly shelved until after the 2004 election. In his 2004 State of the Union, George W. Bush infamously cashed in his political capital and made individual accounts his number one domestic priority. However, in spite of a nearly \$3 million strong road trip in 2005 aimed at pressuring conservative Democratic Senators whose red states he had won in 2004, Bush's efforts to break through in the Senate backfired in the face of rising public opposition (while 58% of Americans expressed support for private accounts in September 2004, by February 2005, 58% opposed individual accounts vs. 34% in favor).<sup>21</sup>

The one place where George W. Bush succeeded in making the individual account movement's agenda law was in the realm of health care, where private Health Savings Accounts (HSAs) and Medicare Advantage were established as part of the Medicare Part D bill enacted in 2003. While Medicare Advantage more resembled private group insurance than individualized accounts, opponents of social insurance hoped it would work as a thin end of the wedge on privatizing Medicare, while focusing on the virtues of HSAs. Like the IRAs and 401(k)s created in the 1970s and 80s, Health Savings Accounts were individual accounts used to pay for high-deductible private insurance (with a minimum deductible of \$1,200 for an individual and \$2,400 for a family), and now offered both tax-free contributions and withdrawals (an earlier, less popular Medical Savings Accounts merely allowed for tax-free withdrawals). Back in 1983, Ferrara had hoped that these kinds of accounts would begin to disentangle the reciprocal solidarity built into Medicare and create a new anti-Medicare constituency; since the failure of the Clinton health care plan in 1994, hard-right conservatives (as opposed to the more moderate pro-mandate conservatives) had also argued that HSAs would give Republicans a solution to the growing problem of rising health care costs by imposing market discipline on health care consumers with "skin in the game" and thus reducing demand for medical services.

### Historical Outcomes of Individual Accounts

Despite the hopes of privatization advocates, individual accounts have been disastrous failures everywhere they've

been tried. The example of Chile's individual retirement account system, promoted by privatization advocates since its inception in 1981, went horribly wrong almost from the beginning. To begin with, in order to finance transition costs that have run to 5-6% of GDP per year, the Chilean government has had to establish a value added tax, cut social expenditures, increase the age of retirement, and dramatically increase government debt levels, and even then will only finish making the transition in 2050.<sup>22</sup> Secondly, given high management fees that rise to as high as 16-20% of annual contributions (with annuitization costs adding another 8-9%), the high rates of returns touted by pro-market forces have been cut to an average of only 0.3%.

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### Individual accounts have been disastrous failures everywhere they've been tried.

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When the Chilean market turned down in 1994, the system began to fall apart – one-half of the funds managing individual accounts made losses that year, and “between 1995 and 1998 returns were -2.5%, 3.5%, 4.7%, and -1.1%.”<sup>23</sup> These losses forced the Chilean government to sink \$66 billion into pension payments in order to bring millions of pensioners up to a minimum of \$140 a month,<sup>24</sup> and unsurprisingly, Socialist President Michelle Bachelet pushed through a major reform of the system that turned away from private accounts to establish a Solidarity Pension to guarantee a minimum income to the poorest 60% of the population.<sup>25</sup>

Likewise, Thatcher's partial privatization of Britain's supplemental pension system much touted by privatizers has been a major failure. Thatcher's reforms cut the state-run supplemental pension replacement rate to 20% and provided a 2% tax rebate to those who switched into Appropriate Personal Pensions (APP), leading to 4 million people switching out of the state-run program, which cost the British government £9 billion in unforeseen transition costs and zeroed out a surplus in the National Insurance Fund.<sup>26</sup> As was the case in Chile, management fees (including management expenses of 2.5% per year, fees for switching providers or failing to make payments, and annuitization rates) eat up 43% of individual contributions on average.<sup>27</sup> A major scandal in the 1990s in which managers provided suspect advice to savers saw one-third

of individual accounts holders lose a combined total of \$20 billion in pension assets. Altogether, the combination of cuts to state pensions and the low return after fees is projected to leave 33% of the elderly living in poverty by 2050.<sup>28</sup>

Similar outcomes have been found in Argentina, Bolivia, Slovakia, Poland, Romania, Latvia, Lithuania, and Estonia: individual accounts are poor vehicles for retirement security because inequalities of income lead to inequalities of contributions, high management fees cancel out stock market returns, and financial scandals and market crashes can wipe out built-up assets for those unlucky enough to retire in the wrong year.

On the health care front, where activists actually managed to create an individual account system in this country, the results haven't been much better. However, while HSAs have grown to about 13.5 million users, they've yet to come close to the 100 million people covered by government health insurance, let alone the 170 million people covered by traditional employer-based group insurance, and are unlikely to grow much further or have a significant effect on health care costs.

The reason individual accounts don't work in the realm of health care has to do both with the distribution of health and wealth in America. 70% of health care users in the United States spend less than \$1,000 a year because they're largely healthy and don't have to deal with a chronic condition, functional limitation, or a catastrophic medical event. These people wouldn't really benefit from a Health Savings Account because they're already spending less than the deductible. The 5% of users who account for 50% of personal health spending have such high and continuing health care costs that they would blow through the \$3,000 yearly deposit limits on HSAs almost immediately – 92.6% of them have a chronic condition and 62% of them have some form of functional limitation. This leaves 25% of users who spend more than \$1,000 a year who might benefit from HSAs. However, it turns out that “putting skin in the game” actually increases health care costs, as patients avoid preventative care and routine checkups to save money, which makes them more likely to develop more expensive catastrophic conditions.

This reality of American health care is layered on top of the existing problem of high and increasing income inequality.

In order to contribute to HSAs, users need several thousand dollars a year in post-living expenses income to save, and most people don't have that; as the legendary social insurance advocate Isaac Rubinow once said, “the assertion that, in the case of the wage-earning class, individual saving may solve the problem of poverty, necessarily supposes the existence of a surplus in the budget of the average wage-earner's family.”<sup>29</sup> It's no accident then, that the average gross income of HSA users in 2008 was \$139,000 a year, two-and-a-half times that of non-HSA users.<sup>30</sup>

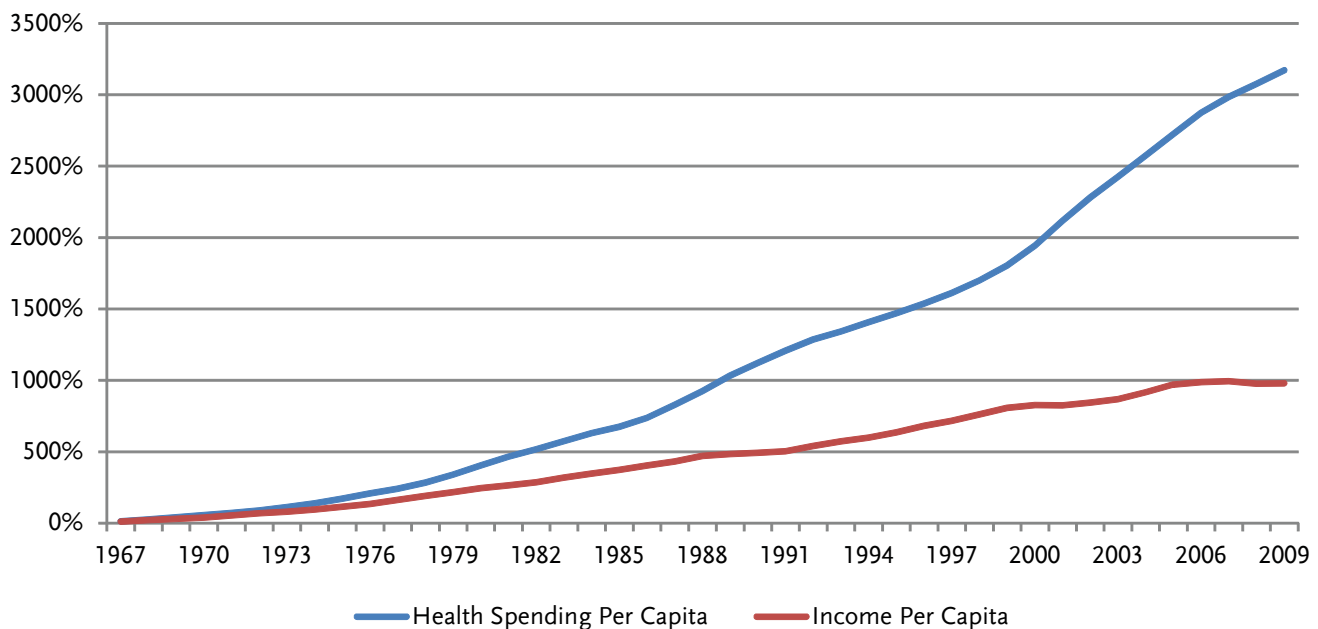
Therefore, HSAs can't replace traditional social insurance, nor can they make much of a dent in health care costs. However, what they can do is further decouple the younger, healthier, and more affluent from group insurance in general, which conservatives hope will make these people turn against the Medicare taxes imposed against them in the same way that IRAs and 401(k)s were intended to build an anti-Social Security constituency. HSAs can also allow employers to ditch their traditional private group insurance plans and dump health care costs onto their workers, which will ironically break down the largest form of private health coverage in America while accelerating the pressure of rising health care costs on even larger numbers of Americans, potentially swelling the constituency for universal public health insurance.

When it comes to HSAs, the basic problem is that health care is by nature a failed market. It's impossible for the layperson to anticipate his or her future health care needs (and even with frequent diagnostics and checkups, the use of actuarial tables, or DNA analysis, extremely difficult). Moreover, many of the most expensive health care costs arise in situations that leave the consumer unable to exercise economically rational behavior (it's hard to price health care options when you're wheeled into an emergency room), and in non-emergency situations, consumers lack the medical expertise to choose between competing alternatives.

Even if it were possible to be economically rational about health care, the problem is that individual incomes aren't growing nearly enough in comparison to health care costs to allow most consumers to save enough money.

We see the same thing in retirement accounts. 75% of Americans nearing retirement had less than \$30,000 in their retirement accounts. It takes twenty times one's

Figure 3: Cumulative Annual Percentage Growth in Per Capita Health Spending and Income



Source: OECD; Census Bureau

yearly income to maintain current living standards, or \$500,000 to maintain the median wage.<sup>31</sup>

## The Foundations of Social Insurance

Since the beginning of the 20th century, social insurance has been the keystone of progressive efforts to provide economic security and ward off poverty. The Committee on Economic Security called together by Franklin D. Roosevelt in 1934 to deliberate over the creation of a social insurance system that could ease the country’s economic crisis and protect it from a future Great Depression was staffed by many veterans of the failed attempts to pass social insurance legislation during the 1910s and 1920s and by those who had succeeded in establishing state-level social insurance in Wisconsin in 1932. The result was the convening of competing Progressive ideas on social insurance.

Advocates for actuarially-sound prefunded systems squared off against those who preferred a pay-as-you-go approach to avoid the deflationary effects of building up reserves through taxes in a depression. Those who preferred social insurance taxes to be levied at the level of individual firm so that rates could be varied in order to push industrial

employers to regularize employment quarreled bitterly with those who favored a flat rate of taxes pooled across the entire economy that would allow better cross-subsidization between wealthier and poorer workers. Representatives from the Children’s Bureau drew up plans for a national “mothers’ pension” system, while public health advocates from the Julius Rosenwald Foundation drew up a scheme for a joint federal-state health insurance system.

The ultimate result of their deliberations was a system designed as a social contract between all members of society to protect one another from all of the “vicissitudes of modern life,” of which old age was but one element. The draft legislation that FDR’s brain trust envisioned contained sections that were designed to protect specific populations from the risks each typically faced. Taken together, the provisions were designed to stretch a safety net underneath the whole of American society.

Old Age Insurance would provide a retirement pension – but only for the 46% of the American workforce that was securely attached to the industrial economy. For the majority of workers, including all agricultural and domestic workers (which meant the vast majority of African Americans and women), those who fell into poverty in old age would be provided benefits through Old Age Assistance (OAA), a

joint Federal-state welfare program for the elderly (that was rolled into the Federal Supplemental Security Income (SSI) program in 1971). Women and children who had lost their (male) provider would receive welfare benefits through Aid to Dependent Children. Adult workers would be protected against a sudden loss of wage income by Unemployment Insurance, but as was the case with Old Age Insurance, only 46% of the workforce would be covered.

Despite these limitations, activists within the Social Security Administration as well as Congressional Democrats from the Party's liberal and moderate wings pushed repeatedly to expand social insurance in the direction of universal

protection.

Over the next 40 years, the Social Security system was amended repeatedly to expand eligibility, raise the level and variety of benefits, and establish innovative programs to cover new populations. In 1939, Congress established Survivor's benefits and expanded Aid to Dependent Children, thus bringing most women under the umbrella of Social Security. In the same amendment, regular Social Security benefits were accelerated and a Trust Fund was established which allowed the system to support a higher benefit level. In 1956, agricultural and domestic workers were added to the rolls of the eligible, bringing the

Table 1: Attempts to Reduce Social Security Since 1980

Proposal	Changes	Outcome
1981-1982 Reagan-Stockman Plan	Cut cost-of-living adjustment (COLA) Increase penalty for early retirement \$75-100 billion in cuts over 5 years	Fails in Senate
1983 COLA Reduction	Cut COLA entirely for '83	Dropped in Senate
1983 Amendments	Reduction in COLA Adjust CPI Increase in payroll tax Increase retirement age	Passed into law
1988 COLA Reduction	Reduction in COLA	Dropped in budget negotiations
1995 Kerrey-Danforth Commission	Increase retirement age Adjust CPI Cut COLA Promote individual accounts	Commission fails to achieve consensus
1995 Kerrey-Simpson Bill	Increase retirement age Adjust CPI Cut COLA Promote individual accounts	Died in Senate Committees
2001 Moynihan-Parsons Commission	Promote individual accounts	Commission recommendations not picked up
2005 Bush Privatization Effort	Promote individual accounts Adjust CPI "Progressive Indexing"	Not picked up by Congress
2010 Simpson-Bowles Commission	Change benefit formula Increase retirement age Adjust CPI	Commission recommendations not picked up by President or Congress

majority of African-Americans within both Old Age and Unemployment Insurance. In the 1960s, amendments created Disability Insurance and raised benefit levels once again. In 1972, Social Security benefits were indexed to inflation with a permanent COLA (Cost-of-Living Adjustment), and the old OAA system was rolled into Supplemental Security Income two years after.

In the realm of health care, activists waged a thirty year struggle to include medical and hospital insurance, following stalemate with the American Medical Association on the 1935 Rosenwald Plan. In 1939, Senator Wagner (author of the Social Security and National Labor Relations Acts) introduced a National Health Act to establish joint Federal-State universal health insurance, only for the bill to die in committee thanks to an alliance of Southern Democrats and conservative Republicans. A similar fate was meted out to the Wagner-Murray-Dingell Bill proposing Federal public health insurance, unemployment insurance, and poor relief in 1943, 1945, 1946, 1949, and so on. In 1965, the passage of Medicare and Medicaid finally broke through the firewall of opposition from conservatives and the American Medical Association to add health insurance to the suite of social insurance programs covering the elderly and poor. Both in 1974 (with the near-passage of Nixon's Comprehensive Health Insurance Plan and the Kennedy-Mills Bill) and 1979 (with the introduction of dueling Kennedy and Carter proposals for national health insurance), the U.S came close to including health care within the sphere of social insurance.

### Historical Results of Social Insurance Programs

Despite thirty years of attempts to downplay the virtues of Social Security and to invent a narrative of greedy seniors and oncoming crises, along with the attendant drive to cut Social Security to the bone to save Social Security, the reality is that Social Security has reduced elderly poverty from above 50% in 1935 to less than 10% today.<sup>32</sup> When we look beyond Old Age Insurance to consider social insurance more broadly, we find that 47.9% of pre-transfer poverty in America is eliminated by social insurance.<sup>33</sup> Likewise, when we look at health insurance, Medicare and Medicaid cover 15.2% and 16.5% respectively of the U.S population, and when all forms of government health insurance are included, 32.2% of the U.S receives health care through

some form of government-provided program.<sup>34</sup>

Given this history, it's not surprising that efforts to roll back social insurance or to reduce its benefits have repeatedly failed in the last thirty years, despite the rise of an elite consensus that social insurance should be eliminated, reduced, or privatization.

Although afforded less publicity in debates over the American Relief and Recovery Act (ARRA) than tax cuts versus public works, or in debates over the Affordable Care Act than individual mandates and premium subsidies, the first two years of the Obama Administration saw two significant expansions of social insurance. In the first case, ARRA provided \$7 billion in "Race to the Top"-style incentive money for states that reformed their Unemployment Insurance systems. States could gain ARRA money by adopting "Alternate Base Periods" that allow workers to claim eligibility for UI by counting their most recent earnings as opposed to the previous year's earnings, and agreeing to cover part-time workers who are looking for full-time work and workers who leave work due to family emergencies.

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### 47.9% of pre-transfer poverty in America is eliminated by social insurance.

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In the second case, the Affordable Care Act made some of the most significant changes in Medicare and Medicaid in decades. Medicare's finances were improved through the increase in Medicare taxes on the wealthy and the reduction of Medicare Advantage and provider payments, an attempt was made to contain costs by shifting Medicare payments from fee-for-service to performance-based lump sums, and benefits were improved by the closing of the Medicare Part D "donut hole." Medicaid was transformed by extending coverage to all Americans below 133% of poverty (at least before the Supreme Court made such extension optional), and increasing payment levels to those of Medicare.

However, after the 2010 midterm elections and even more so after the Supreme Court's decision in *NFIB v. Sebelius*, the Obama Administration has made few public defenses (let alone arguments for expansion) of social insurance,

choosing instead to concentrate its efforts on protecting the individual mandate. As a result of this strategic choice, the one model of social policy least defended or advocated for is ironically the most historically successful model for providing health and economic security.

## Conclusion

If history can offer any guide to public policy experts or to the electorate at large, at the very least it can tell us whether we've tried public policies in the past and how well they've worked so that informed decisions for the future can be made on more than theoretical grounds.

The verdict of history when it comes to these three models of social policy is quite clear: employer-based insurance and individual accounts have always been fatally flawed; the former is dying on its feet and the latter is simply not fit for purpose.

Unfortunately for those who love counter-intuitive “truth-telling,” the reality is that social insurance is a historical success. It has been far more effective than either employer-based benefits or individual accounts, and future policy should reflect these lessons. Instead of making a limited and targeted defense of middle class social protections from privatization, we should be making a bold argument for the expansion of social insurance to meet the rising tide of insecurity, inequality, and poverty in America.

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**TWO**

**Good Jobs and Good  
Wages: The High Road to  
Shared Prosperity**

**Jeff Madrick  
Ron Unz  
Robert Kuttner**

# The Case for Wage-Led Growth

*Jeff Madrick, Senior Fellow, Roosevelt Institute and Schwartz Center for Economic Policy Research*

## Introduction: Low Wages, The Crisis, and Unsustainable Growth

The share of wages and salaries in Gross Domestic Product (GDP) has declined in most rich nations over the past 20 to 30 years. Over the same period, income inequality has grown in most of these nations, and rapidly in some of the largest of them, resulting in slow wage growth for most consumers.

The result of wage growth that is persistently slower than the growth of GDP, and a simultaneous shift in distribution towards high-end earners who save more and consume less, has been an inadequate level of aggregate demand needed for rapid, job-creating GDP growth.

Stagnant or, at best, slow-growing standards of living are economic failures in themselves and may well lead to political instability. But they are also harbingers of a more serious crisis. The main theme of this paper is that low-wage policy regimes have resulted in an over-reliance on export-led growth models in nations like Germany and China and debt-led growth policies in countries like the U.S. In export-led economies, there has in turn been pressure to maintain low wages to keep exports price-competitive, especially as newer, even lower-wage economies became integrated into the international system.

Debt-led growth models, particularly in the U.S. and the southern periphery of Europe, are the mirror image of export-led growth in Asia and in the core of the Eurozone. Because wages did not rise sufficiently in the deficit economies, consumers in the U.S. and some European countries borrowed aggressively to maintain their standard of living, in the process purchasing the attractively priced products of countries like Germany and China. China's and Germany's surpluses were then recycled back to the U.S. and other debtor economies. Recycled dollars from China enabled Americans to borrow at low rates: similarly recycled euros from Germany to peripheral Eurozone nations enabled those countries to borrow cheaply.

Some European nations did restrain borrowing, but their economies grew relatively slowly in the 2000s as a consequence of inadequate demand in the system. But the U.S. in particular maintained growth by allowing household borrowing to rise rapidly and savings rates to decline to near zero levels.

The relationship between export-led growth and debt-led growth contained other negative feedback loops as well. Excessive manufacturing imports from export-led economies undermined the growth of higher-wage industries in deficit economies, eroding the productive capacity of those economies. This in turn placed further downward pressure on wages. Consumer access to credit at low interest rates tended to ameliorate political frustration over low wages – at least for a while.

Neither export-led growth models nor debt-led growth models are indefinitely sustainable. The debt taken on by importing deficit economies at some point becomes excessive, and when these economies reach their borrowing limits they are forced to pay down debt and curtail their demand for the goods of export-led economies. The result of the pursuit of these two models over the past decade or two has been two major financial crises and the Great Recession. The root of the problem is relatively low wages.

As the International Labor Organization wrote, “The counterpart to the export growth model is the debt-driven growth model of some major importing countries. Exports are an important part of the development dynamic, but equal focus needs to be paid to ensuring that markets grow

sustainably, which in large measure is a question of ensuring that household incomes mainly derived from wages also grow.”

The financial crises we have experienced since 2007 are the culmination of a worldwide low-wage policy regime that has existed for a long time. In the U.S., conventional measures of wages and salaries for median full-time male workers have not risen since 1969 and, by more accurate measures that take into account part-time work, have fallen substantially since then. This long period of stagnation is unprecedented in American history. Women’s earnings have gone up since the 1960s, but despite some historically uninformed optimistic claims, they have not risen rapidly by historical standards.

In most of Europe and indeed across the world, average wages have not risen as rapidly as GDP since the 1990s and in many cases since the 1980s. According to data from the Extended Penn World Tables and the UN, the wage share of GDP has fallen in advanced countries since 1980 (see Figure 2, for example). Wage share has fallen markedly since the 1970s in China as well. Meanwhile, inequality has risen most sharply in Anglo-American economies like the U.S. and Britain, but also in countries like China. These trends have placed pressure on the standard of living of most workers in these nations.

The unsustainability of low-wage growth models came to a head with the financial crisis of 2007-2008 and the Great Recession. And rising current account imbalances borne in part of diverging wage and productivity growth among Eurozone economies was the primary cause of the crisis in Europe that began in 2010.

The financial crises and recessions that have ensued since have exacerbated the underlying problem of low wages. Real national income plummeted in most rich nations in the recession and unemployment rates reached record levels in OECD nations. As a result, real wages fell sharply in 2008 and have been unusually slow to recover. In most European nations, wages have grown slowly, and in some like Britain and Ireland, where severe austerity economics has been adopted, they continue to fall. In the U.S., real median wages have fallen since the end of the recession. Weak wage growth has therefore impeded economic recovery across most of the Western economies, and austerity policies in much of Europe have already led to a second

recession in three years.

Prevailing economic theory has contributed to the policy mistakes that are responsible for these conditions. According to the dominant view of economists, low wages are thought of as a source of growth because there is less pressure on either inflation or profits. The influence of this neo-classical theory has been extended even after the Great Recession. Keynesianism, which emphasizes the importance of strong aggregate demand, made only a momentary comeback.

The long-term problems associated with slow wage growth were by and large ignored by orthodox economists and policymakers until the recent crises. The neglect persisted even in light of the rapidly growing current account imbalances within Europe and between the U.S. and Asia, notably China. These imbalances were the direct result of low-wage policy regimes in both rich and developing nations.

Yet rather than draw the correct lessons from the recent crisis, the rich world has now reinforced policies designed to restrain or reduce wages. Led by Germany, European officials have insisted on austerity programs aimed at reducing budget deficits and wage levels in periphery nations through government spending cutbacks and higher taxes. These programs have rested on two mistaken beliefs. First, policymakers assumed that direct reductions in government spending and higher taxes along with deregulatory reforms of labor and services would raise “confidence” and that restored fiscal probity and structural changes would produce efficient self-adjustment. Second, they believed that the induced slow growth and outright recession in fiscally troubled peripheral nations, along with labor reforms, would also result in the needed suppression of wages (what is known as internal devaluation), thus making peripheral nations more competitive.

The austerity approach is failing unambiguously, however. As one Eurozone nation after another has fallen into a second recession, the Eurozone rate of unemployment has reached a record level. Meanwhile, the goals that were set for deficit reduction remain unreachable or have slipped further away.

In the U.S., too, the Obama stimulus of 2009 has largely run its course, job creation may already be slowing down from its early 2012 pace stimulated by an unusually warm

Winter, inequality remains very high as nearly all of the income gains since 2009 have gone to the wealthy, and median wages have declined despite recovery.

Today, the lack of worldwide demand for goods and services is more than evident. Unemployment rates and unused capacity are high, as are vacancy rates in real estate and the inventory of unsold homes. GDP growth rates are slow. Debt-laden Americans can no longer borrow to com-

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## U.S. and European economies will not adequately recover in the short run or establish rapid growth in the long run unless the low-wage policy regime is reversed.

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pensate for low wages. To the contrary, they are now deleveraging. Indebted nations in Europe are having trouble accessing the debt market and rates have been shooting upward. To be able to borrow, peripheral economies have been forced to rely on Eurozone guarantees and programs that have been made contingent on the adoption of recession-inducing policies.

Ironically, the U.S. and European economies will not adequately recover in the short run or establish rapid growth in the long run unless the low-wage policy regime is reversed. In an era in which labor has been globalized, this will not be easy. For now, almost every rich nation in the world has forsworn Keynesian stimulus in practice, including the U.S., in favor of austerity programs involving government spending cutbacks in 2011 and 2012. To be sure, there is a lot more talk of growth in both Europe and the U.S., and even some discussion of some Keynesian-oriented ideas. But in spite of the rhetorical shift toward growth, Keynesian advocates are largely being ignored in a world still dominated by Say's-Law-thinking in which supply is assumed to create its own demand and an increase in savings through deficit cuts is assumed to create investment. With such theory still prevailing in major capitals, the dangers of fiscal deficits and inflation are routinely exaggerated, and the idea of wage increases remains anathema.

Since the crisis, some internationally influential economists are now discussing the contradictions of export-led and debt-led growth models, including Paul Krugman,

Raghuram Rajan and Branko Milanovic. But the world has not yet come to terms with the failure of a low-wage policy regime, let alone embraced the policy reforms needed to make wage-led growth possible.

## The Making of the Low-Wage Regime

There are a variety of causes of low wages. Some of the causes are related to an evolving economy subject to technological change and globalization, as orthodox economists often stress. But many of the causes are the result of politically motivated, theoretically dubious, and unnecessary choices made by policymakers in leading nations.

Mainstream economists largely emphasize the rise of skill-biased technologies as a cause of inequality and hence low wages for those who are less well-educated. Globalization and the offshoring of work have created low wage competition for rich nations and also reduced the power of already weak unions.

But another major factor in low-wage regimes has been, until recently, the relentless, single-minded war against inflationary expectations by central banks in Europe and the U.S., which has directly led to higher unemployment rates designed to create fear among workers about demanding raises.

The deregulation of work across Europe has also been a major factor, following the lead of America, which has relatively low unemployment benefits, lax implementation or outright reversals of labor laws, and a low minimum wage. These were political decisions, sometimes made under the influence of the orthodox economic fixation on government deficits and free markets, but often made at the behest of vested powerful business interests. They were not economically inevitable, as some continue to claim.

More ambiguous, but I will argue critical, has been the role of financialization – by which, I mean the adoption of stock market-driven criteria to manage business. Financialization rewarded lower wage costs and short-term profits with high stock prices, contributing to a growing cultural tolerance of lay-offs. Executives benefited directly as the issuance of stock options as part of executive pay packages grew dramatically over the past two decades.

## The U.S. Road to Low Wages

The U.S. deliberately chose a low-wage economic policy in the early 1980s when Paul Volcker raised interest rates sharply – the Federal funds target rate reaching more than 18 percent – bringing on a harsh recession intended to stop what was then interpreted as runaway inflation.

Volcker's objective was two-fold. The first was to reduce the rapid rate of money growth, which Milton Friedman and his followers had claimed was the main source of inflation, along with federal budget deficits. The second was to break inflationary expectations, which he believed had become entrenched in the economy through persistent pressure to raise wages to compensate for rising prices.

In fact, the causes of inflation were mixed and complex. They included not merely budget deficits and money growth but also multiple oil prices hikes by OPEC, worldwide crop failures, the mismanaged unfreezing of U.S. prices, a sudden and unanticipated slowdown in productivity growth, and a systematic overestimate of housing inflation by the government.

The driving concern of many economists and policymakers in the 1970s and 1980s was that whatever set inflation off, it took on a life of its own through inflationary expectations. People bought sooner rather than later to beat rising prices, thus stoking rather than reducing demand. More important, inflationary expectations fed demands for higher wages, putting pressure on companies to raise prices. A favorite interpretation of many mainstream economists was that once inflationary “momentum” set in, as Jimmy Carter's chief economist, Charles Schultze put it, it fed on itself.

Unions in particular were blamed for the rising wages. Many union contracts were indexed to inflation and other companies followed suit. In turn, companies raised prices to maintain profit margins.

Volcker almost surely was a skeptic of Friedman's monetarism and used it instead as a cover story to justify the creation of a recession through higher interest rates. In any case, by the 1990s, Friedman's monetarism had been discarded as simplistic but it served Volcker's purpose. The harsh recession and collapse in aggregate demand

that resulted from Volcker's interest rate policy did indeed crush inflationary expectations and begin the long, persistent deterioration of union power.

At the Fed under Greenspan, the battle against inflationary expectations prevailed until the late 1990s, even as inflation declined. One important theoretical justification for the policy was a more lasting contribution from Friedman, the natural rate of unemployment. Before this, Keynesian economists argued that higher inflation led to lower unemployment rates—a relationship defined by the famed Phillips curve. Friedman's counterattack was that higher inflation did not reduce the unemployment rate. Rather, using government policies, whether monetarist or Keynesian, to push the unemployment rate below the natural rate (the Non-Accelerating Inflation Rate of Unemployment or NAIRU) resulted in ever-higher inflation, he postulated. Friedman argued that workers were momentarily duped by resulting wage hikes to take jobs as the unemployment rate momentarily fell below its natural rate. But higher inflation then reduced their real wage and they then were no longer attracted to work. Therefore reducing the unemployment rate could lead to uncontrollable inflation and economic instability.

Republican and Democratic economists alike adopted NAIRU as a policy guide. It seemed to conform to the experience of the 1960s and 1970s, but the relationship was in fact superficial. It became clear over time that even if NAIRU existed, no one actually knew what the NAIRU was. Many economists claimed it was 6 to 6.5 percent in the 1980s; yet, in the late 1990s, the unemployment rate fell below 4 percent without causing inflation.

In reality, NAIRU was arguably overestimated well before the late 1990s, and therefore authorities kept the unemployment rate higher than was needed to suppress inflation. Higher unemployment rates in turn have been closely linked by academic research to slower growing wages.

But there were other important political actions that helped reduce wage growth and undermine worker bargaining power. Volcker supported, for example, Reagan's influential decision to fire the air traffic controllers when they went on strike in 1981. As an indication of Volcker's interest in stopping the unions, William Greider noted:

[Volcker] carried in his pocket a little card on

which he kept track of the latest wage settlements by major labor unions. From time to time, he called various people around the country and took soundings on the status of current contract negotiations. What is the UAW asking for? What does organized labor think? Volcker wanted wages to fall, the faster the better. In crude terms, the Fed was determined to break labor.

Reagan also began to relax and reverse rules protecting organized labor and the enforcement of labor laws in general, including implementation of the minimum wage. Union coverage fell from about 30 percent of private labor markets to 7 to 8 percent in the 2000s.

The battle against labor had also become widely accepted as necessary among mainstream economists. Meantime, as New York Times reporter Steven Greenhouse documented in his book, *The Big Squeeze*, businesses became more aggressive about breaking unions and met less and less resistance from federal watchdogs.

In this period, the minimum wage was allowed to fall sharply after adjusting for inflation (see Figure 1).

Regarding the defeat of organized labor, Michael Mussa, former IMF chief economist, triumphantly described the

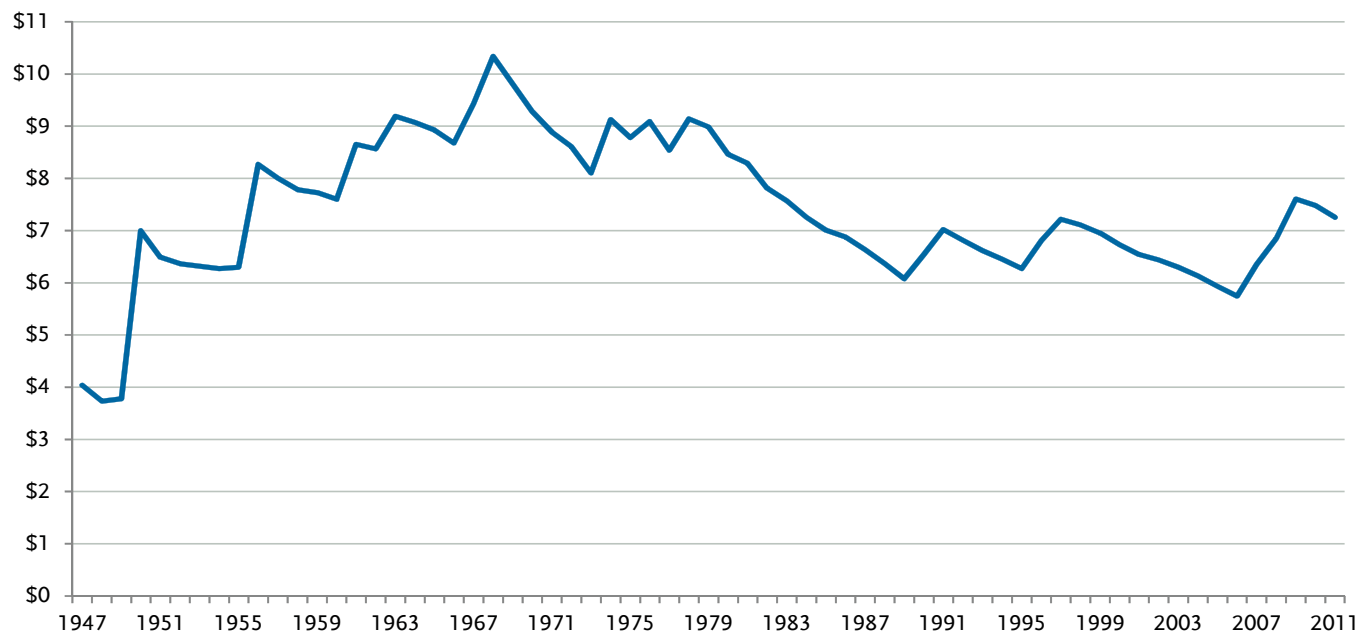
government ‘victory’ in 1994: “To establish its credibility, the Federal Reserve had to demonstrate its willingness to spill blood, lots of blood, other people’s blood.”

Greenspan was unabashedly dedicated to creating worker insecurity in order to suppress wage gains. Greenspan proudly testified before Congress in 1997 that it was working. As growth quickened, he said, “The rate of pay increase still was markedly less than historical relationships which labor market conditions would have predicted. Atypical restraint on compensation increases has been evident for a few years helped still more and appears to be mainly the consequence of greater worker insecurity.”

A couple of years later, Greenspan cited statistics that made him still more proud. In earlier years, with unemployment recently at 8 and 9 percent, International Survey Research reported that 12 percent of workers feared losing their jobs. In 1999, the same firm reported that 37 percent worried about losing their jobs even with unemployment under 4 percent.

In sum, although the Fed’s explicit target was to keep inflation low, the indirect target was to suppress wage growth through a high unemployment rate. Economist Michael Perelman has documented much of this; as he notes, the “traumatized” worker was a key factor in the Fed’s thinking

Figure 1: United States Real Federal Minimum Wage, 1947-2011



Minimum wage calculated using CPI - U in 2011 dollars.

well into the 2000s. Even as the Fed lowered interest rates, wage increases were small, to the delight of many on the Fed. The Fed governor, Edward Kelley, had put it this way at an earlier Open Market Committee meeting:

“I don’t know how much has to do with the so-called traumatized worker. How long is the American workforce going to remain quiescent without the compensation increases that it thinks it should get? When employment is as strong as it is right now, I don’t think we can depend on having permanently favorable results in that area. This has been a rather big key to the present happy macro situation where we have a high capacity utilization rate and a relatively low inflation rate. We all feel rather good about that.”

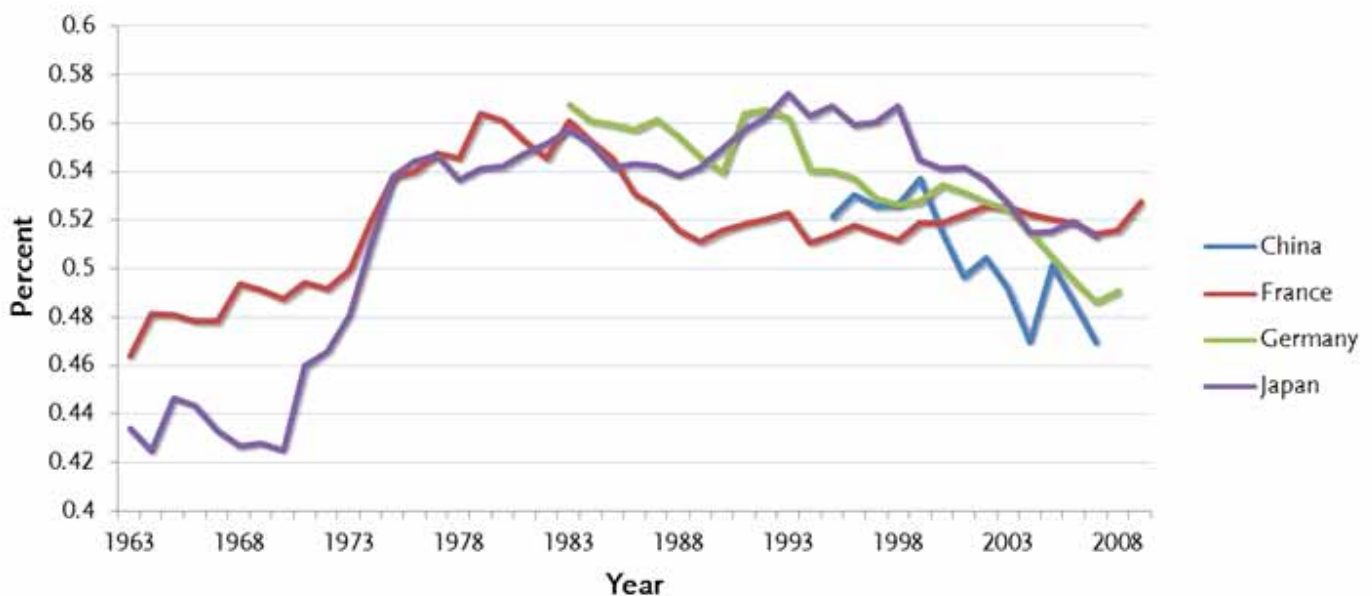
Beginning in the early 1980s, the growing influence of finance and the increasing financialization of American companies was another major factor in slow wage growth. As noted earlier, CEOs and other executives were increasingly given stock options, which focused them on maximizing short-term profits to raise the stock price. Also, corporate takeovers, LBOs and privatization generally required an increase in cash flow immediately to cover the debt service to finance the transactions, often at the expense of the payroll. Managers unthreatened by take-

overs, like Jack Welch, who became CEO of GE in 1980, nevertheless adopted minimization of wage costs as a strategy to raise stock prices. Some researchers have found that public companies subject to stock market pressure and run by CEOs motivated by stock option compensation invested substantially less than private companies without such pressure.

It is important to recognize that financialization was also a policy choice. Active advocacy of deregulation allowed excessive speculation and unregulated trading by banks. Fees for transactions such as LBOs or the issuance of absurdly priced IPOs were very high, unmediated by true competition among financial firms. The tax deduction for cash pay was limited but stock options were unregulated. Nor were corporations at first required to expense them. Washington either looked the other way or deliberately did finance’s bidding. All the while, labor protections were cut and a culture in which labor was increasingly expendable was favored. Maybe most important, debt was the motor of financialization and enjoyed a significant tax advantage: interest expense was tax-deductible on many financial transactions, including takeovers and in general financial speculation.

In effect, the U.S. government subsidized the rise of finance, a fact about which the academic community rarely

Figure 2: Wage Share as Percent of GDP, Selected Industrialized Countries



Source: Extended Penn World Tables, drawing from United Nations Data

complained. By contrast, academic economists rose in near-unison against subsidizing manufacturing, arguing that it was a sunset industry seeking protection from international competition. Another problem was the strong dollar, which favored finance over domestic industry. The Clinton administration deliberately encouraged a high U.S. dollar, which also served as a subsidy to Wall Street by enabling it to import capital at low interest rates, much of it recycled from export economies that enjoyed trade surpluses with the U.S. Wall Street firms could thus borrow cheaply and also sell mortgage and other debt products at attractive rates to clients.

The general refusal to subsidize manufacturing, partly in deference to the support for free trade policy, also undermined wages. Yet manufacturing was subsidized by other nations around the world. There was also a decided anti-manufacturing policy in the U.S. as the high dollar policy placed exports at a significant disadvantage.

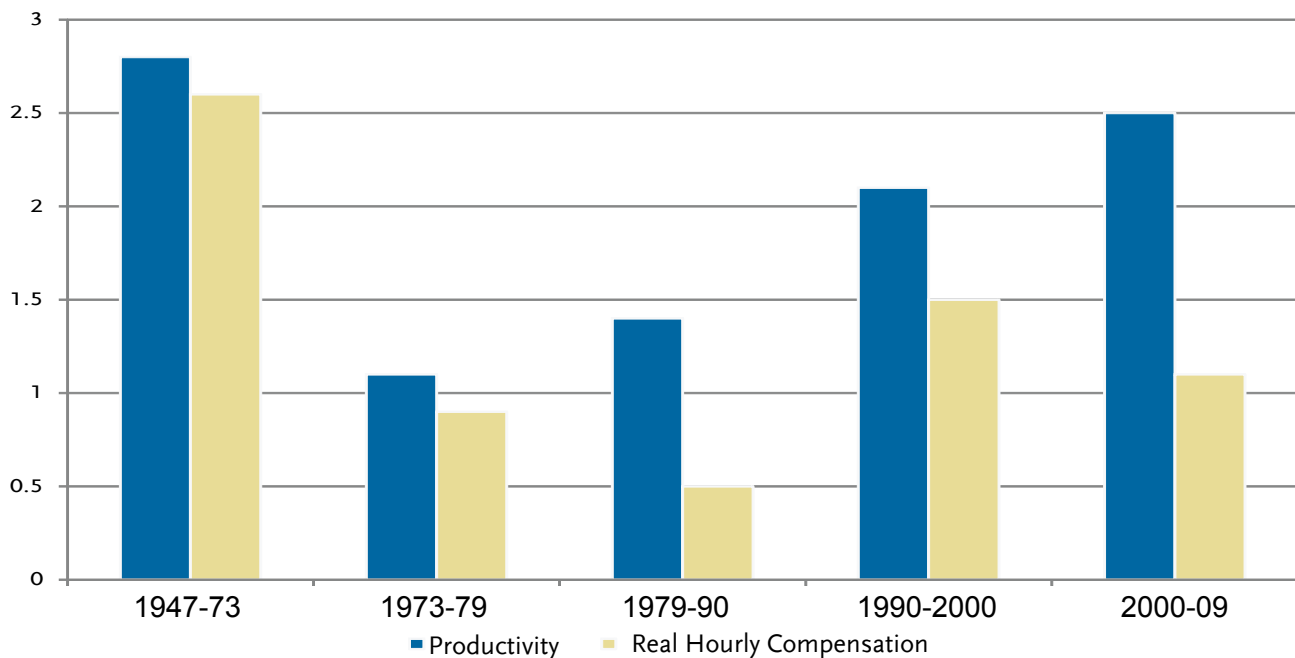
In the 2000s, other factors, including the offshoring of jobs, also kept wages down. Wages did not grow at all in the recovery and expansion of the 2000s under George W. Bush. Nor have they fared any better in the recent recovery under Barack Obama. Median weekly wages stood at \$747 (in current dollars) for all full-time workers in the

first quarter of 2010, after the official end of the recession in June 2009, and were only \$763 in current dollars in the first quarter of 2012. In constant 1982-1984 dollars, median weekly wages declined from \$344 in the first quarter of 2010 to \$334 in the first quarter of 2012. Low union coverage and deep-seated worker insecurity were still among the core reasons for the stagnant wages.

Mainstream economists never conceded that faster economic growth could promote more equal wages. When confronting questions about growing inequality, Greenspan for example explicitly denied that looser monetary policy could affect it. Skill-biased technology served as an adequate explanation of inequality for him and others, and inequality therefore could not be influenced by traditional fiscal or monetary policies. As he told a Congressman in 1997, regarding inequality, “It is a development which I feel uncomfortable with. There is nothing monetary policy can do to address that, and it is outside the scope, so far as I am concerned, of the issues with which we deal.”

The cumulative effect of these policies was the poor performance of wages for four decades. The Hamilton Project, housed at the Brookings Institution, found that median wages earnings (half earn more, half earn less) for all men 25-64 working full-time were in 2009 about what they were

Figure 3: Productivity Growth and Real Hourly Compensation Growth, Annual Percent Change



Source: Bureau of Labor and Statistics, “Productivity-Compensation Gap” [http://www.bls.gov/opub/ted/2011/ted\\_20110224.htm](http://www.bls.gov/opub/ted/2011/ted_20110224.htm)

in 1969. But many fewer men as a proportion of the work force now worked full-time. When the Hamilton Project measured the median earnings of all men aged 25-64, it found that their median earnings were \$13,000 lower than they were in 1969 (measured in 2009 dollars).

Obviously, this decline long preceded the Great Recession. Indeed, median earnings for all men never again recovered their pre-1981 highs – not during Reagan’s two terms or even during the Clinton boom.

Women have done better, but not well by historical standards, despite some claims otherwise. Another Hamilton Project Report shows that since the early 1980s, median earnings for full-time working women have risen from around \$28,000 to \$35,000, an increase of about 25 percent. Still, over 30 years, this is an annual growth rate of less than 1 percent, a far lower annual rate than in the 1950s and 1960s when wages rose by 2 to 3 percent a year; through much of America’s industrial history since the 1800s, wages rose over long periods by 1 to 2 percent a year.

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### Due to reduced wage share and higher inequality, wages for typical workers have not kept pace with the growth of productivity.

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Because many more women are working part-time and full-time than in earlier years, the median earnings for all women has risen faster than for full-time workers. But even that flattened out in the early 2000s. Today, full-time women workers earn no more at the median than in 2000. For a more detailed study of the poor performance of full-time male and female worker wages, we present our own findings in Appendix 1, broken down by age and education as well as gender. Of note, even median college-educated workers did not do especially well by historical standards since 1969, although their gains did exceed those of workers with only a high school diploma.

Had wages risen slowly because the economy grew slowly, no case could be made that workers bore more of the cost of a low-inflation strategy than others. But wages for most grew more slowly than the rest of the economy because of rising inequality and because wages were becoming a

declining share of the economy. According to the BLS, the labor share of output declined in America since the 1970s.

Due to reduced wage share and higher inequality, wages for typical workers have not kept pace with the growth of productivity, either, thus contradicting the “trickle down” notion that wages would share equally in productivity growth. Roughly since 1979, productivity has grown faster than real hourly earnings, as seen below. This is partly because much of wage share has gone to top earners, even as overall wage share fell. Because higher end workers save substantially more of their income than those in the middle and below, aggregate demand was reduced still more than a falling wage share would suggest, with retarding consequences for growth.

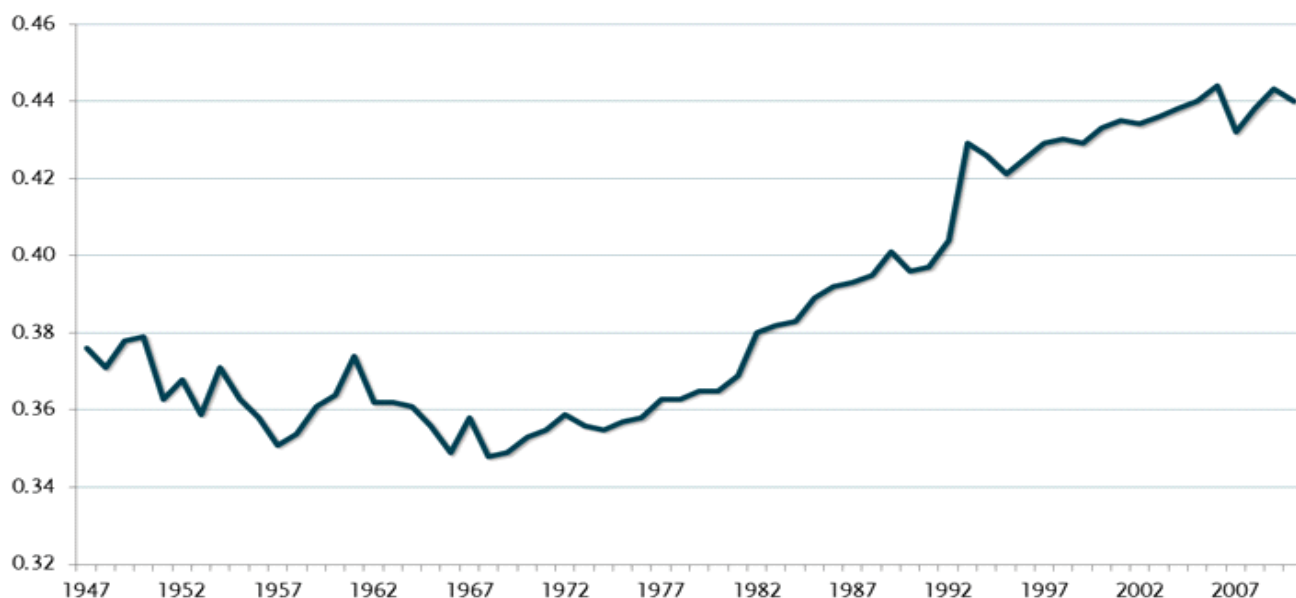
### The European Path to Low Wages

The influence of the U.S. over the economic policies of other nations in these years was considerable. The U.S. model – which stressed low inflation, less regulated labor markets, and financial deregulation – was seen as exemplary. The European Central Bank, created in 1998 with the adoption of the euro, inherited a staunch anti-inflation tradition from the powerful Bundesbank of Germany. Moreover, unlike the Federal Reserve, which was also directed to focus on employment, the ECB’s only legal mission was to maintain low rates of inflation. Accordingly, it has adopted a tight monetary policy since its inception.

In addition, the U.S. model was noted for its less generous safety net and its flexible labor market. In an attempt to mimic America’s 1990s “success,” many nations across Europe reduced their safety net while they deregulated labor policies. Germany in particular adopted a set of policies, often in cooperation with unions, to suppress wage growth. Wage share started generally falling in the late 1980s and early 1990s, and more so into the 2000s.

While no Eurozone nation reduced its safety net to the modest American version, many countries in Europe did follow the U.S. in allowing wage growth to fall behind the rate of growth of productivity, and some did so as early as the 1980s and 1990s. In Germany, wages fell behind productivity growth beginning in the 2000s. The slower growth of wages in Germany is attributable to a variety of factors including job sharing incentives, acceptance by

Figure 4: Gini Coefficient for Families (United States)



Source: United States Census Bureau

labor unions of lower wages, and reduced unemployment benefits.

Even if wage share had not fallen, inequality has risen in most of these same nations as well, and for Anglo-American nations quite sharply. For the U.S., wages began to grow significantly more unequal beginning around 1980. Most important, the level of aggregate demand that is generated by a pool of unequal wages is less than if they were equal because high-wage workers spend less.

As seen in Table 1 below, the incomes of the top quintile have grown much faster than those of the bottom quintiles in Germany, the U.S., and the OECD as a whole during the period from the mid-1980s to the mid-2000s.

### Theories Supporting the Low-Wage Policy Regime

As noted earlier, most mainstream economists did not focus on the economic dangers of a low-wage regime, whether caused by inequality or a declining wage share of GDP – or both. They generally limited their concerns to the social effects of inequality, but even then there was inadequate attention paid to rising inequality until the Great Recession and, arguably, the rise of Occupy Wall Street.

Mainstream theory essentially supported the view that

Table 1: Income Growth for Top and Bottom Quintiles, mid-1980s to mid-1990s

Household Income	Average Annual Change mid-1980s to mid-1990s		Average Annual Change mid-1990s to mid-2000s	
	Bottom Quintile	Top Quintile	Bottom Quintile	Top Quintile
Germany	0.4	1.6	-0.3	1.3
United States	1.2	1.9	-0.2	1.1
OECD	1.2	2.1	1.5	1.9

high inflation was the key danger to growth and stability and that low rates of unemployment could readily set inflation off again, as it was believed to have done in the 1970s. For two decades, as we discussed earlier, Friedman's natural rate of inflation held sway until it foundered on the rocks of contradictory experience in the late 1990s when the unemployment rate fell without inducing inflation.

But other mainstream theories took its place to lend intellectual support to the low-wage regime across the world. First, based on theories of rational expectations, it had become more widely accepted that any government policy designed to increase the rate of economic growth and reduce the unemployment rate would be neutralized by consumers and businesses. In the more extreme version of rational expectations, known as Ricardian equivalence, if Keynesian fiscal stimulus were adopted, consumers would save an equivalent amount of the stimulus rather than spend it because they realized that the government would eventually have to raise taxes to compensate for the near-term deficit. Many if not most mainstream economists believe that consumers will save enough of a stimulus to offset most of its stimulative potential, although the view remains contentious. Keynesian policies, consumers supposedly would realize en masse, would not expand the economy sufficiently to relieve the need for higher taxes. Similarly, expansionary policies by a central bank were limited in their positive effects.

Second, there was widespread acceptance of the view that rising inequality was largely due to skill-biased technologies. Policymakers, therefore, argued that there was little they could do except to improve education. As we noted earlier, Greenspan adopted this view and it guided his approach to monetary policy.

Third, inflation targeting – that is, making low inflation rates the sole objective – also became widely accepted as an appropriate policy for central banks. It rested on the idea that the central bank would send a message to consumers, businesses and bond investors that inflation would remain low and stable. Therefore, interest costs would fall or at least not rise and, in general, confidence would stay high because future price instability, like the experience of the 1970s, would not recur.

Ben Bernanke, the current chairman of the Federal Reserve, had been a leading advocate of a version of this position.

He heralded the period from the 1980s to the mid-2000s as a Great Moderation of less volatile growth, proof that a focus on low inflation was working. The Federal Reserve did not practice formal inflation targeting but pursued nevertheless a milder form.

There was no economic evidence that inflation rates above 2 or 3 percent a year would impede economic growth. Yet the great majority of economists and policymakers held this view – many of them out of a general concern that once inflation rose it could easily get out of hand – again, the fear of a replay of the 1970s, even though union representation was now low and the bargaining power of labor weak.

Fourth, it bears emphasizing that the central theoretical assumption underlying these widely accepted policies was that economies were self-adjusting as long as government did not interfere. Economists had returned to faith in the “general equilibrium model” that prevailed before the Great Depression, which argued that economies after recessions returned to optimal rates of growth on their own – or at best, with minimal stimulative help from the Fed or the Treasury.

Similarly, there was renewed faith in Say's Law, which Keynes had struggled successfully to demonstrate with certainty did not prevail in recessions. The late-18th and early-19th century French economist J.B. Say argued that supply created its own demand. If we build cars, the process would create the income to enable people to buy them. If the nation saved enough, interest rates would be lowered sufficiently to raise business confidence and investment. In a Say's Law world, deficits reduced national savings and therefore “crowded out” private investment. By contrast, Keynes argued, government budget deficits were usually necessary to restore demand and therefore business confidence.

In a Say's Law world, rising profits, a contributor to savings, were also almost invariably considered a principal cause of investment and therefore growth. High wages undercut profits and therefore often impeded economic growth; high wages were not considered necessary to provide adequate income to buy products.

Finally, there was the widespread acceptance of the benefits of trade liberalization among economists and policy-

makers. But trade liberalization with low wage, export-led economies like China put downward pressure on wages. Indeed, lower wages were seen as the best way of helping make exports more competitive. With fewer policies to subsidize manufacturing or regulations to protect domestic markets, a lower wage became one of the few ways for U.S.-based companies to compete internationally. And the search for lower wages led to widespread offshoring and outsourcing, putting even more downward pressure on the domestic labor market. Higher American wages in non-tradable sectors could have offset the downward pressure on wages in the traded sector and could have helped maintain aggregate demand. But with the power of labor weakened by deregulation and other measures, along with the rise of low-wage sectors such as retail, wages also suffered in non-traded sectors as well.

As economists on the Right and Left lauded Bernanke's Great Moderation, they did not bother to note that economic growth, adjusted for business cycles, did not speed up in these years. To the contrary, as seen in the table below, the rate of GDP growth slowed in every ensuing decade of the Great Moderation. The era was also accompanied by jobless recoveries in the early 1990s and the early 2000s compared to rates of job growth in recoveries from

earlier recessions. In fact, according to the International Labor Organization (ILO), every dollar of increased GDP supported fewer jobs in this era. In the 2000s, as noted, wage growth completely stalled in the U.S. even before the Great Recession. In addition, there were repeated serious financial crises since the early 1980s that took their toll on income, even before the tech bubble in the 1990s and the housing bubble in the 2000s.

A similar pattern of weak economic growth was also evident in Europe, as illustrated by the following chart (Figure 5).

For most economists and policymakers, the control of wage growth was generally seen as an accomplishment as it reduced inflationary pressures and raised profits. Even if it were a function of inequality, more rapid growth was not seen as the answer to inequality; more education was. Whether higher wages were needed to support aggregate demand was rarely asked, even as major economies turned to exports and debt to support demand instead. The eventual result was financial catastrophe and the Great Recession.

Table 2: Slower Growth Rates in Each Succeeding Expansion Since the 1980s in the U.S.

	Employment	GDP	Personal Income	Industrial Production
1949-53	4.4	7.5	6.5	11.5
1954-57	2.5	4.0	4.9	6.3
1958-60	3.6	5.7	4.7	10.8
1961-69	3.3	4.8	5.2	6.5
1970-73	3.4	5.2	5.8	8.1
1975-80	3.6	4.3	4.1	5.5
1980-81	2.0	4.4	4.7	6.4
1982-90	2.8	4.2	3.6	3.8
1991-2001	2.0	3.6	3.8	4.2
2001-07	0.9	2.7	2.7	2.4
2009-11	0.3	2.5	2.4	5.9

Source: Economic Cycle Research Institute

## The Low-Wage Regime: The Unforeseen Cause of the Crisis

Neither debt-led nor export-led growth models were explicitly adopted as a way to supplement low wages in respective economies. In the U.S., the build-up of household debt was a consequence of stagnant wages and increased international competition with low-wage, export-led economies. Ever higher levels of household debt were required to create enough aggregate demand to support economic growth at moderate rates. Had wages been higher, mounting consumer credit would not have been as necessary.

Beginning in the 1980s, especially following the success of Japan, export-led models were widely accepted as a path to economic development. Export-led growth was an economic policy choice often made by nations in the take-off stage of their economic development to supplement their slowly developing domestic markets. Had their domestic markets been more robust or more mature, export growth would have been less necessary to support economic growth generally. But dependency on export-led growth continued even among rich nations with a substantial middle class, such as Japan and Germany. Such dependency

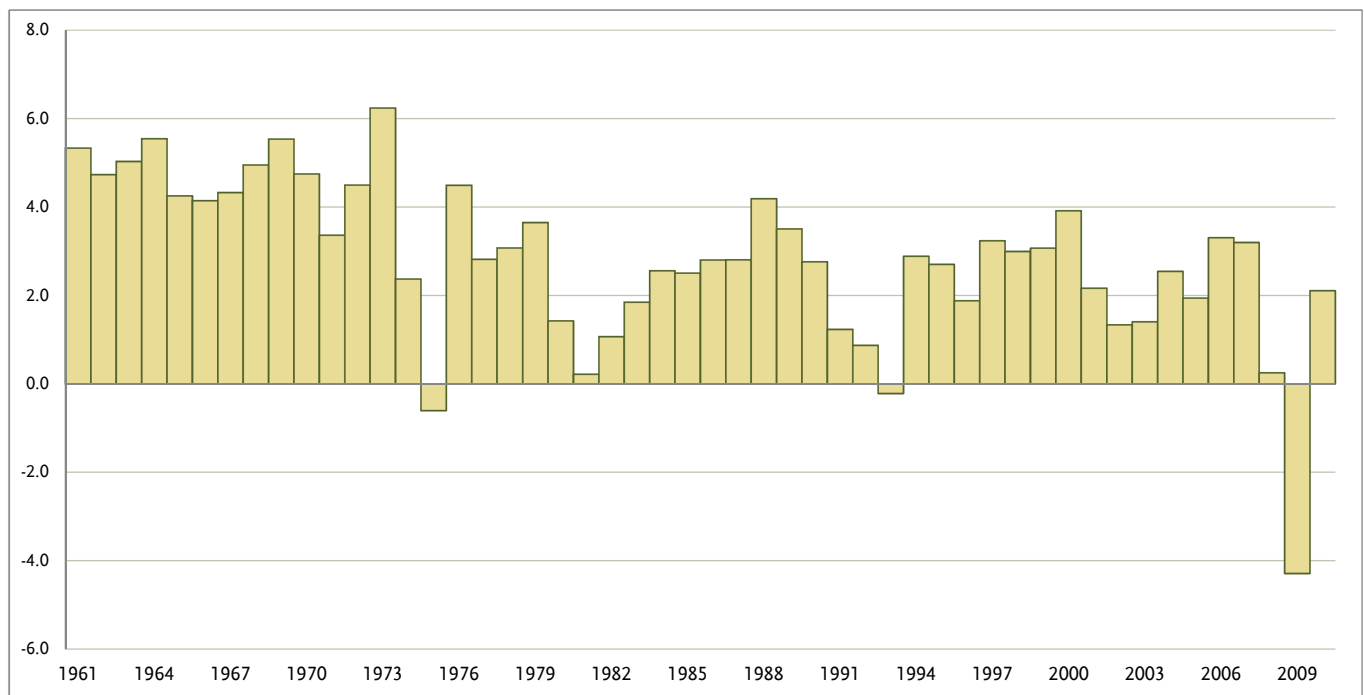
created a vicious circle because export competitiveness in turn depended on restraining wages.

The U.S. is the leading example of a debt-led growth model. As discussed above, its evolution was long, although it gathered steam in the late 1990s and 2000s. The low-wage era in the U.S. began in the early 1980s, and it is not likely a coincidence that household debt as a proportion of GDP began to rise in this period (after the harsh recession ending in 1982). Household debt as a proportion of GDP had been basically flat during the rapid growth of the 1960s, after having risen in the 1950s as Americans started to spend again and buy homes on credit after the harsh war years.

Household debt, led by the mortgage boom, rose especially rapidly in the 2000s, when wage growth was flat, despite low rates of unemployment (see Figure 6). Because of low unemployment rates, the lack of wage growth received too little attention from policymakers.

Raghuram Rajan of the University of Chicago Booth School of Business was among the earliest mainstream economists to warn of a frail financial system due to stagnating wages. In his book, *Fault Lines*, he notes “the every-

Figure 5: Annual GDP Growth Rate (European Union)



Source: World Bank Development Indicators

day result [of inequality] for the middle class is a stagnant paycheck as well as growing insecurity.” The resulting borrowing, he says, allowed American consumers to “pay less attention to their stagnant monthly paychecks.” A group led by Jean-Paul Fitoussi and Joseph Stiglitz attributed the crisis similarly to income inequality, resulting in reduced aggregate demand as more income channeled to higher-income workers was saved rather than spent.

With their borrowing, American consumers also kept spending on imported goods that were no longer produced domestically because of the rise of low-wage competition. As a result, the U.S. current account – which is the trade balance plus the balance on investment and transfers (mostly, dividends and interest) – fell into a large and persistent deficit in the early 1980s. After a managed decline in the value of the dollar in the late 1980s, the deficit improved temporarily toward balance before it worsened again in the 1990s and 2000s, falling to a deficit of more than 6 percent of GDP in 2006 (Figure 7).

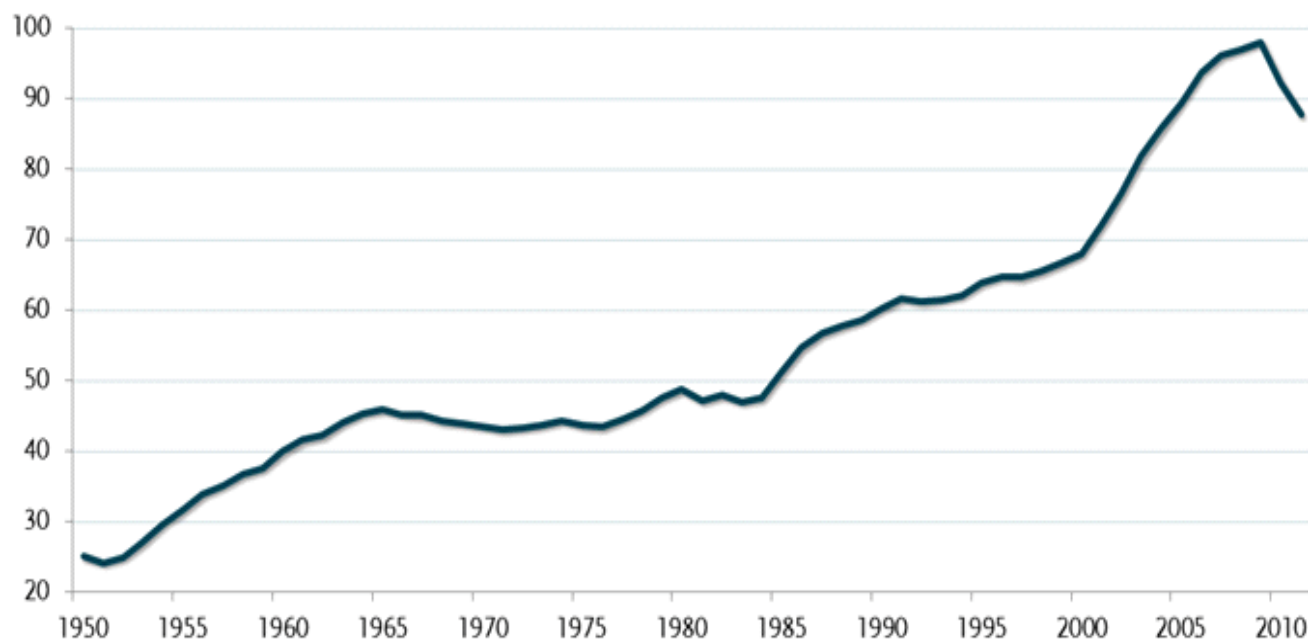
The large early deficits with Japan and later with other Asian nations accounted for most of the U.S. imbalances beginning in the 1980s. Following China’s entry into the World Trade Organization in 2001, the trade imbalance

with China grew especially rapidly and became a larger and larger share of the U.S. current account deficit.

As part of its strategy to manage its currency, China deliberately built up reserves in U.S. dollars. China’s surpluses were recycled into the U.S. via purchases of U.S. Treasuries and government agency debt, including mortgage-backed securities. That flow of funds enabled Americans to borrow aggressively to consume – and often to consume Chinese goods. The availability of this tide of funds for mortgage lending was one of the causes of the crisis. The level of borrowing was also seriously expanded by complex innovative and often deceptive Wall Street practices, as well as higher leverage by these firms, that for many years paid off handsomely in huge bonuses to Wall Street employees. In short, a dangerous feedback loop between borrowers in the U.S. and Chinese exports developed over 30 years, reaching a crescendo in the 2000s, aided by Wall Street lending practices.

Let us now turn from debt-led growth models to export led-growth models. Export-led growth models were widely thought of as an acceptable and even the optimal strategy for growth by developing nations or those devastated by World War II. As noted, Japan’s successful export growth

Figure 6: Household Sector Debt As Share of GDP



Source: Federal Reserve. U.S. Household sector debt includes credit market debt outstanding and household sector liabilities but excludes corporate equities and mutual fund shares.

strategy influenced other nations. For developing nations, export growth models also replaced what many believed were failed import-substitution models of the 1970s and 1980s. Under the import-substitution model, governments placed tariffs and quotas on imports in order to help build manufactures at home and a strong industrial and wage base.

The Third World recession in the 1980s was widely blamed on import-substitution policies, but was in fact due to factors beyond those policies. Many developing nations borrowed heavily when their commodities exports rose in price due to the 1970s inflation, and the economies were hit with a shock when tight money plunged the world economy into recession, raising the rates they had to pay while reducing the prices their commodities fetched.

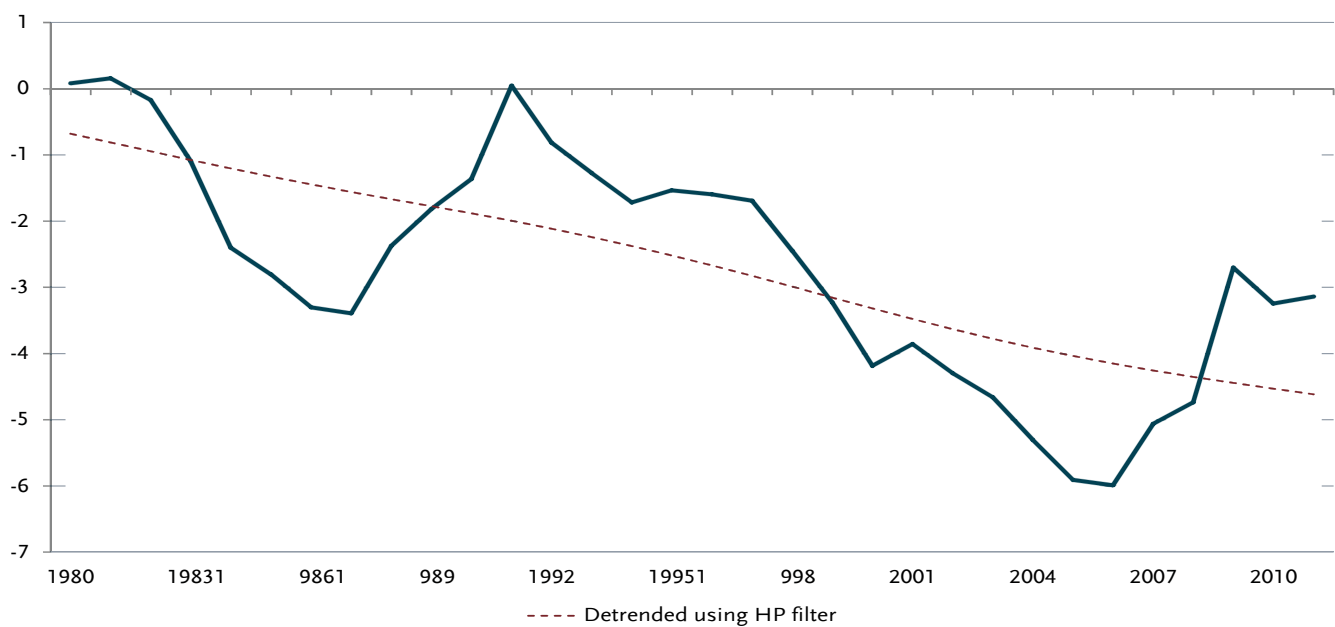
As a result of the perceived failure of import substitution, export-led growth became the economic model of choice among emerging economies. The export-led growth model experienced its own crisis in the 1990s with the 1997 Asian Financial Crisis. But the response to the crisis only reinforced the export-growth model. When Asian economies collapsed as the hot money flow from the West was reversed and capital was withdrawn, many government

leaders vowed to build a war chest of foreign exchange reserves to defend the value of their domestic currencies.

In order to prevent such future crises, many leading emerging economies decided to further subsidize and stimulate exports, moderate consumption, and build up savings of foreign reserves rather than spur domestic demand and growth in their own workers' wages. One policy tool was of course the manipulation of currencies, keeping them low enough against the dollar and other major trading partners to support exports. But they would also subsidize exports in other more subtle ways involving a complex web of measures that benefited export industries.

The U.S. had been the major market for the goods of export-led growth nations (the U.S. was even Germany's second biggest export market) since World War II. But the U.S. trade balance became negative only in the 1970s, and then began to accelerate as the number of export-led economies began to grow in the 1980s and 1990s. These trade deficits had to be financed by debt. China's surplus, the flip side of deficits elsewhere, rose at one point to 10 percent of its GDP (see figure 8, above). Rising demand in the U.S. for foreign-made goods created growing holdings of dollars overseas, which had to be lent back to the

Figure 7: Current Account Balance as Share of GDP (United States)



Source: International Monetary Fund

U.S. This kept interest rates low but it also resulted in even more borrowing and buying by consumers and still greater current account deficits.

What enabled this feedback loop to become extreme was a combination of the reserve currency status of the dollar and the mercantilist practices of Asian export economies. The currencies of most other deficit economies would have fallen as trade deficits increased, and that would have reduced imports and increased exports, restoring balance to the trade account. But the U.S. dollar was in constant demand no matter the U.S. trade position, because it was the principal reserve currency in the world. Ever-greater trade deficits could be incurred, but the dollar largely held its value, reinforced further when other nations like China manipulated their currencies.

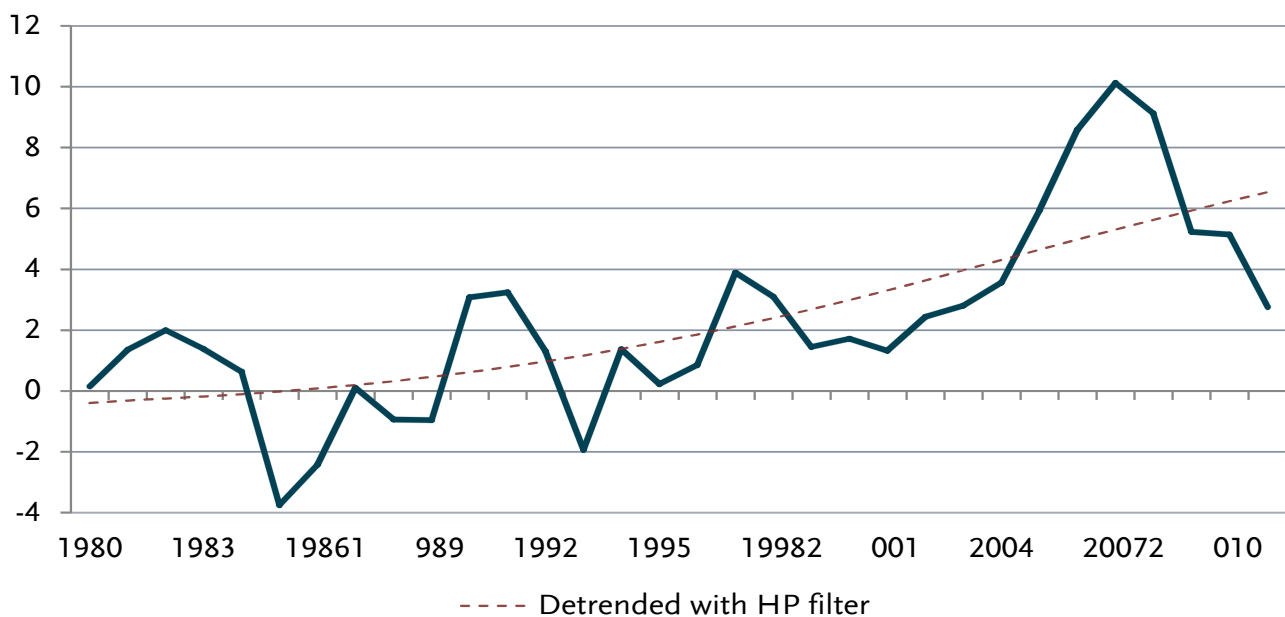
Germany, the world's other major export-led economy, had subsidized and focused on export manufacturing for years following World War II. But this export-led model ran into trouble in the 1990s when Germany's unit labor costs – the wage cost to make a product – had become much higher than its trading partners in Europe in part because of German unification. In the 1990s, Germany's current account was in fact in persistent deficit (Figure 9). With the adoption of the euro in the late 1990s, Germany began to

restrain wage growth sharply and raise productivity levels in key manufacturing export industries.

By the early 2000s, it had succeeded and unit labor costs, a function of both wages and productivity, fell below levels in other major European trading nations. Similar to the relationship between China and the U.S., Germany's currency was essentially fixed against its trading partners according to the rate at which each adopted the euro. Even as Germany's trade balance with other nations rose to a substantial surplus of 7 percent of GDP, the fixed euro provided advantages. Had Germany been independent of the European Monetary Union, the Deutsche Mark would have risen sharply, undermining its export advantage. Instead, the European nations bought German products at their relatively attractive prices and increasingly borrowed to do so. A property boom in nations like Spain and Greece resulted as interest rates in those nations fell, converging with rates in larger less risky European nations. Many across Europe and the British isles gladly bought the public and private debt, as rates came down and currency risk was eliminated. Meanwhile, Germany exploited the weaker euro, improving its competitiveness both within and outside the Eurozone.

But as argued earlier, these export-led growth models can-

Figure 8: Current Account Balance as Share of GDP (China)



Source: International Monetary Fund

not be sustained because they depend on deficit nations taking on too much debt. They are also classic beggar-thy-neighbor strategies that undermine the development of high-wage exporting manufacturers in the importing nations, raising still more the need for the nations to take on debt as wages stay low. To repeat, dependence on exports also creates incentives to keep wages lower in exporting nations, thus reinforcing incentives for a weak domestic market. A principal condition for the success of the German and Chinese export models was also respectively the adoption of the euro and China's pursuit of a de facto currency union with the U.S. dollar. Japan's earlier success depended on its aggressive maintenance of a low value for the yen.

Note in the chart below (Figure 10) how the surpluses of Germany, China and Japan are offset by deficits in the U.S. and most other European nations.

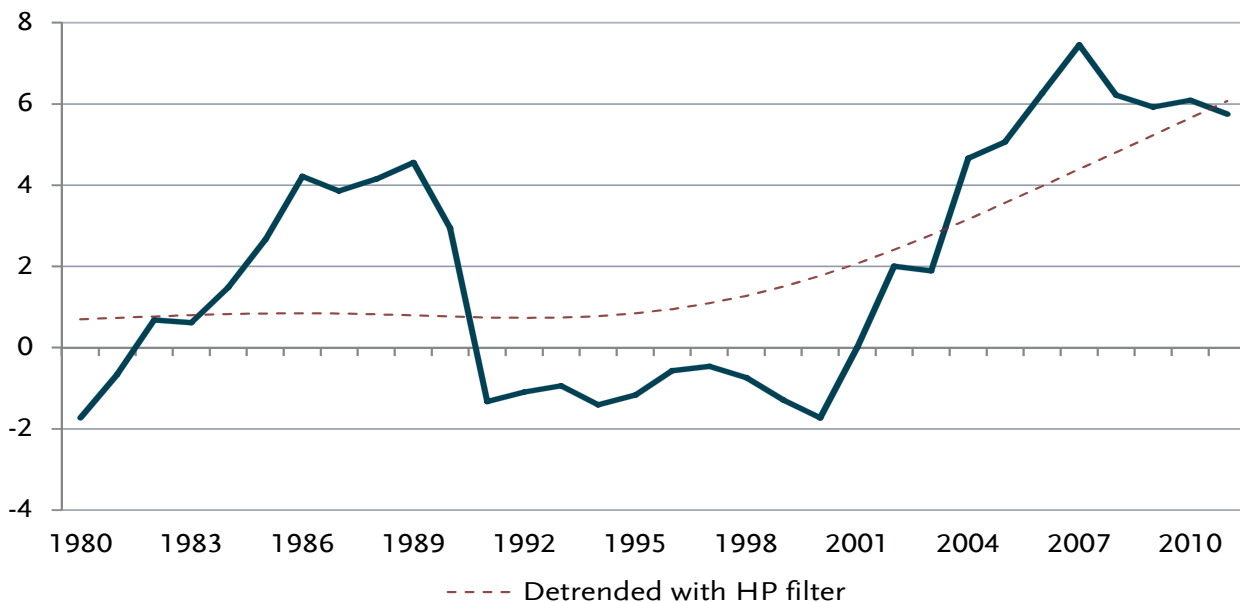
The export-led growth model could only succeed until the debt bubbles in the deficit economies burst. In that sense, export-growth models were on a worldwide basis debt-led growth models.

## A Low-Wage Policy Regime Cannot Support Long-Term Economic Growth

The best way to maintain sufficient aggregate demand, to create high employment, and stimulate investment without inducing insupportable levels of debt is through adequate wage levels. This concept, a simple version of which is known as Fordism (Henry Ford famously paid workers up to \$5 a day, saying he couldn't sell his cars if they couldn't afford to buy them), has largely been ignored over the last several decades by mainstream economists intent mostly on keeping inflation low. Demand was rarely if ever considered inadequate until the time of the financial crisis and the consequences of having to borrow to support demand were given short shrift in both the academic and policy worlds.

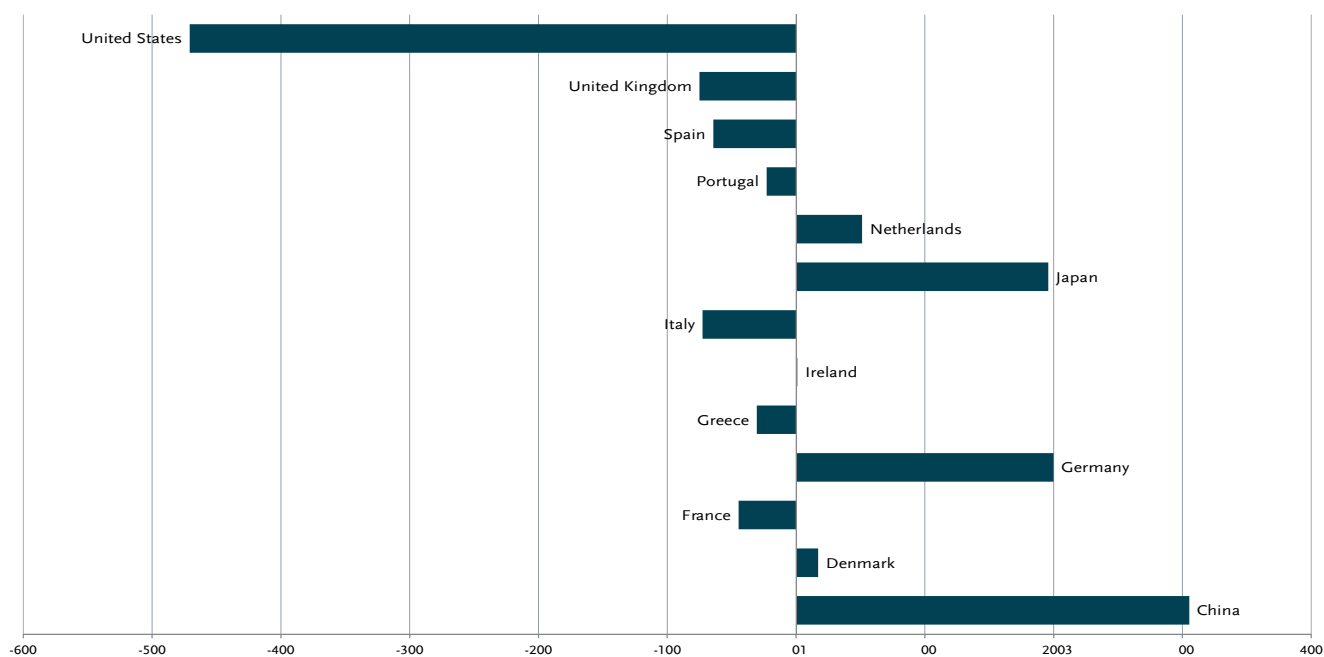
Today, a shortage of consumer demand is evident in high unemployment rates, unused capacity, unbought homes, and a very slow economic recovery that has sunk into a new recession in Europe. In the near-term, fiscal stimulus is necessary to start the process towards growth. But over time, short-term Keynesian policies will not be adequate for political reasons, as they are likely to run up against the over-done fears in the bond markets about budget deficits. Furthermore, a principal headwind retarding recovery

Figure 9: Current Account Balance as Share of GDP (Germany)



Source: International Monetary Fund

Figure 10: Current Account Balance in Billions of USD, 2010 (Leading Industrial Economies)



Source: International Monetary Fund

is the high level of household debt: in order to pay down debt, households must save more and consume less. This supports the case for a focus on wage policy. Higher wages would speed up the deleveraging process while raising aggregate demand. Coupled with Keynesian stimulus, more aggregate demand would stimulate faster GDP growth and create more jobs. It would, in turn, raise tax revenues sufficiently to stabilize budget deficits, given that in circumstances of idle capacity, the multiplier effect of public spending is high.

The resistance to a high-wage regime is and will remain substantial but is based on a narrow view of economic policy. In a world of global competition, high wages are thought to undermine competitiveness. But widespread internal devaluations, which are now being demanded across the Eurozone – depressing wages through austerity policies of higher taxes and reduced government spending – cannot work. They may be appropriate in moderation for an individual country or two, but if adopted simultaneously by a larger group of economies, they will undermine growth by driving down aggregate demand, leading to a downward spiral of lower taxes and higher deficits. And that in turn will only prompt renewed calls for more austerity, resulting in still higher deficits. This result is not a mere likelihood. Recession is now spreading across the

Eurozone and causing social instability. To put it simply, not all countries can devalue at the same time; there will be no one left to buy exports.

A mutual set of policies to raise wages in surplus as well as deficit economies – or at the least stabilize them in deficit countries and then begin modest increases – can redress current account imbalances that were the proximate cause of the financial crisis in Europe and an underlying cause of the crisis in America. Such policies will facilitate the process of deleveraging, support the aggregate demand needed to re-stimulate growth, and raise tax revenues. Only then can debt be rolled over and deficits and long-term debt be managed over time.

Clearly, however, absent protectionist measures, higher wages in deficit nations must be accompanied by higher wages in surplus economies to redress current account imbalances. Without such coordination, higher wages in deficit nations would result in growing trade imbalances with wage-restrained exporters as unit labor costs rise. Germany and China, in particular, must begin to recognize their obligations.

Resistance to higher wages is based in part on fears that rising wages will stoke uncontrollable inflation. At this

moment with enormous slack in the economy, this concern is far-fetched. Another concern is that higher wages will undermine profits, which many orthodox economists regard as the source of investment. But why then is investment not booming in the U.S. when corporate profits have soared and when interest rates are near historical lows? Or in the U.K., where wage levels are falling?

Below I sketch out the broad outlines of a program of recovery and reform. The sequencing of the proposed reforms is important. The program must begin with a new and significant fiscal stimulus coupled with further monetary measures by the ECB and the Federal Reserve in order to raise levels of economic growth. Ideally, the fiscal stimulus should concentrate on Keynesian measures that would create jobs and put upward pressure on wages. These measures must then be followed by a more explicit worldwide high-wage policy.

But even the mildest forms of short-term Keynesianism have been taken off the table. In the U.S., the prevailing conventional wisdom among Democrats is that the current economic model still will work once the mortgage overhang and the high federal budget deficit are somehow dealt with. When moderate growth returns, they say, income inequality can be rectified through tax and redistribution policies. To the extent that such policies are politically feasible, however, they will likely be inadequate. Growth will probably not be rapid enough to reduce unemployment sharply and thereby decrease inequality and raise wages substantially. Current account imbalances will not be corrected so easily.

Higher progressive taxes and an improved safety net are necessary in the longer run to compensate for inequality, and they will increase aggregate demand to some degree because of the higher propensity to spend among those receiving benefits. But these redistributive measures alone will not be enough to correct the underlying problem. For example, raising taxes by a substantial 10 to 15 percentage points on those in the top income tax bracket of 35 percent would yield perhaps \$80 billion a year in extra tax revenue. This is hardly adequate to stimulate growth through redistribution. It would take a much steeper tax increase to make a real difference. Thomas Piketty and Emmanuel Saez calculate that doubling the actual income tax rate paid by the top 1 percent from 22.5 percent to 45 percent could raise nearly 3 percent of GDP, perhaps \$450 billion.

The likelihood of such an increase, however, is virtually nil. In any case, it would be unwise to rely on steep progressive taxation alone because the super-high incomes of the

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## Redistributive measures alone will not be enough to correct the underlying problem

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top 1 percent may well be diminished in the future. There simply may be less money there to tax. It is a progressive misconception that the top 1 percent got super-wealthy by directly taking money away from the rest the way Robber Barons of an older era took money away from workers by keeping wages low. Rather, the 1 percent generated enormous profits through Wall Street trading, excessive speculation, and arguably unethical practices that added little to sustainable GDP other than what the rich then made and spent. The true costs to the nation were misdirected investment and then crisis and recession.

Other popular solutions are also of questionable value. Because Rajan and others attribute inequality largely to skill-biased technology, they recommend few significant policy changes other than a more deliberate effort by government to improve and equalize educational opportunities. This focus on skill-biased technologies is hard to explain given that the income of other nations, if more unequal than they once were, are not nearly as unequal as they are in the U.S. Why hasn't the skill-biased technology pressure affected them as much? As important, typical wages for men even with a college education have risen only marginally since the late 1960s and early 1970s. To be sure, they may have bested wages for high school graduates, but they hardly assure a middle-class life to those who have four-year degrees.

## Putting Wages at the Center of Domestic and International Economic Strategy in the Long Run

The main missing element in the Democratic reform agenda is higher wages. As noted earlier, coordinated rising wages worldwide can reverse the current account

imbalances that have caused so much instability over the past decade or two.

But how do we get to a wage-led economic regime?

We must begin with the understanding that a lower share for wages in the economy is not the necessary result of self-adjusting economies as technology changes and markets globalize. They are instead the result of policy choices, including labor, monetary, tax, and fiscal policies that have worked to suppress wages and raise profits. Government has the power to change these.

### A Virtuous Circle of Rising Wages: Full Employment

We now need a virtuous circle of rising wages leading to strong domestic markets and more balanced current accounts. To accomplish this, the world's major economies can no longer make low inflation their first priority. Full employment should be the first priority among rich nations today.

Two dominant mainstream ideas require rethinking. First is the fear of uncontrollable inflation. This fear is not based on empirical evidence or even well-developed theory but rather is a residue of the experience of the 1970s and 1980s. It is also of course indelible in the German memory. In the U.S., it has led to a strong-dollar policy, which suppresses inflation by keeping import prices low, but in turn places exports at a competitive disadvantage.

The second is what Joseph Stiglitz calls deficit fetishism, a fear that high public deficits will crowd out private investment and may someday result in financial crisis. Crowding out in times of stagnation and low interest rates, as in the U.S. today, is highly unlikely as is a return of unmanageable inflation. Long-term budget problems for the U.S. are largely related to rising healthcare costs and will not become damaging for another 15 to 20 years. Claims that Social Security will bankrupt America are absurd.

Even if these concerns were finally minimized, faster growth alone will not be adequate to raise wages sufficiently because labor markets do not work in textbook fashion. A higher minimum wage, laws to protect labor organizing, government job creation programs, and a reduction in financial influence are among the other policies needed to sustain growth.

International competition from low-wage nations has obviously also increased pressure on the American worker. Some of this has been inevitable, but not all. A reversal of the high U.S. dollar policy would help significantly. As we shall see below, government industrial policies and support for manufacturing should be considered especially in light of policies in other nations that subsidize or otherwise support their tradable goods sectors.

Some policymakers, of course, fear that higher wage policies will undermine US competitiveness. It is likely there is ample room for higher wages in especially high-productivity growth industries. But there is also ample room for higher wages through a raised minimum wage and collective bargaining in non-tradable goods and services, from retailing to home care to health care.

The greatest difficulty going forward will be that progress will require global cooperation, not beggar-thy-neighbor responses. It is equally important for China and Germany to raise wages and reduce dependence on exports. In China, wages are already rising, with measurable early benefits to U.S. manufacturing and job creation. The experiences of Brazil and Argentina in supporting wage-led growth can serve as a model. Agreements on currency levels are also critical. Even if Germany and China raise domestic wages to create wage-led growth, however, the U.S. and other deficit nations must also focus on improving their export capability.

The U.S. need not wait for China. There is a growing awareness that being close to the customer and supply chains can be important competitive advantages. The U.S. government can strategically subsidize investments in manufacturing, transportation, and R&D with the goal of creating higher-paying jobs.

### Focus on Productive Investment

We are not arguing that wages, if supported by social policies, cannot someday rise to destructively high levels. But in many major rich nations, this is, as we have shown, not the case now – not nearly the case, in fact. Economic policy must be set in the context of its time. On balance, in the current economic environment, higher wages over time will encourage productive investment by business, which will raise the rate of productivity growth.

In the case of the U.S., a policy of strong domestic investment in infrastructure and manufacturing industries is also increasingly critical to sustainable growth. The inadequacy of transportation systems in the U.S. is widely known. Government infrastructure investment is a win-win situation, providing greater aggregate demand while increasing the efficiencies of doing business, including access of commuters to work. Thus, the boost to productivity is two-fold.

Regarding manufacturing, America has long had an anti-manufacturing bias in its economic policy. The high dollar, supported politically since the Clinton administration and in the early years of the Reagan administration, undermined manufacturing competitiveness. Meanwhile, other nations support their manufacturing base through a variety of subsidies, both subtle and explicit.

Wages in the manufacturing sector are generally higher than wages in the service sector. That gap has closed somewhat in recent years, but it is still substantial. Rebuilding American manufacturing therefore would have a positive effect on the overall wage structure in the U.S. Given the nature of international competition, a manufacturing policy that includes a range of subsidies is now appropriate as part of a productive investment program. But a lower dollar may be the key policy tool in both stimulating domestic investment and creating high-paying jobs.

Increasingly, mainstream economists support a return to manufacturing. As the Boston Consulting Group has noted, rising wages in China plus geographical advantages in manufacturing near customers and suppliers is creating a new if still moderate wave of re-shoring and in-sourcing. The consulting firm estimates the U.S. could add two to three millions manufacturing jobs within a few years. In his January State of the Union Speech, President Obama recognized at last the importance of creating more manufacturing jobs, making it the first point of his speech.

## Reversing Financialization

Financialization has contributed significantly to a misallocation of resources away from productive investment and to stagnating wages in the U.S. Finance must be directed to its original purpose, which is to channel savings into productive uses.

A paper by economist Thomas Philippon suggests that finance, whose size in the economy has doubled since the 1970s, has not contributed to productivity growth and may have reduced it. More disturbing, the costs of finance for channeling resources to business have risen rapidly, suggesting that 2 percent of GDP is simply wasted. That would come to \$300 billion today. Where is the waste going? Most likely to trading, concludes Philippon, which he claims has no obvious economic value.

Indeed, between 2001 and 2007, investment as a percentage of GDP in the U.S. was historically weak. The inefficiency and misdirection of an ever larger financial industry is probably a major reason.

Aside from the misallocation of resources, finance has also played an important role in the suppression of wage growth, as discussed earlier. CEOs of public traded companies increasingly are compensated with options that are based on stock prices. For a generation, public investors have rewarded an increase in short-term profits. One National Bureau of Economic Research study finds that private companies without such short-term pressure invest considerably more as a percent of their assets than do public companies. Economists Christian Weller and Luke Reidenbach also assess the dampening effects of such short-termism on wages and investment and find them highly influential.

The reversal of financialization, therefore, is now required. The Dodd-Frank Act is largely dedicated to avoiding another crisis, not to the proper functioning of finance as an intermediary between savings and investment.

Two general reforms are needed to redirect finance. First, the size and conflicts of interest within large financial institutions must be controlled. A great deal of misdirection of investment is the consequence of speculation and excessive trading, supplemented by leverage. These can all be restrained by higher capital requirements, maximum leverage restrictions, and direct prohibition of proprietary trading, such as the Volcker Rule attempts to do. To the extent trading is encouraged by illegal or unethical investment behavior, such as front-running and trading on inside information, tougher rules and monitoring are required, as are civil and criminal penalties where appropriate.

Regarding the suppression of wages, executive compensation can be more closely regulated to reward the long-term health of the companies they manage. Tax policies can be employed to this end as well. Excessive risk-taking by managers can also be made more transparent and even restricted by appropriate regulatory bodies.

The role of finance in the suppression of wage growth and low levels of investment has not been adequately acknowledged by policymakers or discussed in the media. A return to wage-led growth and reduced worldwide imbalances requires a reversal of financialization, as suggested here.

*For full appendices of this paper, please see the original document [available online here](#).*

*The author would like to give special thanks to Nikolaos Papanikolaou for his invaluable research assistance.*

## Notes

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8. Michael Greenstone and Adam Looney, [“Women in the Workforce: Is Wage Stagnation Catching Up to Them Too?”](#) April 2011.
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10. Bureau of Labor and Statistics, “International Labor Comparisons,” <http://www.bls.gov/fls/images/chart-book3.12.png>. Further data available from BLS [here](#).
11. Rajan blamed much of the consumer borrowing binge to come on U.S. government encouragement regarding home ownership, a process he misleadingly oversimplified. He claimed that it was government that enabled borrowing, partly through housing policies and Fannie Mae and Freddie Mac. A more careful reading of the evidence shows clearly that Wall Street coupled with aggressive mortgage brokers were the principal cause of the crisis, not Fannie and Freddie. They made hundreds of billions of dollars of bad loans to home buyers, upon which Wall Street firms sold trillions of dollars of securities that were more risky than even sophisticated buyers realized or than ratings agencies warned of. In the first half of the 2000s, when all the damage was done, a far higher proportion of Wall Street financed debt went bad than did Fannie and Freddie’s. It’s government laxity about regulations that was to blame, not direct encouragement for housing for low-income Americans.
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# Raising American Wages...by Raising American Wages

Ron Unz, *Publisher, The American Conservative*

With Americans still trapped in the fifth year of our Great Recession, and median personal income having been essentially stagnant for forty years, perhaps we should finally admit that decades of economic policies have largely failed.

The last two years of our supposed recovery have seen American growth rates averaging well under 2 percent.<sup>1</sup> Although our media often pays greater attention to the recent gains in stock market and asset prices, such paltry growth means that many of the millions of jobs lost in 2008 and 2009 will never be regained, and the broadest measures of American unemployment and underemployment will remain stuck in the vicinity of 15%.<sup>2</sup> Meanwhile, an astonishing 93% of the total increase in income during the recovery period has been captured by the top one percent of earners, who now hold almost as much net wealth as the bottom 95 percent of our society.<sup>3</sup> This polarized situation does not bode well for our future, and unless broader social trends in jobs and incomes soon improve, dark days surely lie ahead.

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If we seek to create jobs and raise incomes for ordinary Americans, we should consider what sorts of jobs and incomes these might be. Since economists and policy analysts tend to have advanced degrees and many leading journalists these days are Ivy League alumni, their employment perceptions may often diverge from reality. So let us review the official government data from the Bureau of Labor Statistics (BLS), as discussed by Prof. Jack Metzgar of Chicago's Center for Working-Class Studies and brought to my attention in an excellent column by the late Alexander Cockburn.<sup>4</sup> Metzgar writes:

The BLS's three largest occupational categories by themselves accounted for more than one-third of the workforce in 2010 (49 million jobs), and they will make an outsized contribution to the new jobs projected for 2020. They are:

- \* Office and administrative support occupations (median wage of \$30,710)
- \* Sales and related occupations (\$24,370)
- \* Food preparation and serving occupations (\$18,770)

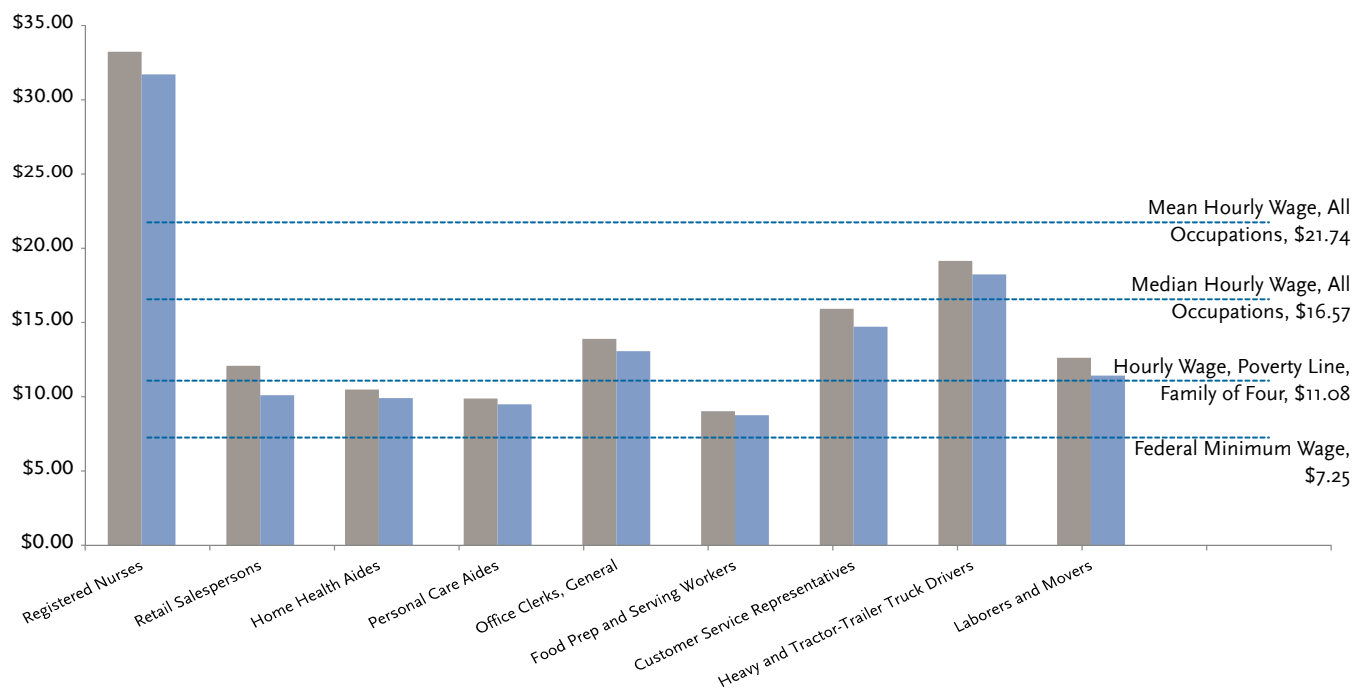
Other occupations projected to provide the largest number of new jobs in the next decade include child care workers (\$19,300), personal care aides (\$19,640), home health aides (\$20,560), janitors and cleaners (\$22,210), teacher assistants (\$23,220), non-construction laborers (\$23,460), security guards (\$23,920), and construction laborers (\$29,280).

Although our bipartisan elites regularly suggest higher education as the best elixir for what ails our economy and its workers, few of these job categories seem logical careers for individuals who have devoted four years of their life to the study of History, Psychology, or Business Education, often at considerable expense. Nor would we expect the increased production of such degrees, presumably at lower-tier or for-profit colleges, to have much positive impact on the wages or working conditions of janitors or security guards.

Consider that only 20% of current jobs require even a bachelors' degree.<sup>5</sup> More than 30% of Americans over the age of 25 have graduated college, so this implies that one-third or more of today's college graduates are over-educated for their current employment, perhaps conforming to the stereotype of the college psychology major working at Starbucks or McDonalds.

Furthermore, this employment situation will change only gradually over the next decade, according to BLS projections. Millions of jobs in our "knowledge economy" do currently require a post-graduate degree, and the numbers are growing rapidly; but even by 2020, these will constitute less than 5% of the total, while around 70% of all jobs will

Figure 1: Hourly Wages, Occupations with Largest Projected Employment Growth 2010-2020



Source: Employment Projections Program, U.S. Department of Labor, U.S. Bureau of Labor Statistics

still require merely a high school diploma.<sup>6</sup>

Education may be valuable for other reasons, but it does not seem to hold the answer to our jobs and incomes problem.

If additional education is a dead end, other partisan nostrums appear equally doubtful. Large cuts in government taxation or regulation are unlikely to benefit the average sales clerk or waitress. And the favored progressive proposal of a huge new government stimulus package has absolutely no chance of getting through Congress; but even if it did, few of the funds would flow to the low-paid private sector service workers catalogued above, and any broader social gains would rely upon a secondary boost in economic activity produced by putting extra government dollars into private pockets.

So how might we possibly raise the wages of American workers who fill this huge roster of underpaid and lesser-skilled positions, holding jobs which are almost entirely concentrated in the private service sector?

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Perhaps the most effective means of raising their wages is simply to raise their wages.

Consider the impact of a large increase in the federal minimum wage, perhaps to \$10 or more likely \$12 per hour.

The generally low-end jobs catalogued above are entirely in the non-tradable service sector; they could not be outsourced to even lower-paid foreigners in Bangalore or Manila. Perhaps there might be some incentive for further automation, but the nature of the jobs in question – focused on personal interactions requiring human skills – are exactly those least open to mechanical replacement. Just consider the difficulty and expense of automating the job of a home health care aide, child care worker, or bartender.

Perhaps the most effective means of raising wages is simply to raise wages.

With direct replacement via outsourcing or automation unlikely, employers responding to a higher minimum wage would be faced with the choice of either increasing

the wages of their lowest paid workers by perhaps a couple of dollars per hour, or eliminating their jobs. There would likely be some job loss,<sup>7</sup> but given the simultaneous rise in labor costs among all competitors and the localized market for these services, the logical business response would be to raise prices by a few percent to help cover increased costs while also trimming current profit margins. Perhaps consumers would pay 3 percent more for Wal-Mart goods or an extra dime for a McDonald's hamburger, but most of the jobs would still exist and the price changes would be small compared to typical fluctuations due to commodity and energy prices, international exchange rates, or Chinese production costs.

The resulting one-time inflationary spike would slightly raise living expenses for everyone in our society, but the immediate 20% or 30% boost in the take-home pay of many millions of America's lowest income workers would make it easy for them to absorb these small costs, while the impact upon the middle or upper classes would be totally negligible. An increase in the hourly minimum wage from the current federal level of \$7.25 to (say) \$12.00 might also have secondary, smaller ripple effects, boosting wages currently above that level as well.

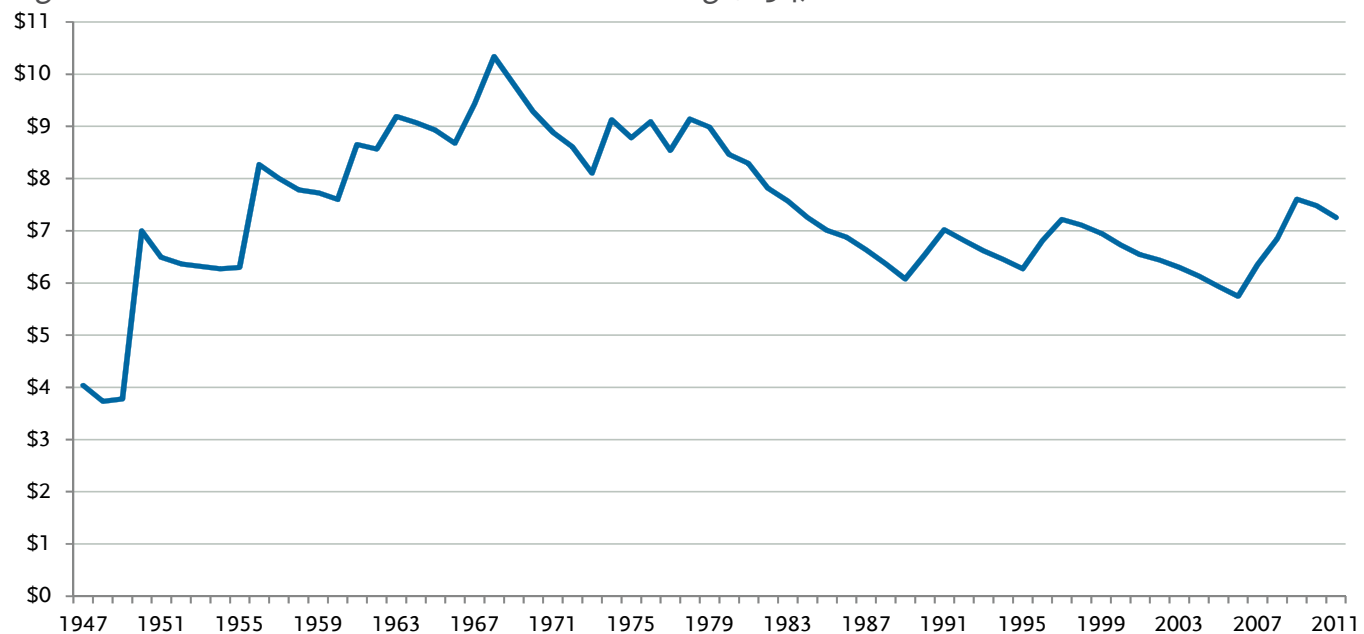
A minimum wage in this range is hardly absurd or extreme. In 2012 dollars, the American minimum wage

was over \$10 in 1968 during our peak of postwar prosperity and full employment.<sup>8</sup> The average minimum wage in Canadian provinces is currently well over \$10 per hour, the national figure for France is more than \$12, and Australia has the remarkable combination of a minimum wage of nearly \$16.50 together with 5 percent unemployment.<sup>9</sup>

Even a large increase in the minimum wage would have very little impact on America's international competitiveness since almost everyone employed in our surviving manufacturing export sector – whether in unionized Seattle or non-union South Carolina – already earns far above the current minimum wage. The same is also true for government workers, resulting in negligible increased cost to taxpayers.

Leaving aside the obvious gains in financial and personal well-being for the lower strata of America's working class, there would also be a large economic multiplier effect, boosting general business activity in our weak economy. America's working poor tend to spend almost every dollar they earn, often even sinking into temporary debt on a monthly basis.<sup>10</sup> Raising the annual income of each such wage-earner couple by eight or ten thousand dollars would immediately send those same dollars flowing into the regular consumer economy, boosting sales and general economic activity. In effect, the proposal represents an enor-

Figure 2: United States Real Federal Minimum Wage, 1947-2011



Minimum wage calculated using CPI - U in 2011 dollars.

mous government stimulus package, but one targeting the working-poor and funded entirely by the private sector.

Ironically, it is likely that major elements of the private sector would be perfectly happy with this arrangement. For example, despite their low-wage and anti-worker reputation, Wal-Mart's top executives lobbied Congress in 2005 for an increase in the minimum wage, concerned that their working-class customer base was growing too impoverished to shop at their stores.<sup>11</sup> Wal-Mart might never be willing to raise its wages in isolation, but if a higher minimum wage forces all competitors to do the same, then prices can also be raised to help make up the difference, while the large rise in disposable consumer income would greatly increase sales.

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Although the direct financial benefits to working-class Americans and our economy as a whole are the primary justifications for the proposal, there are a number of subsidiary benefits as well, ranging across both economic and non-economic areas.

First, the net dollar transfers through the labor market in this proposal would generally be from higher to lower income strata, and lower-income individuals tend to pay a much larger fraction of their income in payroll and sales taxes. Thus, a large boost in working-class wages would obviously have a very positive impact on the financial health of Social Security, Medicare and other government programs funded directly from the paycheck. Meanwhile, increased sales tax collections would improve the dismal fiscal picture for state and local governments, and the public school systems they finance.

Furthermore, as large portions of the working-poor became much less poor, the payout of the existing Federal Earned Income Tax Credit (EITC) would be sharply reduced. Although popular among politicians, the EITC is a classic example of economic special interests privatizing profits while socializing costs: employers receive the full benefits of their low-wage workforce while a substantial fraction of the wage expense is pushed onto the taxpayers. Private companies should fund their own payrolls rather than rely upon substantial government subsidies, which produce major distortions in market signals.

Even on the highly contentious and seemingly unrelated issue of immigration, a large rise in the minimum wage might have a strongly positive impact. During the last decade or two, American immigration has been running at historically high levels, with the overwhelming majority of these immigrants being drawn here by hopes of employment.<sup>12</sup> This vast influx of eager workers has naturally strengthened the position of Capital at the expense of Labor, and much of the stagnation or decline in working-class wages has probably been a result, since this sector has been in greatest direct competition with lower-skilled immigrants.<sup>13</sup>

Not only would a large rise in the minimum wage reverse many years of this economic "race to the bottom," but it would impact immigration itself, even without changes in government enforcement policy. One of the few sectors likely to be devastated by a much higher minimum wage would be the sweatshops and other very low wage or marginal businesses which tend to disproportionately employ new immigrants, especially illegal ones. Sweatshops and similar industries have no legitimate place in a developed economy, and their elimination would reduce the sort of lowest-rung job openings continually drawing impoverished new immigrants. Meanwhile, those immigrants who have already been here some time, learned English, and established a solid employment record would be kept on at higher wages, reaping the same major benefits as non-immigrant Americans within the ranks of the working-poor.

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Finally, one of the more unexpected benefits of a large rise in the minimum wage would follow from a total reversal of bipartisan conventional wisdom. Whereas our elites regularly tell us that an increase in higher education might have the benefit of raising American wages, I would instead argue that a sharp rise in ordinary wages would have the benefit of *reducing* higher education, whose growth increasingly resembles that of an unsustainable bubble.

Between 2000 and 2010, enrollment in postsecondary institutions increased 37 percent, compared to just 11 percent during the previous decade, with the recent increase being almost three times that of the growth of the underlying population of 18- to 24-year-olds. Indeed, relative enrollment growth for older students – 25 and above – was

far greater than for students in the younger, more traditional ages. Furthermore, “Business” has overwhelmingly become the most popular undergraduate major, attracting nearly as many students as the combined total of the next three categories – Social Sciences and History, Health Sciences, and Education.<sup>14</sup>

If rapidly growing numbers of individuals, especially those many years past their high school graduation, are now attending college and majoring in Business, they are probably not doing so purely out of love of learning and a desire for broadening their intellectual horizons. Instead, they have presumably accepted the pronouncements of authority figures that higher education will benefit them economically. Put in harsher terms, they may believe that a college degree is their best hope of avoiding a life of permanent poverty trapped in the ranks of the working-poor.

Although there is a clear mismatch between the requirements of America’s projected jobs and the benefits of a college education, this notion of “college or poverty” may not be entirely mistaken. A recent college graduate is almost 20 percentage points more likely to have a job than a per-

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**A sharp rise in ordinary wages would also have the benefit of *reducing* higher education, whose growth increasingly resembles that of an unsustainable bubble.**

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son of the same age with only a high school degree.<sup>15</sup> As a competitive signaling device, a 4-year degree may help someone land an office job as an administrative assistant rather than one as a fast-food server. But this is costly to the individual and to society.

Even leaving aside the absurdity of young people spending years of their lives studying business theory or psychology to obtain jobs which traditionally went to high school graduates, the financial cost is enormous. A generation or more ago, expenses at solid state institutions and similar colleges were fairly low, and could mostly be financed by small grants, parental savings, and part-time student jobs. But educational costs have increased 133% above inflation over the last thirty years,<sup>16</sup> and the government-subsidized college-loan industry has grown in parallel. Last year, the

total volume of outstanding student-loan debt passed the trillion dollar mark, now exceeding either credit-card or auto loan debt.<sup>17</sup>

Two-thirds of recent college graduates borrowed to finance their education, and their average debt is over \$23,000, while the load for those who pursue graduate or professional degrees can easily exceed the hundred thousand dollar mark.<sup>18</sup> These debts are exempt from bankruptcy discharge, and unless graduates quickly find high-paying jobs – not easy in an economy with very high youthful unemployment – the required payments may remain larger than the combined total of their federal, state, and local taxes. This privatized “education tax” may become a permanent, terrible burden, pushing any plans for marriage, family, and home purchase into the distant future. Barely half of 18- to 24-year-olds are currently employed, the lowest level in over sixty years,<sup>19</sup> so we should not be surprised that a quarter of all student-loan payers are currently delinquent.<sup>20</sup> Without the possibility of bankruptcy to clear their load, permanent debt-peonage for a substantial fraction of the next generation seems a very real possibility.

The aggressive marketing tactics of for-profit colleges and the student loan industry have disturbing parallels with the sub-prime lenders who played a destructive role in the Housing Bubble. Our national elites gave strong public support to the goal of universal home-ownership. Families were warned that if they did not stretch their income and their credit to buy a house at the inflated prices being offered, they would be permanently priced out of the market and condemned to second-class economic citizenship. Today, very similar warnings are made about the failure to invest in a college education, and this is backed by the aggressive advertising and sales tactics of the lucrative and well-connected for-profit sectors of the Higher Education-Industrial Complex, such as University of Phoenix and Kaplan Schools.

The lax lending standards and regulatory policies supporting greater homeownership were a major factor in our catastrophic financial collapse, in which the average family has now lost 40% of its net worth and many millions of Americans are on the edge of foreclosure, bankruptcy, and destitution.<sup>21</sup> Nearly everyone lost, while a tiny handful of individuals and companies made vast, unearned fortunes from facilitating the growth of the bubble or later betting upon its collapse. A similar outcome in higher education

seems quite likely.

Now consider the impact of a sharp rise in the minimum wage, sufficient to remove the taint of poverty overhanging so many of our lower-tier jobs. Those academically-oriented students who plan to pursue challenging college majors in engineering, computer software, or other STEM fields would be completely unaffected by a rise in pay for home health aides, nor would there be any impact on the college plans of those seeking to broaden their horizons with serious academic study in literature, history, or philosophy.

But for those millions who regard postsecondary education as merely a way of punching their ticket with a “business” degree and thereby gaining a shot at a middle class income, the calculus would be different: four years of academic work, four years of foregone income, and many tens of thousands of dollars in tuition and fees would be weighed against earning a reasonable living straight out of high school or with a form of shorter vocational training like an apprenticeship. Certainly in the past, when well-paid factory jobs were plentiful, a large fraction of students made the latter choice, and seldom regretted it.

Meanwhile, if college enrollments were reduced to those

who actually wanted or needed a college education, supply and demand would begin deflating our Higher Education Bubble, forcing a sharp drop in ever-escalating educational costs. Since government loans and subsidies would be targeted at a much smaller pool of students, they could be made more generous, reducing the debt burden on those who do still seek a degree.

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Public policy experts sometimes glorify complexity, proposing intricate, interlocking systems aimed at a desired result. But such structures are only as strong as their weakest link, and a proposal too complex to fully understand is also too complex to fix. Our government has sought to ensure a decent living for American workers through an enormous array of income subsidies, public benefits, training programs, and educational loans; at this point, many of these components have accumulated powerful and parasitic side-beneficiaries while leaving the working class behind.

Since this vast and leaky conglomeration has failed at its intended goal, perhaps we should just try raising wages instead.

## Notes

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7. Research has not provided a conclusive answer to the question of job loss. While economic theory predicts that some job loss would occur with higher minimum wages, the widely cited research of economists David Card and Alan B. Krueger showed “no evidence for a large negative employment effect of higher minimum wages.”
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15. Adam Looney and Michael Greenstone, “[Regardless of the Cost, College Still Matters](#),” The Hamilton Project (October 2012).
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A selection of relevant research can be found [here](#).

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# Economic Recovery and Social Investment

## A Strategy to Create Good Jobs in the Service Sector

Robert Kuttner, Co-Editor, *The American Prospect*; Senior Fellow, Demos

### Introduction

Today's prolonged economic slump is fundamentally different from an ordinary recession. In the aftermath of a severe financial collapse, an economy is at risk of succumbing to a prolonged deflationary undertow. With asset prices reduced, the financial system damaged, unemployment high, consumer demand depressed, and businesses reluctant to invest, the economy gets stuck well below its full employment potential.

In these circumstances, fiscal contraction and tight monetary policy would only make things worse. But even very low interest rates, of the sort being implemented by the Federal Reserve's policy of "quantitative easing," are insufficient to cure the deflationary condition. What's needed is aggressive fiscal policy – and not the kind of fiscal policy promoted by the austerity lobby to "restore confidence" and allay supposed fears of inflation. With creditors willing to lend the government money for 30 years at well under 3 percent interest, there is obviously little fear of inflation driven by deficits. The problem isn't low confidence in deficit-reduction. Banks are now sitting on about \$1.8 trillion in cash or government securities – because they can't imagine where to profitably invest it. Businesses are delaying investment in expansion not because they are fretting about deficit projections for 2023. They are waiting to see customers with money to spend, and general austerity will only reduce that spending power.

But where should this fiscal policy be directed? One, obviously, is investment in a green economy and modern public infrastructure. The other – too little appreciated – is increased outlay in human services, of the sort that can create good, non-exportable jobs and improve the life prospects of the next generation, as well as provide stable, counter-cyclical sources of employment and demand. Government also has the power to structure other service-sector work as decent jobs.

Public investment, including public investment in the service sector, can help the economy climb out of the current deflationary trap – and establish a foundation for a stronger middle class in the future.

### Lessons from the Greatest Generation

Rather than budget austerity, we need very significant public spending to compensate for the shortfall of demand elsewhere in the economy. World War II finally cured the Great Depression with public spending using deficits that exceeded 30 percent of GDP at the height of the war – more than triple the recent peak in 2009. About one-fourth of the increased spending was financed by higher, steeply progressive taxes; the rest was financed by borrowing.

But neither high taxes nor high deficits deterred growth-enhancing investment – quite the contrary: *they underwrote it*. Businesses thrived thanks to the increase in public contracts. The public spending recapitalized American industry, re-employed a generation of workers idled by depression, and invested massively in science and technology that would have civilian and commercial applications after the war. Despite the fact that half of what was produced was blown up, the real economy grew at nearly 15 percent

per year during the war; and despite the emphasis on war production, with the return to full employment civilian living standards dramatically improved.

At war's end, no serious person worried about the debt level 10 years hence in 1955. There was no Bowles-Simpson targeting deficit reduction. Rather, the worry was that 12 million returning GIs would not find jobs and the economy would sink back into depression. So the government doubled down on public investment, with policies like the GI Bill and the Marshall Plan, and a consumer boom took over where the wartime spending boom left off. The debt took care of itself thanks to high growth rates. Within three decades, the debt ratio had dwindled from a 1946 peak of 122 percent of GDP to just 33 percent by the late 1970s.<sup>1</sup>

We don't want another war to play this stimulus role. But there are plenty of worthwhile peaceful candidates for the same, positive fiscal impact of public investment.

### Recession or Hidden Depression?

Though the damage is not as severe, the dynamics of the current economy resemble those of the Great Depression. One common characteristic is a "debt deflation," a phenomenon first identified by Professor Irving Fisher in a classic article in 1933.<sup>2</sup>

In a debt deflation, the value of debts is constant but the value of assets and wages is declining. So the real burden of debts increases relative to purchasing power and saps demand. With debt deflation, falling prices also lead people to put off purchases because the product will likely be cheaper tomorrow. Businesses hesitate to buy raw materials because the retail price may be lower than wholesale ones. Economic activity simply stalls.

Consumers and businesses overwhelmed by debts face an invidious choice. They can tighten their belts and reduce other purchases in order to keep current on the debt payments. Or they can default on the debt, losing their equity and causing a fire sale of assets into a down market, reducing prices still further. Either way, their actions constrain demand and worsen the economy's general deflation.

In the financial collapse of 2008, the most direct debt deflation was confined to housing, commercial real estate, and

securities backed by mortgages. Since the peak in housing values in 2006, average home equity per homeowner has declined from \$200,000 to \$78,000 in inflation-adjusted dollars, the lowest level since 1968.<sup>3</sup>

Thanks to the unprecedented intervention by the Federal Reserve, which bought trillions of dollars of securities, we narrowly avoided a general price deflation. But the wider damage was still massive. Though housing prices appear to have bottomed out in a majority of local markets as of late 2012, they are still about 30 percent below their 2006 peak, leaving tens of millions of homeowners underwater on their mortgages and at risk of default or foreclosure. Even if these vulnerable Americans manage to avoid eviction, they have lost their most significant financial asset, the equity in their homes; that loss in turn depresses their propensity to spend. Nor can most underwater homeowners, with negative equity, qualify for today's record low-interest-rate mortgages, so the Fed's cheap money policy is of no benefit to them.

Along with debt deflation, the related condition similar to the Great Depression is a "liquidity trap." This simply means that economically damaged consumers and businesses are more reluctant than usual to spend and to invest, because they fear that worse is yet to come. They hang on to cash, or stay "liquid." This reverses the consumer behavior of the past 30 years, when American households did the opposite – borrowed to maintain living standards.

On the eve of the 2008 crash, median worker earnings had been barely keeping up with inflation for three decades, as nearly all of the economy's productivity gains went to the top one percent. With interest rates steadily declining since the early 1980s, assets – especially housing – tended to increase in value faster than inflation. So the strategy of the beleaguered American middle class was to use debt as a substitute for income. For the broad middle class (defined as the three middle quintiles of households), the ratio of debt to income increased from 67 percent in 1983 to 157 percent in 2007. Mortgage debt on owner-occupied homes increased from 29 percent to 47 percent of the value of the house. When housing values collapsed, debt ratios increased further.<sup>4</sup>

When the economy crashed and asset values fell, this strategy suddenly became inoperative, and consumer behavior reversed. Households began paying down debt. That may

be prudent and necessary as a long-term rebalancing strategy, but in the short run it deprives the economy of one more source of aggregate demand. And the recession only worsened the income shortfall. Today's median household income is back down to the level of 1995, according to the Census Bureau.<sup>5</sup>

Over the long term, consumer borrowing as a substitute for lagging wages is not sustainable. The cure, of course, is to assure that median wages rise with the economy's increasing productivity, as was the case for the quarter-century after World War II.

In the very useful phrase of the British political economist Colin Crouch, the bubble economy of the past three decades has been pumped up by "privatized Keynesianism." Private debts have soared relative to GDP – short term bank borrowing to finance speculation; mortgage debt; student debt; and consumer borrowing against assets. Public debt, which was declining prior to the George W. Bush years, has risen due to two wars and tax cuts and the reduced revenues of the recession – not because of deliberate stimulus spending, which will account for only about 14 percent of the projected increase in the 10-year post-crash public debt.<sup>6</sup>

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**Government debt has gotten far too much alarmist publicity, but in truth it is the one form of debt that should be increasing in a slump, not contracting along with the rest of the debt-deflation.**

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But the problem with "privatized Keynesianism" is that it is *pro-cyclical*. Unless it is well-regulated, private debt exaggerates bubbles, and then excessively contracts in downturns. Nothing illustrates this better than the housing sector. What's needed is genuine Keynesianism, a strategy whose essence is that it can be *counter-cyclical*. Government debt has gotten far too much alarmist publicity, but in truth it is the one form of debt that should be increasing in a slump, not contracting along with the rest of the debt-deflation.

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The history of the Great Depression demonstrates that it is possible for the economy to be growing, but still be stuck at an economic equilibrium well below full employment. Thanks to the policies of the New Deal, which got us halfway out of depression until the war did the rest, the economy grew at a rate of 11 percent in 1934, 9 percent in 1935, and 13 percent in 1936.<sup>7</sup> Yet the Great Depression persisted, with unemployment in excess of 12 percent and the economy clearly performing far below its potential, until World War II.

According to the National Bureau of Economic Research, which defines a recession as two consecutive quarters of negative GDP growth, the current recession began in December 2007 and ended in June 2009. But more than three years later, a deflationary depression continues. Using the NBER definition, *it is possible to be out of a recession and still be in a deflationary depression.*

The current economy displays the weakest post-recession recovery on record. Even after mild postwar recessions, the annual growth rate in the years immediately following was typically 5 or 6 percent as the economy gained back the recession's losses and more. Growth for 2010, when the economy was benefiting from a relatively small stimulus package, was a modest 3 percent, and then slowed to an anemic 1.7 percent in 2011. With the 2009 stimulus program of the Recovery Act used up, the growth rate for 2012 is projected by the Federal Reserve to be about 2.0 percent. This performance is not sufficient to reduce unemployment or to escape the deflationary trap. Given all of these deflationary trends, there is simply no substitute for government purchasing power to compensate for the other shortfalls of demand.

## **The Case for Investing in People**

The economic collapse triggered by the financial crisis that exploded in September 2008 represented the collision of three trends. One was the license given to speculative finance resulting from increasingly reckless deregulation. That permissiveness allowed bankers to create pyramids of highly leveraged and deceptive securities that collapsed like a house of cards when underlying assets such as sub-

prime mortgages proved nearly worthless.

The second trend was the worsening income distribution. The average per capita productivity of the economy has doubled in a generation. But nearly all of that gain has gone to the very wealthy, who find it impossible to spend all they take in. So the economy as a whole had a shortfall of purchasing power; this was temporarily offset by ever increasing, but unsustainable, levels of household debt.

Third, since the early 1980s, the economy has been losing good, middle class jobs, especially in manufacturing. I first identified this trend in an article I wrote for *The Atlantic* in 1983, “The Declining Middle,” and the patterns have only intensified since then. Middle class jobs are disappearing for several reasons, including the weakening of unions and government supports such as good unemployment insurance, the competition from low-wage countries, and the shift from manufacturing to services. The post-2008 crisis has weakened worker bargaining power even further.

We do need heroic policies to revive and expand U.S. manufacturing. A strong manufacturing sector is necessary for several reasons, including the importance of staying at the cutting edge of advanced technology, restoring a sustainable balance of payments, and capacity in advanced products needed for national defense. Manufacturing jobs are increasingly “knowledge jobs,” and goods production is part of a knowledge chain that runs from materials science to computerized design that we can’t afford to lose. But as manufacturing processes become more highly automated they will inevitably represent a dwindling percentage of overall jobs.

So where will the sources of increased demand and good, middle class jobs come from? One obvious candidate is the creation of good, professional service jobs improving the quality of education and care for the young, the old, and the sick.

### Concealed Choices

The economy is irrevocably shifting from manufacturing to services. But what kind of service jobs will we get? The American work force has gone from 28 percent factory workers and 72 percent service workers in 1978 to 14 percent factory workers and 86 percent service workers today.<sup>8</sup>

But the service sector encompasses tens of millions of “bad” jobs that are unstable and offer low pay with few benefits – in routine clerical work, retail sales, fast food, low-end human services – alongside a relatively small number of well-compensated professional positions, including doctors, lawyers, and scientists, as well as astronomically rich investors in the financial sector.

As the *New York Times* recently reported, in the service sector, especially retailing, corporations find it expedient to keep millions of people who want full-time jobs in part-time work. This allows management to vary the labor force day by day, and even quarter-hour by quarter-hour, in response to projected customer traffic. Other occupations that don’t face daily demand fluctuations, such as warehouse workers, have been converted from permanent full time positions to contingent jobs. These changes have not occurred because schedules require them, but rather to enable management to cut costs by disguising permanent workers as temps or contract employees. This denies workers fringe benefits, social insurance, and makes them all but impossible to unionize because they are not part of potential bargaining units.

While these management decisions are often explained as cost-effective responses to the new economy, they are actually efforts to shift costs and risks of fluctuating business conditions from owners and managers onto workers. In many cases, such as warehouse work and trucking, they represent deliberate misclassification of permanent workers as temps or contract employees. This is illegal under the Fair Labor Standards Act, but the act has been weakly enforced.

In unionized service-sector work such as in the hotel industry, on the other hand, contracts regularize the employment relationship so that all of the risks of customer fluctuations are not on the employee. Unionized hotel workers, for example, may be subject to seasonal layoffs (which are covered by unemployment compensation), but for most of the year they are guaranteed a standard workweek and the benefits of stable employment.

We are shifting irrevocably to a service economy. But there are political choices to be made (or evaded). One path leads to an economy of minimum-wage fast food workers and security guards, many of them with temporary or part time jobs, on one extreme – and billionaire hedge fund manag-

ers and takeover artists, on the other. The other leads to a commercial sector of decent wages and terms of work and a human service sector of middle class professionals that serve social needs – which in turn make for a more productive economy and decent society.

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## We can use taxation, public borrowing, and social investment to create more high-quality careers in the human services.

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Though the path forward is often depicted as an economic inevitability, in fact it is a political choice – but one that is obscured and not sufficiently debated. We can allow an increasingly laissez-faire economy to take a low road of underpaid and under-professionalized service jobs. Or we can use taxation, public borrowing, and social investment to create more high-quality careers in the human services, which in turn will stimulate an economic recovery and produce a society of more balanced life chances.

The Nobel Laureate Wassily Leontief once offered a parable of a manufacturing economy so productive that there was only one human worker and her job was to flip the switch. In such a society, the operative economic questions became distributive: how would we allocate the wealth produced by machines? And what would everyone else do for a living? There is no single economically “efficient” answer. Many possible distributive outcomes are broadly consistent with a highly productive economy.

One answer is that the financial market that financed the technology owns that wealth. Another is that it goes to the single production worker. Neither is a very good, fair, or efficient outcome. The increasing wealth needs to be broadly allocated – “spread around” as President Obama famously told Joe the Plumber – and utilized to create good, middle-class professions.

In 1959, the president of the West Coast longshoremen’s union, Harry Bridges, reluctantly concluded a deal with the shipping industry. He agreed to allow automated containers to replace the jobs of many of his dockworkers. Union members with “A” cards would retain guaranteed jobs. A much larger force of “B” members would become casual

labor. Wages of permanent workers would rise with productivity, nearly all of which was increased capital-productivity. Upon signing the deal, Bridges quipped, “At this rate, by 2000 there will be one longshoreman left on the docks. But he will be the best paid son of a bitch in the United States.” It was a good deal for Bridges’ dwindling membership, but not such a good deal for workers generally.

When I wrote on the “declining middle” in 1983, the Bureau of Labor Statistics had just projected that nine of the ten fastest growing jobs in the 1980s would be low-skill, low-wage service jobs like fast-food workers, security guards, back-office clerks, home health aides, and janitors. And this is exactly what occurred. A deregulated economy’s propensity to generate low-quality service jobs has only intensified. Currently, only two of the ten jobs with the largest projected growth through 2020 have an average salary higher than the economy’s overall average, while five of them (salespeople, health aides, personal care aides, office clerks, and laborers) have average salaries about or below the poverty line for a family of four.<sup>9</sup>

Widening income inequality has exacerbated this tendency. The very wealthy require large retinues of servants, directly and indirectly. Their lopsided purchasing power spawns entire industries of *recherché* fashions, exotic entertainments and McMansion communities. Some of the jobs serving the elite are even relatively well-paid jobs, because the most affluent among us do not want to be served by just anybody. A private chef for a billionaire earns more than a schoolteacher. But this strategy of job-creation in the services does not add up to an attractive or well-balanced society.

Meanwhile, there are tens of millions of Americans who cannot afford to purchase even basic services. And those who do serve them are typically underpaid and under-qualified. Two large and emblematic sectors are health care and early-childhood education.

## Good Human Services as Social Investment and Economic Stimulus

Millions of jobs serving the very young, the very old and the very sick are low-wage jobs. This is a social decision, not the product of private supply and demand, because the

qualifications and earnings for these occupations are set socially. A person caring for three-year-olds, for instance, can be a glorified baby sitter with minimum certification as a day care worker – or a well trained professional in child development. The job can pay minimum wage, or it can be a middle-class occupation and career. This social choice governs not just the quality of the job, but the quality of the early education given – especially to young children who begin life with fewer inherited advantages than the children of the professional class and the business elite.

Whether we have good-quality early childhood education and daycare also influences the capacity of mothers and fathers to be better parents. The rightwing story that poses a choice between family responsibility and social child care has it backwards. In a society that has reliable day care, parents perform less of a juggling act between work and home, and can be more effective in their parental role.

A nursing home worker, likewise, can be a nurse-aide making \$8 an hour, or a licensed practical nurse or trained recreation aide earning almost twice that, closer to \$30,000 a year. Well-qualified and trained nursing home personnel produce not just better career opportunities and economic stimulus, but better quality of life for the elderly. Having competent staff is more efficient in the long run because there is less turnover, less need for outlays on recruitment, better morale, and fewer incidents of neglect that require far more expensive medical treatment.

I've done a rough, order-of-magnitude calculation and found that for an annual expenditure of about \$100-\$150 billion (or under one percent of GDP), we could set a national policy goal of guaranteeing that all human service jobs are professional jobs that pay at least \$25,000 a year (which is itself a lower minimum bar than others have suggested).<sup>10</sup> This requires professionalizing some occupations, as well as universalizing the availability of some categories of woefully underfunded services such as early education. As long as the current deflationary economy persists, this funding could come from additional government borrowing. As the economy recovers thanks to the additional stimulus, the normal increase in revenues could pay for part of the cost, supplemented by increased progressive taxation.

One of the great problems of the manufacturing economy, and of some services such as software engineering,

accounting, call center work, and repair of jet engines, is that globalization allows these jobs to be done offshore by lower-paid workers. Human service jobs, by contrast, must be performed at home. If we have a national policy of guaranteeing that they are good jobs, there is no risk that they move overseas. We get the quadruple benefit of macro-economic stimulus, better jobs, better quality services, and (in the case of the young) improved lifetime opportunity and productivity.

## Early Childhood Education

Extensive research has demonstrated that literally the most productive investment society can make is in high quality early-childhood education. The children of the poor are disadvantaged from the moment of conception, by the realities of poor nutrition, environmental hazards like lead poisoning, and the chaotic and high-stress environments in which their parents live. As infants and toddlers, they are less likely to get the diets or the verbal interactions characteristic of the middle and upper class, and enter school with far smaller vocabularies and more vulnerabilities to health problems.

Very early interventions can alter these trajectories for the better and improve the capacity of the next generation to be productive adults. Professor James Heckman of the University of Chicago has demonstrated that a dollar invested in the early education of children under age three returns eight or nine dollars to the economy.<sup>11</sup> High quality Pre-K education is increasingly universal for the children of the professional and business class, yet is almost non-existent for the children of the lower middle class and the poor, except for a small minority lucky enough to be admitted to the grossly under-funded federal Early Head Start program.

State-subsidized pre-kindergarten funding increased from \$2.9 billion in 2005 to \$4.8 billion in 2008, and the American Recovery and Reinvestment Act of 2009 allocated nearly \$100 billion to education aid as a whole. But that funding has now expired, and most states have since cut back Pre-K funding. Even including ARRA money, state funding for Pre-K has declined in each of the last two years.<sup>12</sup> The big policy mistake was to presume that stimulus spending should be “targeted and temporary.”

This is exactly the opposite of what should be occurring, both as counter-cyclical fiscal policy and as child-development policy. A protracted economic slump is a moment for public outlays to replace shortfalls in private demand and to fill in gaps in public systems, just as we introduced Social Security at the pit of the Great Depression. But the current deflationary depression, uniquely in all the recessions the past 80 years, has been a period of reductions in social spending.

By the same token, day care and all-day school programs that are more than custodial can help compensate for educational disparities. But high-quality early childhood education cannot be delivered by a workforce of high-turnover, untrained, minimum wage workers. In France, where there is a national policy of universal, child-development-oriented early education, pre-kindergarten teachers are required to be more highly trained than public school teachers. They must get additional course credits in public health and early child development, and they are compensated accordingly.

Universal, high quality early childhood education and day-care is an obvious candidate both for stimulus spending and for permanent social outlay once the immediate crisis is behind us. This policy shift, costing around \$50 billion a year, could also create upwards of two million permanent, professional jobs and careers that will never threaten to move to China.

## Nursing Care and Home Care

According to the Bureau of Labor Statistics, two of the fastest growing job categories are home care workers and nurse-aides (also known as Certified Nursing Assistants, or CNAs). These occupations suffer from shortages because the pay is low and the working conditions often frustrating. Nurse-aides typically make slightly above minimum wage, whereas Licensed Practical Nurses (usually a one-year certificate program) earn about \$20 an hour, which annualizes to \$42,000 a year. Registered Nurses, graduates of a two-year or four-year college degree program are still more highly trained, with median earnings in excess of \$60,000.

There is extensive evidence that having home care or nursing-home care performed by staff with the lowest mini-

mally acceptable skill levels is a false economy. The money that is saved on lower wages is lost in medical incidents such as increased bedsores on the part of nursing home residents or failure to diagnose medical conditions early, both resulting in the need for far more expensive hospital stays. It also condemns these service workers to jobs that do not pay well.

In the case of registered nurses, there is a nationwide shortage, projected to be 260,000 RNs by 2025.<sup>13</sup> This shortfall will only increase as insurance coverage under the Affordable Care Act becomes more widespread. The shortage is the result of several trends, including a retiring generation of older RNs and worsening work conditions. As managed care has limited hospital stays, the typical hospital inpatient is now “sicker and quicker,” meaning that nurses are juggling more patients and have less time to familiarize themselves with each case. This change has also accelerated retirements. The same managed care pressures to limit physician time with patients have led to an increased demand for nurses.

Instead of viewing the RN shortage as an opportunity to create more middle class jobs by investing in the education and training of nurses, the United States has outsourced its nurse training to Nigeria and the Philippines, and imports tens of thousands of nurses from these and other foreign countries every year. These are good jobs that could be filled by Americans. Part of the problem is the bottleneck in nurse training programs: pay at community colleges for masters or PhD level instructors is lower than the pay for hospital nurses, so training programs are understaffed and cannot serve all the qualified students who apply for admission. A relatively small amount of public money could solve the nursing shortage and create well-paid professional jobs, while easing the strain on nursing staffs.

Home-care workers are typically funded by Medicaid, whose budget has been severely strained in the recession. Cost-cutting state administrations seek to keep these wage costs as low as possible, typically classifying home care workers as independent contractors with no job security or benefits. Work that could and should be done by LPNs or RNs is often performed by home care workers with little training. This creates a vicious circle of burnout, high turnover, and poor results, even though the vast majority of these workers are conscientious and eager to perform well.

One strategy for upgrading these jobs has been used by trade unions. Recently, in several states, led by California, the SEIU and the American Federation of State County and Municipal Employees (AFSCME) have succeeded in persuading legislatures and governors to approve laws or executive orders establishing public agencies with which home-care workers could bargain collectively, as well as providing additional public funds. In Alameda County in California, the typical wage went from \$4.25 to \$10 an hour. But with state budgets in free-fall, this kind of progress has come to a halt and only a national, federally-funded strategy for upgrading home-care work and pay can fill the gap.

## Education Myths and Realities

A standard litany blames America's anemic economic performance on poorly trained workers who in turn reflect "failing schools." This story is a triple play for conservatives hostile to the public sector. It deflects attention from the true sources of our economic slump; scapegoats a key public institution, its employees and unions; and diverts focus from the underlying problems of poverty.

The evidence is now in that charter schools and voucher schools actually under-perform demographically comparable public schools.<sup>14</sup> What's needed is not more business-like competition but more investment in public education – money that was promised but never delivered under the original No Child Left Behind bargain of 2001 between President George W. Bush and Senator Edward Kennedy. Schools need public funds for longer school days, smaller classes, peer evaluation and mentoring of teachers (as opposed to incentive compensation schemes based on high-stakes tests), as well as high-quality after school and pre-school strategies. Social supports for parents of at-risk children are part of this mix. Teach-to-the-test and rigid formulas of teacher evaluation are not.

The same public school systems, collective bargaining protections, and supposedly incompetent teachers that "fail" in high-poverty areas do just beautifully with middle class kids. As critic Diane Ravitch has documented, American schools with lower than 25 percent poverty rates have test outcomes equal to the best educational systems in the world, such as Finland and Taiwan.<sup>15</sup> Schools are being asked to compensate for all of society's other failings that

produce concentrated poverty. Social investments to complement what schools do can both improve educational outcomes and produce more professional human service jobs.

## Career Ladders and Labor Market Policies

It is not realistic to expect a minimum-wage, poorly trained human service worker to become a skilled professional overnight. To make our broad strategy work, we need an overarching plan for career ladders and public subsidies to help aspiring workers ascend them.

In some occupations, these ladders exist in theory. One can invoke heartening, individual stories of the nurse's aide who graduated to licensed practical nurse, or the classroom aide who went to night school and earned a teaching credential. But the truth is that these are one-offs. Despite a few model programs, our society seems determined to make this path as arduous as possible. Almost by definition, someone working for near minimum wage, often with family responsibilities, has an extreme shortage of time as well as money. Though some rare individuals

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**We need an overarching plan for career ladders and public subsidies to help aspiring workers ascend them.**

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do succeed, it takes uncommon tenacity and self-sacrifice, and sometimes the sacrifice of one's own children.<sup>16</sup> Why should we make this so hard? It is in the best interests of both the individual and society to improve a worker's skills. Other societies have figured this out, and provide subsidies for living expenses during training.

By the same token, the completion rates for two-year Associate's degrees at community colleges are dismal. Less than one third of people who begin programs get a degree within seven years. This poor track record does not reflect slacking off. Most such students are juggling work and family, and earning a living crowds out time to complete a degree. A very good social investment would

be financial aid not just for tuition but to support living costs while community college students complete degrees. Denmark, the nation with the most advanced and effective active labor market policies, makes good use of such supports. Supporting retraining efforts does not crowd out individual responsibility, but rather makes it possible.

These efforts would not only provide needed economic stimulus. They would be part of two broader labor-policy shifts that America sorely needs. First, we need to reverse the trend toward casualization of labor that has been occurring for three decades. One of the great advances of the 20th century was regularization of the employment relationship. Through successful social struggle, growth of unions, and enactment of legislation, most jobs came to provide decent wages and fringe benefits. Workers could not be fired without cause. Loyalty to the firm was reciprocated. Grievance systems were created and respected. Economists termed these jobs primary labor-market jobs. Casual, secondary labor-market jobs, which paid less and offered no such guarantees, continued to exist, but they were the exception. In recent years, however, the shift to casual jobs has become the norm, and in low-paid human-service work, casual, high-turnover jobs are the industry standard.

Second, the upgrading of human-service work would reverse another insidious trend – the employer’s habit of trying to increase the efficiency of labor by fragmenting jobs into separate tasks and paying the lowest possible wage for each task – a strategy known as Taylorism, after the early 20th-century “efficiency expert,” Fredrick Winslow Taylor, who first recommended it.

However, when it comes to human services, many of the supposed economic gains of Taylorism are illusory. Whereas registered nurses once performed multiple tasks and became very familiar with each patient, many hospitals have created a plethora of lower-wage occupations – phlebotomists to draw blood, technicians to perform tests,

nurse’s aides to take blood pressures – leaving the RN to cover more patients and do a far narrower range of tasks. The upgrading of human-service work would be part of an overdue process of reversing Taylorism. More workers would use a broader range of human skills to care for whole human beings, and higher wages would reflect the importance of their work.

More than 60 percent of all human service work is underwritten, directly or indirectly, by some level of government. Thus, public policy determines whether these jobs are professional occupations or casual labor and whether they are adequate to the social need. A national strategy of filling the holes in America’s social safety net could serve both as a counter-cyclical engine of recovery and as a permanent strategy for replacing dwindling manufacturing jobs with good, domestic, non-exportable human service jobs.

To be sure, there are other good candidates for stimulus spending, most notably modernization of infrastructure and conversion to a sustainable green-energy future. However, these are not mutually exclusive, and in the array of policy choices, expanding and upgrading human services has gotten far too little attention and should be a major part of a public investment-led recovery.

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The shift to upgrading work in the service sector, especially work in the human services, can be part of a deficit-financed macro-economic recovery strategy to address the nation’s current unemployment crisis and slow recovery. But this is not enough. It should also be part of a long-term effort to upgrade both the quality of work and of social services. The mistaken slogan of the February 2009 Recovery Act was “timely, targeted, and temporary.” That precluded any medium or long term planning. To adapt to the needs of an economy of the future, efforts to improve service sector employment need to be planned, pro-active, and permanent.

## Notes

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**THREE**

**Independence Through  
Interdependence: Lifelong  
Economic Security**

**Michael Lind, Steven Hill, Robert  
Hiltonsmith, and Joshua Freedman  
Greg Anrig  
Steven Attewell  
Lauren Damme**

# Expanded Social Security

## A Plan to Increase Retirement Security for All Americans

*Michael Lind, Policy Director, Economic Growth Program, New America Foundation*

*Steven Hill, Researcher and Author, Publisher, Steven-Hill.com*

*Robert Hiltonsmith, Policy Analyst, Demos*

*Joshua Freedman, Policy Analyst, Economic Growth Program, New America Foundation*

The conventional wisdom about Social Security is profoundly misguided. According to today's mistaken consensus, the U.S. as a society cannot afford to allocate the money to pay for the present level of Social Security benefits for retirees in future generations. The solution, it is widely argued, is to cut benefits – either directly by means-testing or indirectly by raising the retirement age or allowing inflation to erode their real value over time. In this narrative, tax-favored private savings vehicles like 401(k)s and IRAs should be expanded in order to compensate for the allegedly necessary cuts in Social Security.

This consensus is not only misconceived in its diagnosis but also mistaken in its prescriptions and potentially disastrous in its consequences. Retirement security is often thought of as three-legged “stool” consisting of Social Security, employer retirement plans, and private savings. Social Security has been far more stable and successful than the other two legs of the stool. The reliance on these other legs of the system has resulted in a retirement security crisis for most Americans, shifting costs and risks onto individuals, even as the benefits of these programs go overwhelmingly to upper-income earners. Yet the current debate is arbitrarily restricted to the chief public component of the American retirement system, Social Security.

In reforming America's retirement security system, we should build upon what works. Instead of compounding failure by expanding private benefits, a category that includes rapidly-disappearing defined benefit pensions, employer-provided 401(k)s and individual retirement accounts (IRAs), we should substantially expand the successful, purely public Social Security program.

In this policy paper, we offer one possible way to increase the overall public component of retirement security in the U.S. that we call Expanded Social Security. Just as Medicare already has different components called Medicare A, B, C, and D, the Expanded Social Security program that we propose would have two elements: Social Security A and Social Security B.

Under our proposal for Expanded Social Security, today's Old Age and Survivors Insurance (OASI), commonly known simply as “Social Security,” would be retained, possibly with modifications, as an earnings-based defined benefit program. This would be renamed Social Security A. The expected shortfall in funding for promised benefits that is predicted to occur in the 2030s would be made up for by revenue increases, not benefit cuts.

To supplement Social Security A, we would add a universal flat benefit for all retirees eligible for OASI called “Social Security B.” Social Security B could be funded by revenues other than the payroll tax. Today's Supplemental Security Income (SSI), a means-tested antipoverty program that

helps poor children and the disabled as well as the elderly, has always been funded out of general revenues. SSI thus provides a precedent for expanding the funding base for Social Security B. Indeed, one option would be to convert SSI into Social Security B.

The two components of Expanded Social Security, Social Security A and Social Security B, in combination would provide a much greater share of pre-retirement income than today's OASI does by itself for most Americans. This expansion of the public share of the average American's retirement income would make both tax-favored employer-based pensions and tax-favored individual savings accounts less necessary, allowing federal tax expenditures for those private programs to be reduced or eliminated. Combining major reductions in tax-favored private retirement savings programs with a substantial increase in the public portion of the American security system would make the retirement security system as a whole more progressive, more efficient, and more stable. Designed properly, a new retirement security system could substantially boost public retirement benefits for most Americans without increasing the percentage of GDP devoted to the combined public and private elements of our nation's retirement system as a whole.

In addition to increasing the public contribution to the retirement security of most Americans, Expanded Social

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**Instead of compounding failure by expanding private benefits, we should substantially expand the successful, purely public Social Security program.**

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Security would have other benefits for individuals, businesses and the economy. Unlike employer-provided pensions or 401(k)s, Social Security B would be universal and would not depend on the generosity of particular employers. At the same time, funding Social Security B with revenues other than payroll taxes could maintain or increase the publicly-funded share of retirement security without expanding the payroll tax beyond the levels needed to maintain benefits under Social Security A (today's OASI).

Other reforms might achieve similar results by different methods. Any strategy that expands the reliable and efficient public share of retirement security in America would be an improvement over today's system, which is biased toward the affluent and skewed toward private savings. Our purpose in proposing the Expanded Social Security Plan is to challenge the conventional wisdom about Social Security and to provoke a debate about whether and how to expand the public element of the American retirement security system. At present the discussion is dominated by those who want to privatize or shrink Social Security and those on the defensive who propose merely incremental reforms to preserve it. We seek not merely to move the ball, but also to move the goalpost in order to enlarge the boundaries of the national conversation about the future of retirement security in America.

## **Retirement Security in America: A Three Legged-Stool**

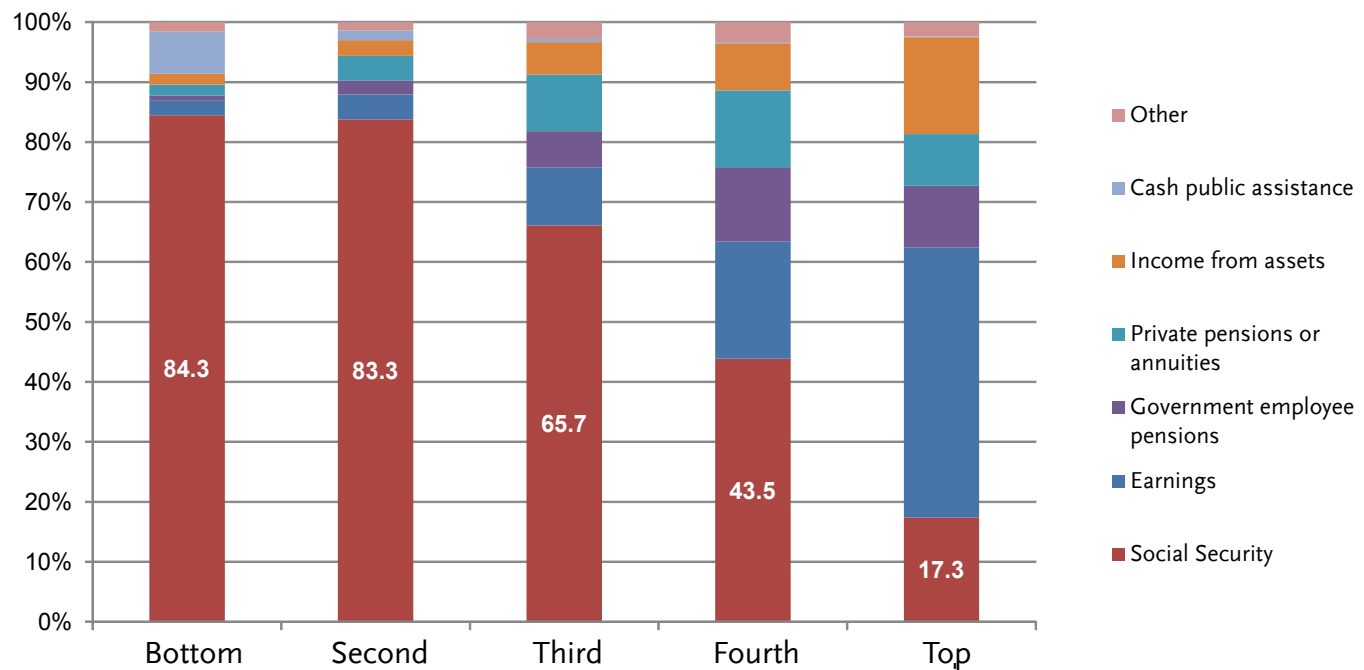
Today, individual retirement policy in the United States can be compared to a three-legged stool. The three legs are the public programs of Social Security (OASI) and the portion of Supplemental Security Income (SSI) that goes to the elderly poor, employer-based retirement plans like defined benefit pensions and defined contribution 401(k)s, and personal assets, chiefly the value of one's home.

Social Security is the largest and most stable component of this amalgam, providing 37 percent of all income for Americans ages 65 and older in 2010.<sup>1</sup> Social Security is an especially important source of income for lower-income older Americans, providing 84 percent of the income of older Americans in the bottom 40 percent of the income distribution.<sup>2</sup>

The other major public source of retirement income, Supplemental Security Income (SSI), makes up less than 0.5 percent of all older Americans' income. SSI is the source of 7 percent of income for elderly Americans in the lowest income quintile.<sup>3</sup>

The combination of traditional pensions and defined contribution plans such as 401(k)s and IRAs provides 18 percent of all income for older Americans. Both defined benefit pensions and defined contribution plans are much more

Figure 1: Sources of Income for Americans aged 65+, by Income Quintile



Source: U.S. Social Security Administration, *Income of the Population 55 or Older, 2010*

important to more affluent elders: they provide 25 percent of all income for older Americans in the second-highest income quintile compared to just 3 percent of income for those in the lowest income quintile (see Figure 1). Although the share of older Americans' income from tax-favored private savings has stayed relatively constant over the past 30 years, the source of that income has shifted dramatically. Defined contribution plans like 401(k)s are now responsible for an increasing share of that income, as income from defined benefit pensions has declined.

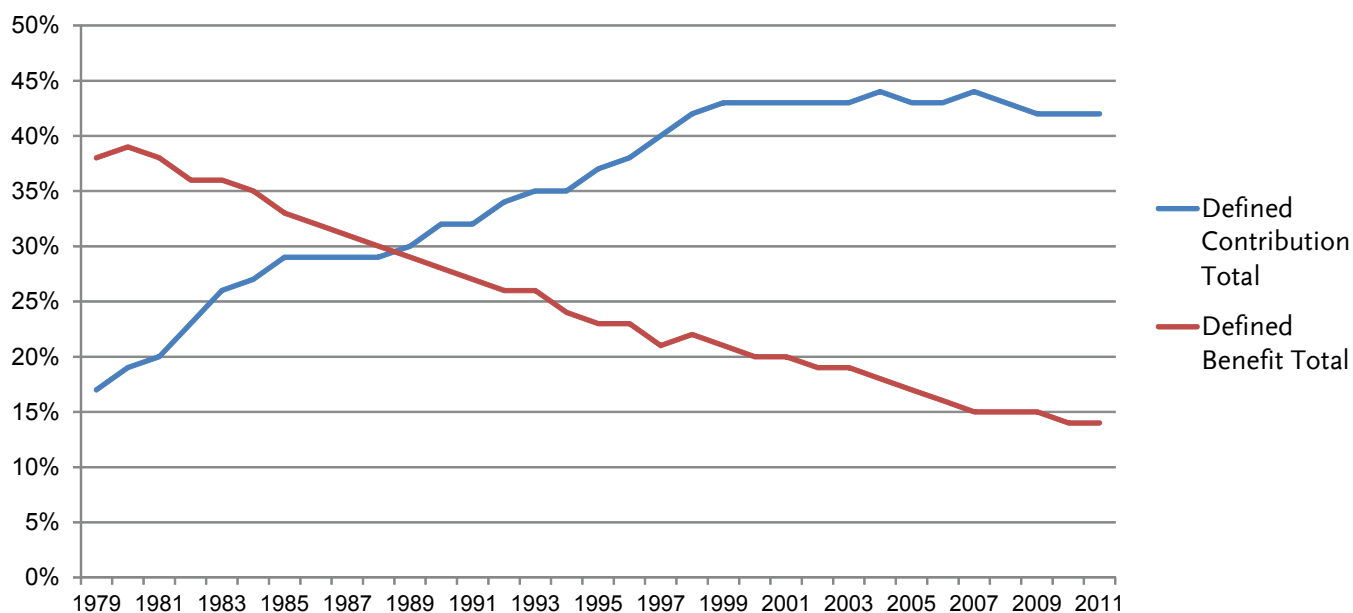
The rest of the income of older Americans comes largely from asset income (income from savings accounts, investments, or reverse mortgages on homes, for example) and earnings, which are responsible for 11 percent and 30 percent, respectively, of all income of Americans aged 65 and older. By contrast to today, in which people rely more on earnings than assets, less than a generation ago the relative importance of these sources was reversed. In 1984, older Americans received 28 percent of income from assets and just 16 percent from earnings, and assets still accounted for a greater share of income as recently as 1992.<sup>4</sup>

The problem of an insecure retirement is not reserved for the lowest income earners. Fewer than half of the middle

quintile (40th – 60th percentile) of the elderly have any form of pension income, and only a slim majority have any form of asset income. These problems predate the recent downturn: even before the Great Recession that began in 2008, 43 percent of middle-income and 54 percent of lower-income Americans already were at risk of having insufficient retirement funds.<sup>5</sup>

But the economic collapse has made the situation worse. The financial crisis has taken its toll on the private retirement resources of most Americans that are intended to supplement Social Security: employer retirement plans and individual savings and investment. Two out of three of the legs of retirement security have proven insufficient, with Social Security remaining as the only stable leg. This leaves retirement security as an unstable, one-legged oddity for the majority of retired Americans who now depend almost exclusively on Social Security. But even though Social Security has become, by default, a de facto national retirement system for most Americans, the Social Security payout at its present level is not adequate to compensate for the crumbling of the other two elements of retirement security.

Figure 2: Private Sector Workers Participating in Employment-Based Retirement Plans, 1979-2011



Source: Employee Benefit Research Institute

## The First Failing Leg of Retirement Security: Employer Retirement Plans

Employer-based retirement plans always have been the least broadly distributed asset, with fewer than 40% of elderly Americans today (those 65 and over) earning income from any type of pension program.<sup>6</sup> The traditional defined benefit pension, in which employees receive a guaranteed payout during retirement from their employer, once provided a secure stream of retirement income on top of Social Security for many Americans. However, it has been disappearing over the past four decades, and now covers fewer than a third of all workers.<sup>7</sup>

Among private-sector workers, the number is even lower. In 1980, approximately 40 percent of private sector workers were covered by a pension with a guaranteed payout, and about 80 percent of employees in medium-size and large companies had such plans in 1985, according to data from the Labor Department.<sup>8</sup> In 2006, only about 15 percent of private sector workers had guaranteed payout pensions (see figure 2), including 32 percent at medium and large organizations. In the public sector, a higher percentage of workers still are covered by guaranteed payout pensions, but the number of public sector workers has declined dra-

matically in recent years, accelerating as a result of the Great Recession. There are now a million fewer federal employees than when Ronald Reagan left office, and public sector employment as a percentage of the population is at a 30-year low.<sup>9</sup>

Many public pension plans are plagued by a serious threat to their stability due to underfunding by state and local governments. According to some calculations, states have funded only about 80 percent of their pension liabilities, leaving a \$3.32 trillion funding gap – an estimate which understates the shortfall due to investment declines from the latter half of 2008.<sup>10</sup> One study concluded that there is a less than 5 percent chance that the current pattern of pension fund investments can fulfill obligations to retirees in 15 years. In addition to pension liabilities, states are responsible for more than \$530 billion in other unfunded benefits, including retiree health and dental insurance, life insurance, and legal services.<sup>11</sup> The public pension funding gap extends to major U.S. cities as well. All of this underfunding predates the Great Recession, which has made the shortfall even more severe.

In addition to dwindling in importance, employer defined benefit pensions have shown poor economic results. American pensions were some of the hardest hit in the

world by the Great Recession and stock market collapse, falling in value by 37% from their peak in 2007. They have still not fully recovered.<sup>12</sup> Even at the largest corporations in the United States, pension plans are underfunded. Only 18 of the 338 companies in the S&P that offer defined benefit plans are fully funded, and seven companies, including the nation's largest, ExxonMobil, had more than a \$10 billion funding deficit in 2011.<sup>13</sup>

As private employers have shifted away from providing defined benefit pensions, they have turned to defined contribution plans like 401(k)s instead. Unlike traditional defined benefit pensions, defined-contribution plans allow employees to set aside fixed amounts of money into investment accounts. That amount is excluded from their gross wage when calculating taxable income, lowering their tax burden. One advantage of this method is that the 401(k)s and IRAs are somewhat portable from job to job. But workers' eventual retirement income from these accounts depends entirely on how much money they set aside during their working lives and how well the stock market and investments in their accounts performed. Employers have greatly preferred 401(k)s over defined-benefit pensions because workers shoulder the primary responsibility for funding them rather than the employer.

The growth of the 401(k) stems from legislation in the late 1970s. In the Revenue Act of 1978, Congress inserted a new section into the tax code, section 401(k), that allowed workers to take part of their pay as tax-free deferred compensation. Section 401(k) was not the first tax provision that allowed Americans to save for retirement in tax-deferred accounts: Individual Retirement Accounts had been created as part of the 1974 Employee Retirement Income Security Act (ERISA) and 403(b) accounts (tax-deferred accounts for employees of non-profits) have been around since the 1930s. But section 401(k) was the first provision that allowed workplace-sponsored tax-deferred retirement

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**Individual retirement plans have proven to be more costly for both the government and employees than the system they replaced.**

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accounts for all types of employees, and thus opened the door for the proliferation of such accounts that has

occurred in the decades since.

Since 1979, defined contribution and 401(k) retirement plans have gone from covering only about 17 percent of the private workforce to about 42 percent today (see Figure 2, above).<sup>14</sup> In some businesses, the employer contributes to the 401(k) plans that are managed by the employees, but the contribution amount is much less than under a defined payout pension.

These individual retirement plans – most prominently, 401(k)s – have been sold to American workers as the new and improved successors to traditional pensions. 401(k)s, however, have proven to be more costly for both the government and employees than the system they replaced. They force workers as individuals to face a number of significant risks, including losing their savings to a stock market downturn, through investing their money unwisely, or outliving their savings. US workers were insured more efficiently and more securely under the traditional pension system.

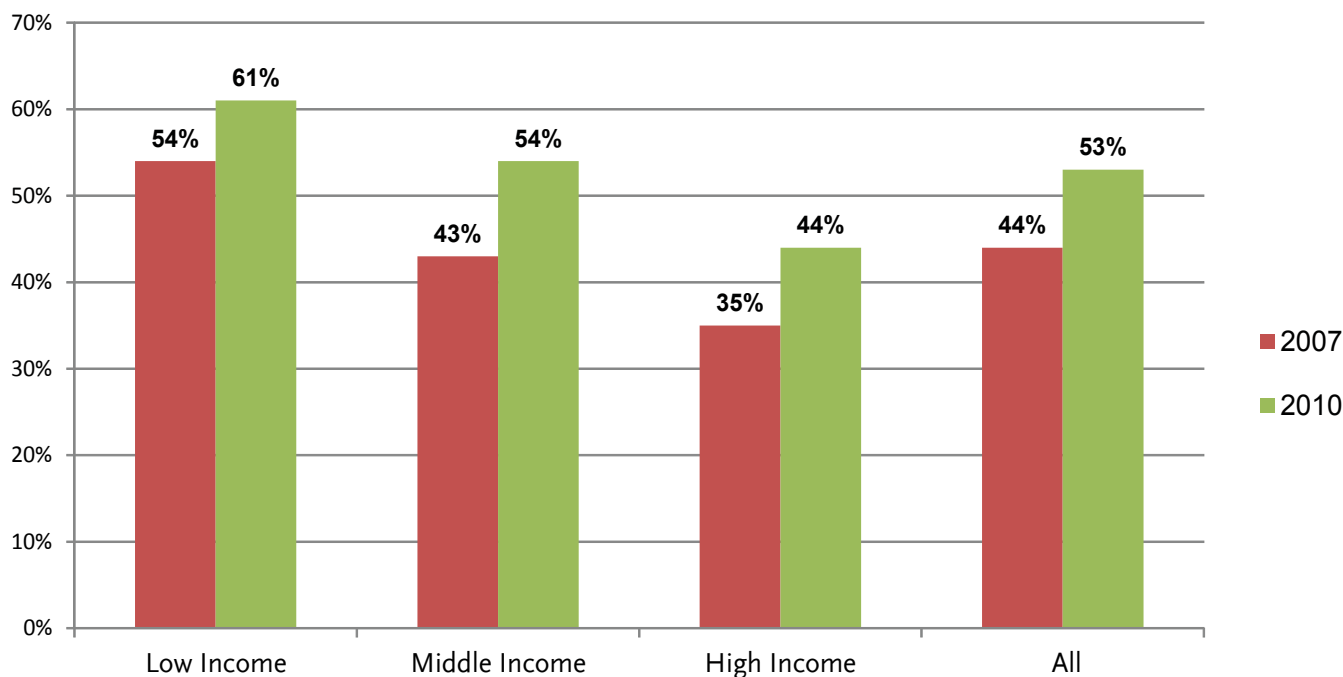
The risks individuals face in a defined contribution plan include:<sup>15</sup>

*Market risk:* workers who have 401(k)s risk losing a chunk of their savings in a market downturn or crash, a particularly damaging prospect for workers nearing retirement. The costs of this risk were shown clearly in the financial crisis: individuals lost 2.8 trillion in the value of their 401(k) or IRA plans.<sup>16</sup>

*Investment risk:* in addition to the overall volatility of the market, 401(k)s force workers to manage their own portfolios, which often leads to lower-than-optimal performance for many reasons: workers sell winning investments while holding losing ones, tend to hold undiversified portfolios, are invested in too many high-risk stocks, and generally lack the expertise necessary to earn high returns.<sup>17</sup> A study by the National Bureau of Economic Research found that more than one-quarter of baby boomer households (who are due to begin retiring over the next decade) thought “hardly at all” about retirement, and that financial literacy among boomers was “alarmingly low.” Half could not do a simple math calculation (divide \$2 million by five) and fewer than 20 percent could calculate compound interest.<sup>18</sup>

*Longevity risk:* retirees relying on their 401(k) to supple-

Figure 3: Percent of Households At Risk of Not Having Enough Income to Maintain Standard of Living at Age 65



Source: National Retirement Risk Index, Center for Retirement Research at Boston College. “At Risk” is a measure of households whose projected replacement rates are more than 10% below NRRI targets.

ment Social Security may outlive their savings.

*Contribution risk:* workers often contribute too little or too inconsistently to their accounts to accumulate a sufficient nest egg. Financial experts say it will take a monthly retirement income of about 70 to 80 percent of pre-retirement income levels – in addition to \$200,000 to \$300,000 in personal savings – for the average American to have a secure retirement.<sup>19</sup> Yet most older Americans have saved only a fraction of that. In 2010, 75 percent of Americans nearing retirement age had less than \$30,000 in their retirement accounts.<sup>20</sup> About half of all Americans are at risk of not having sufficient retirement income, and three-fifths of low-income households are at risk of not having sufficient retirement income to maintain their pre-retirement standards of living at age 65 – which was already a low standard to begin with. All of these problems were exacerbated by the Great Recession (see Figure 3).<sup>21</sup>

*Leakage risk:* workers often whittle away their savings by cashing out assets when they change jobs, by borrowing from their 401(k)s, and by making hardship withdrawals from their accounts before retirement.

High account fees charged by investment management firms exacerbate these risks and take a big bite out of already-inadequate savings. The “hyper-individualized” administration and investment management generates excessive costs that are ultimately absorbed by the workers themselves.<sup>22</sup> By some estimates, these costs are more than twice as high as they would be under a more efficient retirement system.<sup>23</sup>

It is important to emphasize that these risks and costs are an inherent part of the 401(k) system. It follows that reforms like stricter regulations on brokers, disclosure of 401(k) fees, or requiring plan sponsors to offer lower-cost index funds would fail to fix this fundamentally broken system. Fees would still remain high and workers would still be forced to shoulder most of the risks.

Thus both the private and public components of the U.S. employer-based retirement system are under severe strain, as the Great Recession combined with pre-recession patterns of rising inequality and a diminishing social contract have taken their toll. Even when significant numbers of workers were covered by a guaranteed payout pension, the lack of portability provided a powerful disincentive for

workers to change jobs or shift their careers. While 401(k)s can be more portable, they have shifted risks and costs onto employees and have failed to provide sufficient support for retirees.

With defined benefit pensions covering fewer workers and defined contribution plans by definition riskier and more costly for employees, this leg of the three-legged retirement stool has grown too short and is too unstable to provide retirement security.

## The Second Failing Leg of Retirement Security: Asset Ownership

The second failing leg of retirement well-being consists of individual asset ownership, centered on homeownership. For tens of millions of Americans, security in their elderly years has been directly linked to the value of their homes. Yet the rupture of the housing bubble illustrated in dramatic fashion the danger of over-reliance on home values for retirement security.

Homeowners lost approximately \$8 trillion in home equity during the Great Recession, a 53 percent drop in the overall value of the national homeownership stock.<sup>24</sup> About 10.7 million Americans – 22 percent of all homeowners – are still underwater today, owing more on their mortgage than their home is worth.<sup>25</sup> These homeowners are, in effect, flat broke if they have no other accumulated savings or retirement vehicle.

This has been devastating for Americans' retirement well-being because home ownership accounts for a large proportion of the assets owned by much of the population. During the 2000s, before the housing market crash, real property accounted for between 77 and 85 percent of tangible household assets.<sup>26</sup>

Individual levels of non-home assets are also too low to serve even as a personal buffer, let alone the basis of a secure retirement. A recent study found that nearly half of Americans (43.6%) do not have enough savings to cover basic expenses if they were to lose their source of stable income. These 132.1 million “liquid asset poor” Americans include many members of the middle class and upper middle class: more than a quarter of households earn-

ing between \$55,465 and \$90,000 per year – the entire range of which is above the median household income of \$50,054 – have less than three months of liquid savings. Over 30% of all households do not have a savings account at all.<sup>27</sup>

The lack of private savings has weakened the other legs of the retirement stool. More than one in four households has had to withdraw savings from their 401(k) or 403(b) retirement accounts before retirement to pay for emergency savings (the “leakage risk” of 401(k) plans). These early withdrawals totaled \$60 billion out of a total of \$176 billion (40%) contributed by employees to defined contribution accounts in 2010, and early withdrawals come with heavy penalty fees.<sup>28</sup> With defined contribution plans already insufficient to cover retirement needs, the lack of private savings to cover working-age contingencies has made the problem worse.

The second leg of the three-legged retirement stool, other savings and asset ownership, has proven to be as weak and unreliable as employer pensions and defined contribution plans. And with home prices recovering at a glacial pace in most parts of the country, this loss in equity has significantly reduced the economic security of the lower and middle classes, which are less likely to have pensions and other assets such as private savings (beyond homeownership) to sustain them.

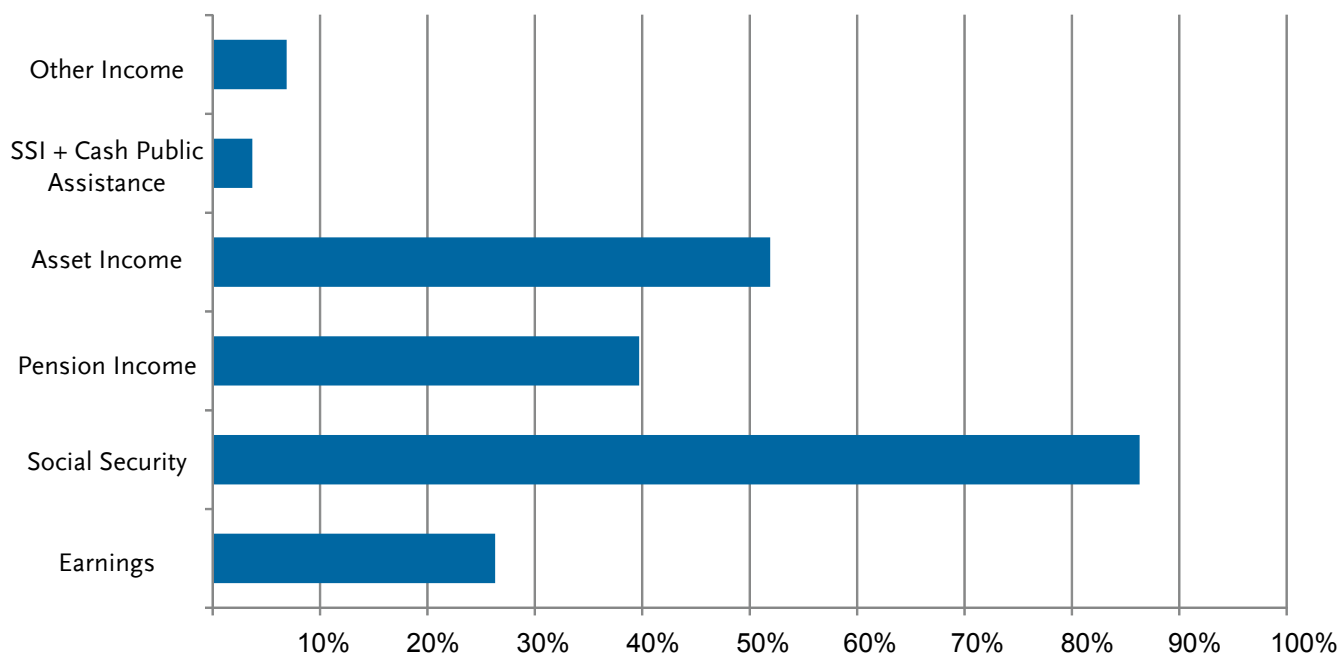
## Building on Success: Increasing the Public Benefit Share of Retirement Income

In the decades ahead, the vast majority of baby boomers and other retirees will be almost completely dependent on the single leg of Social Security for their retirement.

The bottom two income quartiles for those aged 65 and over depend on Social Security for at least 80 percent of their income, but even the second richest quintile still depends on Social Security for nearly half of its retirement income. Middle-income elderly – the 40th to 60th percentile – currently rely on Social Security for 2/3 of their income.

Due to the inadequacy of pension plans and miscellaneous

Figure 4: Percentage of Americans 65+ with Income from Each Source



Source: U.S. Social Security Administration, *Income of the Population 55 or Older*, 2010

household savings, the one-legged stool of the U.S. retirement system is increasingly unstable. For more and more Americans, the dream of a secure retirement is threatened. Social Security has become a single pillar national retirement system, a role for which it was never intended or designed. This development is not to be lamented, however. On the contrary, the centrality and stability of the public component of the American retirement security system should be embraced and built upon.

Social Security is already one of the most popular public programs in the country. Numerous surveys show much greater support for preserving benefits for Social Security and Medicare than reducing them, even if it means raising taxes. A December 2012 Pew Research Center poll showed that 56% of people were opposed to raising the eligibility age for either Social Security or Medicare, and, even among Republicans only, more people disapproved of raising the eligibility age (and thus reducing benefits).<sup>29</sup> A Kaiser Poll from January 2013 had nearly identical results: 58% opposed any reduction to either Social Security or Medicare.<sup>30</sup>

Given the popular consensus about the looming budgetary shortfall, many polls have explored public opinion on reductions in these social insurance programs. But few

have looked at whether there is support for *expansion* of these programs. A late 2012 poll by the National Academy of Social Insurance asked this question, however, and found strong public support. Three out of four respondents said that we should consider increasing Social Security benefits, and 84% said that current benefits are inadequate.<sup>31</sup>

Table 1: Natixis Global Retirement Index

Top 20 Nations			
1	Norway	11	Australia
2	Switzerland	12	Israel
3	Luxembourg	13	Canada
4	Sweden	14	Belgium
5	Austria	15	Japan
6	Finland	16	Slovenia
7	Netherlands	17	Czech Republic
8	Denmark	18	Slovakia
9	Germany	<b>19</b>	<b>United States</b>
10	France	20	United Kingdom

In the wake of budget negotiations in February 2013, Pew found that 41% would increase spending on Social Security while only 10% would decrease it.<sup>32</sup>

The United States is also less generous to its seniors than other advanced nations. The U.S. gross replacement rate for the average earner – how much of a person’s income is covered by mandatory pension programs – is 39.4 percent, below the average of 57.3 percent for countries in the Organisation for Economic Co-operation and Development (OECD) and 61.6 for countries in the European Union.<sup>33</sup> On other pension replacement metrics like gross pension wealth, which is indexed for life expectancy and retirement age, the United States also lags behind.<sup>34</sup>

These measurements by definition only assess pensions, which use income as a proxy for relative levels of well-being. But that income is used to purchase the services, food, shelter, medical care and other items that a retiree needs. In many developed nations, health care, transportation and mass transit, and senior care in institutions are more cost efficient and less expensive. The United States ranked 19th globally in a recent retirement security index – behind nearly every advanced nation except the United Kingdom. Due to high health costs on seniors and the inadequacy of defined contribution savings plans, the United

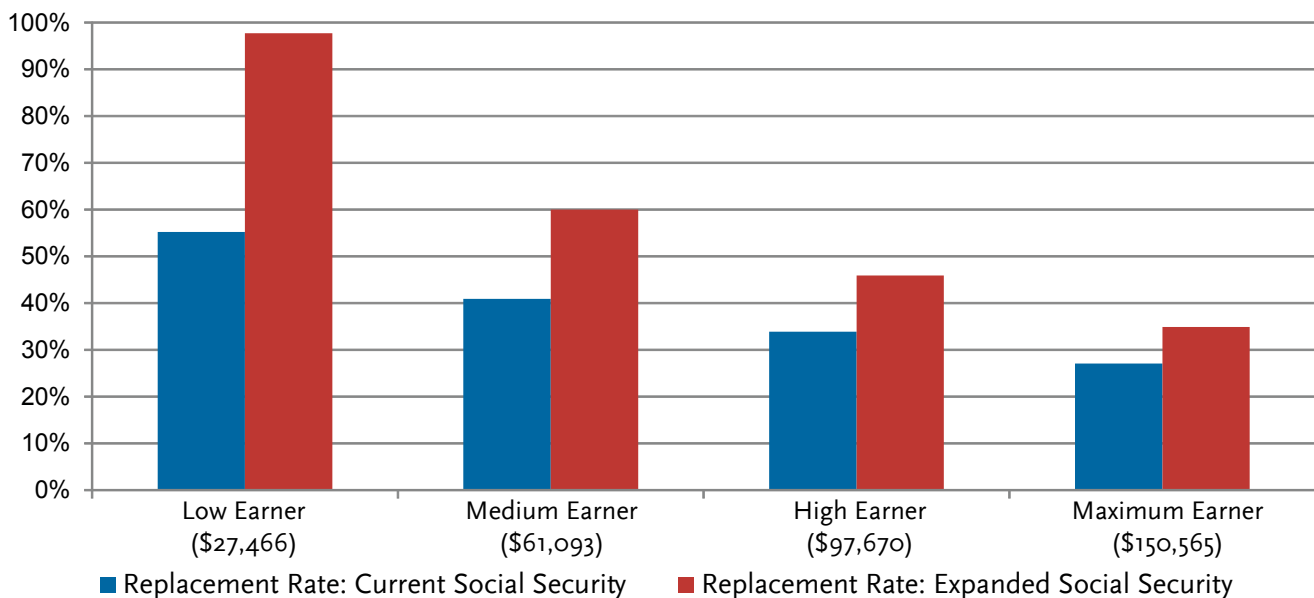
States even ranked behind countries including Slovenia, Slovakia, and the Czech Republic (see Table 1).<sup>35</sup> Using pensions/retirement income as the main measure of elderly well-being fails to provide a complete picture of quality of life and makes the relatively stingy U.S. public retirement system seem more generous than it really is.

Instead of trying to diminish the importance of Social Security as a share of retirement income, we should increase it and expand it so that it becomes a more robust core of Americans’ retirement system.

### Expanded Social Security: A Proposal for a New Retirement Security System

Insanity has been defined as repeating the same action and expecting a different result. By that definition, the conventional wisdom that Social Security, the most successful element of retirement security, should be reduced, while Americans should be compelled to rely more on less-successful private alternatives, is insane. The private alternatives to Social Security – tax-favored employer pensions, tax-favored individual savings accounts, and individual asset ownership – have all failed in comparison to

Figure 5: Replacement Rates by Earnings Level, 2035, Current Social Security vs. Proposed Expansion (60% Replacement Rate)



Source: Authors’ calculations based on Social Security Administration data

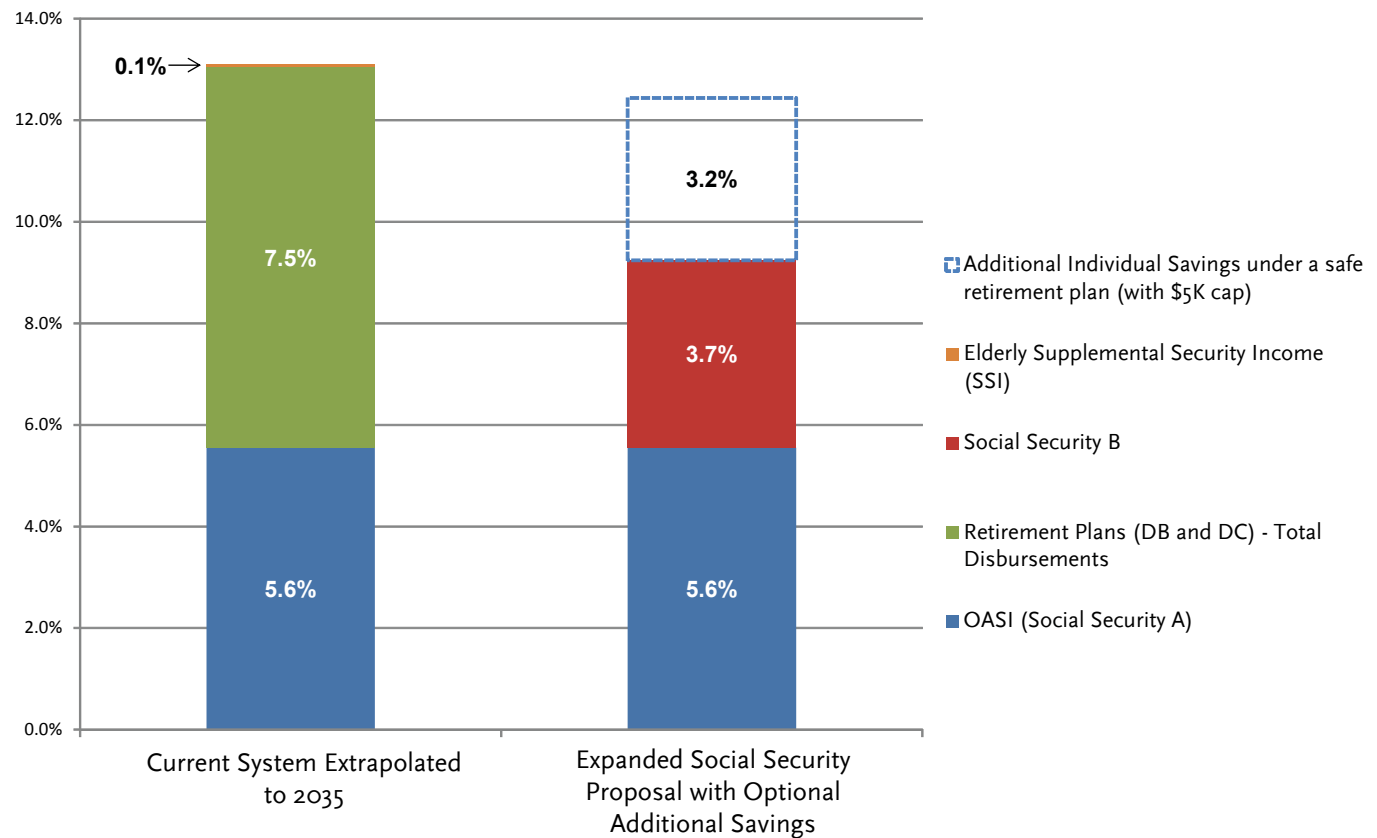
Social Security. Rather than hoping that private sources of retirement income will show better results in the future, we should reduce the reliance of most American workers on those unreliable alternatives by expanding the popular, efficient and successful Social Security system.

We propose to replace most of the country’s current, inadequate, hybrid public and private retirement system with a two-part, wholly public system called Expanded Social Security.<sup>36</sup> Expanded Social Security would have two distinct parts. The first part, Social Security A, would be similar to the current Social Security Old Age and Survivors Insurance (OASI) program, which provides a retirement benefit related to earnings. The second part of Expanded Social Security would be a new universal flat benefit, Social Security B, to supplement the traditional earnings-related benefit that would continue to be provided by Social Security A.

Some version of this “double decker” public system is similar in form to that in a handful of other countries. Japan, Canada, and Luxembourg, to name a few, have both a basic flat public pension and a public defined benefit program based on earnings.<sup>37</sup>

In order to illustrate our proposal, we have designed a scenario in which, when Social Security A and B are combined, a career-medium earning worker would be guaranteed 60 percent of his or her average working wage in retirement income. This amount provides a much sturdier foundation than the current system, which replaces only about 40 percent of income for the average worker. This level also makes Social Security B’s flat benefit similar to the poverty line, thus essentially eliminating poverty among the elderly. We use the year 2035 as our example year for our calculations because it allows for medium-term projections and is the first year of data available after the estimated exhaustion of the Social Security trust fund

Figure 6: Estimated Total Publicly-Sponsored Retirement as Share of GDP, 2035, Current System vs. Proposal



Source: Authors' calculations from CBO and SSA data

(and thus is the focus of contemporary discussions).

For the sake of clarity, the scenario excludes some factors, like arrangements for a transition from the old system to the new, which would be significant if a version of our proposal were adopted.<sup>38</sup> Nevertheless, the example provides a useful glimpse at one form that Expanded Social Security could take and basic estimations of its cost and its benefits for elderly earners across the income spectrum.

If we assume that Social Security benefits are maintained at current levels and that there are no additional cuts to the program,<sup>39</sup> we propose to set Social Security B at \$11,669 per year for all elderly earners. This will guarantee a replacement rate of 60 percent for a medium earner based on calculations derived from Social Security Administration data. With this flat benefit, low-income earners will see their replacement rates boosted to nearly 100 percent. High-income earners – those making around \$100,000 per year – will have a public replacement rate of 46 percent, and very high earners (\$150,000 per year) will have a public replacement rate of 35 percent (see Figure 5).

The proposed system would be much more progressive than the current retirement security landscape. Because of the flat benefit, lower-income and middle-income earners would have higher levels of income in retirement. Upper-middle income earners would also likely be at least equally as well-off: the increase in income from the flat benefit would offset most or all of the income they derive from employer retirement programs. The highest-income earners would bear the burden of these proposed changes, as they would no longer be able to rely on the tax-favored programs that primarily benefit affluent individuals. However, they would still receive a higher level of direct public benefits than they do currently due to the universal addition of Social Security B.

## Expanded Social Security: How Much Would It Cost?

The 2012 Trustees' Report projects that the existing Social Security program (OASI) will have 78.1 million beneficiaries in 2035. We add to this total the approximately 1.5 million elderly Americans who currently receive SSI but not OASI for a total of 79.6 million people projected to be eli-

gible for Social Security B in 2035.

Providing Social Security B's flat benefit to the projected eligible population would initially cost \$928.9 billion in 2035.<sup>40</sup> The program's cost would rise yearly in step with the growth rate of the retiree population. The Trustees' Report estimates this rate will be 0.5 percent in 2035, so we can expect the cost of Social Security B to grow at the same pace. (For full details on how these calculations were made, see Appendix B).

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Because tax-favored plans skew disproportionately toward upper-income Americans, the current system is not only inefficient but also inequitable.

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This cost estimate might sound large, but it must be taken in proper context. Figure 6 contrasts the present retirement security system, extrapolated to 2035, with our hypothetical alternative. As the graph indicates, if the current system were unchanged, the publicly-sponsored retirement system in 2035, defined as Social Security and SSI plus disbursements from tax-favored employer and individual retirement plans, would be equal to 13.1 percent of GDP. Of this total, a greater share would be tax-favored private retirement plans (7.5 percent) than Social Security or OASI (5.6 percent). Because these tax-favored plans skew disproportionately toward upper-income Americans, this plan is not only inefficient but also inequitable.

The bar on the right shows a version of our Expanded Social Security Plan, consisting of Social Security A, Social Security B, and an optional, limited tax-favored private savings plan with a cap of \$5,000 per year (for more on the optional third part, see section below). The two-part public core of the proposed Expanded Social Security system would cost 9.3 percent of GDP, and the optional additional tax-favored private savings component would add, at most, 3.2 percent of GDP for a total cost of 12.4 percent of GDP. Thus, as this illustration shows, spending from Social Security A and B, combined with disbursements under a modest tax-favored private savings plan, adds up to less as a share of the economy than the 2035 version of today's far less fair and far riskier publicly-sponsored retirement

system as a whole.

For additional comparison, this projected cost of the proposed two-part program would still be less than that *currently* spent by some OECD countries on their retirement systems. France, for example, spends 12.5 percent of GDP on its retirement programs.<sup>41</sup> Thus, the combined costs for Social Security A and B seem like a relative bargain considering that they would be providing retirement income for a considerably older population than exists in any OECD country today.

## Paying for an Expansion of Social Security

One benefit of Expanded Social Security is that it would allow the total public retirement benefit for most Americans to be dramatically increased without increasing the payroll tax rate. Under our proposal, the two components of Expanded Social Security would be paid for by separate revenue streams. Social Security A would be paid for by payroll taxes. Social Security B, the new universal, flat benefit, would be financed by revenues other than payroll taxes – either general revenues or a dedicated tax or taxes. Although there is no short-term Social Security “crisis,” there is a long-term Social Security problem. In 2010, the program began paying out more than payroll taxes brought in.<sup>42</sup> The Social Security trust fund is projected to make up the difference for two decades, but around 2033 the trust fund will run out. Thereafter the gap between Social Security’s revenue and spending is projected to be between 1 and 1.5 percent of U.S. GDP.<sup>43</sup> This shortfall needs to be addressed to maintain the current base level of benefits so that the additional expansion of the program can be implemented.

The reform of OASI/Social Security A should consist solely of payroll tax increases, rather than benefit cuts. Today OASI is paid for by the combined employer-employee payroll tax, which is set at 12.4 percent of wages below \$113,700. Because of increasing wage inequality in America in the last generation, Social Security taxes, which covered 90 percent of wages in 1980, now cover less than 84 percent.<sup>44</sup> Increasing the payroll tax until it covers 90 percent of wages once again would plug half of the shortfall. Lifting the lid on Social Security payroll taxes as a percentage of

wages entirely could eliminate the current funding gap altogether.<sup>45</sup>

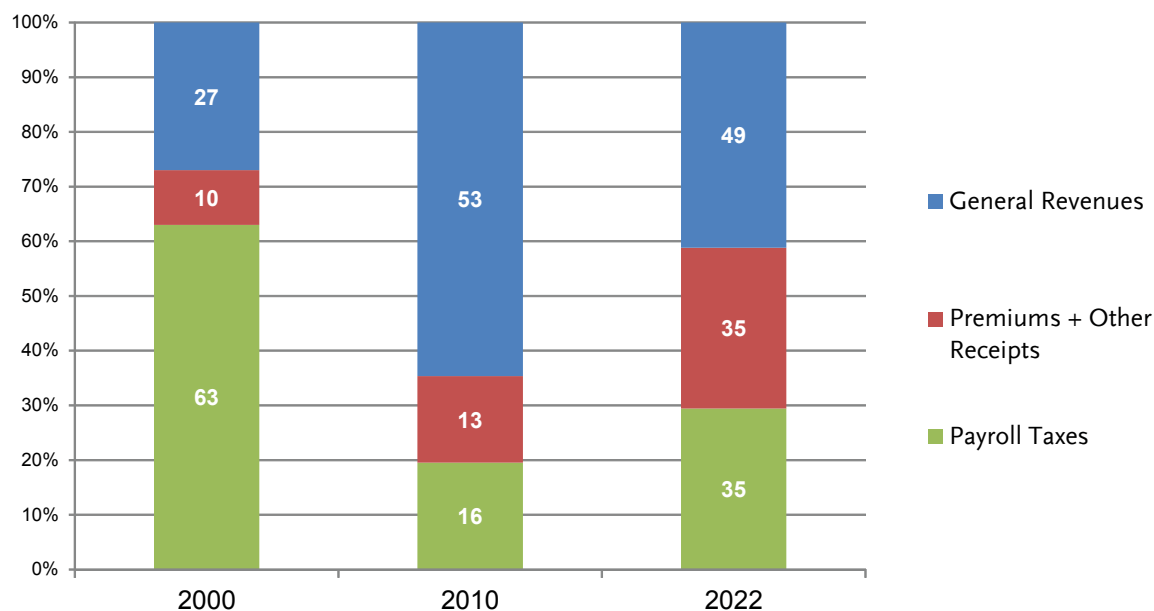
Another financing option would be to broaden the base of tax income by taxing unearned income such as capital gains, investment income, and dividends at the same payroll rate that affects earned labor income. As it stands, unearned income is exempt from payroll taxes. Expanding the taxable base by including both earned and unearned income would generate more revenue for Social Security and would be very progressive, as most unearned income accrues to the wealthiest individuals. Other legislation is moving in this direction: the 2010 health care reform law included a provision to tax unearned income at 3.8 percent to help finance Medicare.<sup>46</sup>

While a reformed payroll tax would continue to pay for OASI (Social Security A in the new proposal), we need to look elsewhere to fund the expansion of Social Security that we believe is necessary. The new flat benefit, Social Security B, could be paid for out of either general revenues or a new dedicated tax or taxes, which might include portions of a federal value-added tax (VAT). (For a discussion of how today’s SSI program could be converted into Social Security B, see Appendix A). Many defenders of the current payroll tax-only system of financing fear that mingling other funds with payroll taxes would undermine public support for the direct public benefits portion of the program. The example of Medicare, however, suggests otherwise.

According to Congressional Budget Office data, in 2010 payroll taxes and other earmarked taxes covered more than 93 percent of the cost of Social Security. But in the same year, little more than a third of Medicare’s costs were covered by payroll taxes. Slightly more than half were paid for by general revenues, while roughly a seventh of Medicare’s costs were provided by beneficiary premiums and other earmarked receipts (see Figure 7). If premiums are factored out, then other revenues covered roughly 60 percent of Medicare’s costs while payroll taxes covered around 40 percent.<sup>47</sup>

The difference between Social Security and Medicare arises from the fact that Medicare consists of multiple programs: Medicare Part A, which covers hospital insurance, is financed by payroll taxes, while Medicare Parts B and D, which cover doctors and prescription drugs, are paid for

Figure 7: How is Medicare Financed?



Source: Donald Marron, Tax Policy Center from CBO data

by general revenues and premiums (Medicare Part C consists of private plans).<sup>48</sup> If public support for a social insurance program depends on whether it is financed wholly by payroll taxes, with no infusion from general revenues or other sources of revenue, then public support for Medicare should be weaker than public support for Social Security. But there is no evidence for this. On the contrary, both Medicare and Social Security enjoy strong public support. Indeed, it is likely that few Americans understand how the programs are financed. Their popularity arises from the perceived need for them and the perceived as well as actual benefits, not from the specific details of how they are paid for.

The long-term funding gap for the main part of Social Security can be fixed by broadening the payroll tax base to high incomes or untaxed gains, and the addition of the universal flat benefit can be funded with general revenues or a new dedicated tax or taxes. Together, this will create a solvent, more robust social insurance system.

### A Third Part? Optimal Designs for Optional Private Savings

The Expanded Social Security system that we propose is

designed to increase the public component of retirement income for most Americans and to reduce the need for reliance on tax-favored or taxable private savings without increasing payroll taxes that hurt American businesses. The fact that, under the Expanded Social Security plan, a majority of Americans would be less dependent on vanishing employer pensions, unreliable IRAs and 401(k)s and inadequate household wealth is a *feature* of the Expanded Social Security plan, not a *bug*.

Nevertheless, individuals and families would be free to amass additional private savings for retirement, to supplement the more generous public retirement system that we propose. This would be most relevant for higher-earning individuals for whom Expanded Social Security will not replace as large of a share of their pre-retirement earnings.

It is not clear, however, that such optional, additional private retirement savings should be subsidized by taxpayers through favorable tax treatment, if the benefits for tax breaks for private retirement savings are enjoyed chiefly by the affluent, as is currently the case.<sup>49</sup> This year, the government will spend \$165.4 billion through these tax expenditures to subsidize individual retirement savings, nearly 80 percent of which will accrue to the top 20 percent of earners.<sup>50</sup> With all Americans receiving Expanded Social Security, the need for these regressive tax-based benefits

will be much less pressing. No public interest justifies the provision of subsidies through the tax code for the private retirement savings of the affluent – yet that is exactly what current policy does.

If Congress, after enacting a version of Expanded Social Security, also wanted to promote individual savings for middle-class Americans, it should consider abolishing 401(k)s and other tax-favored individual retirement accounts and replacing them with simple, universal private retirement savings vehicles with strict contribution limits that are more efficient and equitable.

Defined contribution plans can exploit economies of scale in order to lower management fees and other administrative costs if individual savings are pooled and if “churn” is minimal, as in index funds. This is the logic behind proposals that all Americans, not only federal employees, be allowed to invest in the federal government’s Thrift Savings Plan. The same logic underlies Senator Tom Harkin’s proposal for Universal, Secure, and Adaptable (USA) Retirement Funds and economist Teresa Ghilarducci’s proposal for Guaranteed Retirement Accounts (GRAs).<sup>57</sup> While the details differ, all of these social insurance plans would promote risk sharing and minimize administrative costs by creating large pools of savings. In addition, the USA Retirement Funds and GRAs would be designed to protect savers to varying degrees against the tumult of stock market fluctuations.

The addition of a private retirement savings element to Expanded Social Security would need a cap on contributions so that the program helps middle-income earners without becoming a lavish subsidy for the rich. In our scenario, we have a cap of \$5,000 per year into either a GRA or equivalent universal retirement account.

But a warning is in order here. It is easy to imagine the private money management industry, threatened by the Expanded Social Security proposal, adopting a version of our Social Security B proposal for a flat benefit and combining it with an expanded tax-favored private retirement system, perhaps along the lines discussed above – while cutting or eliminating today’s earnings-based contributory Social Security program (which would become “Social Security A” in Expanded Social Security). Indeed, many past proposals for the partial or complete privatization of Social Security have included a flat, means-tested public

benefit to be supplemented by an expansion of tax-favored private savings.

In our view, any such policy would defeat the purpose of our Expanded Social Security program, which is to reduce, not increase, the reliance of American retirees on tax-favored pensions and tax-favored private retirement savings accounts alike. Any proposal to create a public flat benefit as an alternative to Social Security’s public contributory benefit, rather than as an add-on, should be rejected as an attempt at backdoor privatization of Social Security.

## Expanded Social Security: Toward Greater Retirement Security for All Americans

The three-legged stool of retirement security in the United States – Social Security, employer plans, and private savings, mostly derived from homeownership – has become wobbly and unstable. With employers walking away from their traditional role of providing a private pension, with defined contribution plans like 401(k)s and IRAs dependent on the vagaries of the stock market, and with low levels of personal asset ownership, Social Security now is the only stable leg remaining that is able to prop up retirement security for hundreds of millions of Americans.

We propose to replace a wobbly stool and its failing private components with a single, sturdy, portable and purely public column made up of a strong pillar atop a solid foundation: Expanded Social Security.

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**We propose to replace a wobbly stool and its failing private components with a single, sturdy, portable and purely public column.**

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An expansion of Social Security along the lines that we envision not only would be good for America’s retirees, it also would be good for the broader macroeconomy. It would act as an “automatic stabilizer” during economic downturns, keeping money in retirees’ pockets and stimulating consumer demand, especially among low- and middle- income

individuals who are more likely to spend an extra dollar on goods and services than are affluent individuals. In addition, unlike some elements of the current retirement system, such as pensions, no component in the Expanded Social Security plan is contingent on benefits provided by particular employers. By replacing all or most employer-provided, tax-favored retirement savings plan with a new flat public benefit and, perhaps, a modest optional savings plan, Expanded Social Security would completely unlink the retirement income of individual Americans from particular jobs and particular employers. And Expanded Social

Security would help American businesses trying to compete with high value-added foreign companies that don't have to provide pensions to their employees, because those countries already have national retirement plans.

The combination of today's Social Security A with our proposed Social Security B to create Expanded Social Security would provide a stable, secure retirement for every American and contribute greatly toward a solid foundation from which to build a strong and vibrant 21st century economy. America's hard-working citizens deserve no less.

## Appendix A: Expanding Social Security by Repurposing Existing Programs

Our proposal is to create a double-decker Expanded Social Security system by adding a universal flat benefit called Social Security B to supplement a modified version of today's Old Age and Survivors Insurance (OASI), which would be renamed Social Security A.<sup>52</sup> One way to achieve this outcome would be to create a completely new Social Security B program. But it would also be possible to achieve the same outcome by repurposing three of today's existing federal programs: OASI, DI and SSI.

Disability Insurance (DI) is a universal, earnings-based program for nonelderly disabled workers, paid for out of the Social Security payroll tax. DI now accounts for 17.8 percent of total Social Security expenditures.<sup>53</sup> (OASDI refers to the combined resources and spending of OASI and DI.)

Supplemental Security Income (SSI) is a means-tested welfare program, providing benefits to the elderly poor as well as to disabled poor working-age adults and disabled poor children. About one quarter of SSI recipients are 65 or older.<sup>54</sup>

Expanded Social Security could be created in two steps, by repurposing DI and SSI.

First, all disabled working-age adults and children would be removed from SSI and enrolled in DI. It is unnecessary to have two distinct federal income programs for the disabled. As a universal, earnings-related program funded by part of the payroll tax, DI can be expected to enjoy greater

political support than SSI, a means-tested welfare program. As the saying goes, "Programs for the poor are poor programs."

Shifting all disabled nonelderly from SSI into DI would leave SSI as a means-tested program of income support exclusively for the elderly poor. The second step of repurposing would be to remove the means test and turn SSI into Social Security B, a universal, flat benefit for all retirees, regardless of whether they are eligible for additional earnings-related benefits. This universal benefit would render the need for a targeted elderly antipoverty program obsolete.

Because SSI is already funded out of general revenues, creating Social Security B by modifying and enlarging SSI would also achieve the goal of adding new revenues to an expanded public retirement system without increasing the payroll tax. Even conservative economists tend to agree that a minimum basic income for the elderly, as a redistributive welfare program rather than an earnings-based annuity, should be paid for out of general revenues or other broad taxes, rather than out of payroll taxes.<sup>55</sup> Indeed, this is generally the practice in countries with double-decker public retirement systems.<sup>56</sup>

In the interests of continuity, the existing names of the three programs might be kept, even after the reallocation of responsibilities: Old Age and Survivors Insurance (OASI) or Social Security A, Supplemental Security Income (SSI) or Social Security B, and Disability Insurance, now a program for the nonelderly disabled only.<sup>57</sup>

## Appendix B: Assumptions and Estimates for Expanded Social Security

What follows are the assumptions and calculations we used to arrive at the proposed flat retirement benefit and its costs. Since the proposal is intended to complement Social Security, we use the Social Security Administration’s projections from the 2012 Trustees’ Report, available at <http://www.ssa.gov/oact/tr/2012/tr2012.pdf>. Though our own opinions may differ from some of the Report’s assumptions, for consistency’s sake we adopt wholesale the report’s intermediate cost assumptions for our own projections for the cost of Expanded Social Security. The trustees consider the intermediate cost assumptions, reproduced in Figure B.1 below, to be their baseline, and thus so do we. For continuity’s sake, all of our figures derive from those

because 60 percent is large enough to be a substantial increase in benefits for middle and low income earners, and it also coincides with a flat benefit level that guarantees an income that meets the national poverty level to ensure that no elderly person is impoverished. Alternately, we could choose a lower floor of 50 percent, which would cost less but require that more households took part in either taxable private savings or the optional third part we propose. The numbers for this calculation are also included in this Appendix.

The hypothetical medium earner earns, on average over her/his career, an amount equal to 100 percent of the Average Wage Index (AWI)<sup>58</sup>; in other words, they are the quintessential statistically-average earner. The yearly benefit amounts shown in the table are scheduled benefits, not payable benefits:

because Social Security cannot legally run a deficit, the benefit amount scheduled will only be paid if the projected shortfall is closed through increased taxes or better-than-average economic performance. If benefits are cut or if the economy performs as expected and Congress takes no action to close the shortfall, “payable” benefits will be just 75 percent of scheduled benefits. Our estimates assume, as detailed in the paper, that Congress closes the shortfall in some manner. If no changes are made and we

want to maintain our guaranteed 60 percent replacement rate for the medium earner, Social Security B would have to be increased additionally to close this gap.

Our cost estimate is based off of the projection from Figure B.2 showing that a medium-earning worker who retires at normal retirement age (age 67) in 2035 is scheduled to receive a yearly benefit of \$24,987, an amount which replaces 40.9 percent of her/his average pre-retirement earnings; other categories of workers (low, high, and maximum) are projected to receive benefits as shown in the

Figure B.1: Social Security Trustees’ Long-Range Economic Assumptions, 2012

Long-range assumptions	Intermediate	Low-cost	High-cost
Total fertility rate (children per woman), starting in 2036 . . . . .	2.0	2.3	1.7
Average annual percentage reduction in total age-sex-adjusted death rates from 2011 to 2086 . . . . .	.77	.39	1.18
Average annual net immigration (in thousands) for years 2012-86 . . . . .	1,080	1,375	790
Productivity (total U.S. economy), starting in 2024 . . . . .	1.68	1.98	1.38
Average annual percentage change in average wage in covered employment from 2021 to 2086 . . . . .	3.92	3.51	4.31
Consumer Price Index (CPI), starting in 2021 . . . . .	2.80	1.80	3.80
Average annual real-wage differential (percent) for years 2022-86 . . . . .	1.12	1.71	.51
Unemployment rate (percent), starting in 2021 . . . . .	5.5	4.5	6.5
Annual trust fund real interest rate (percent), starting in 2022 . .	2.9	3.4	2.4

Source: Social Security Administration, 2012 Trustees’ Report, Page 8.

from the Social Security Administration.

Figure B.2 below shows the scheduled Social Security benefits and income replacement rate for medium-earning workers retiring in future years, based on the aforementioned “intermediate cost” economic and demographic assumptions. This table is the starting point for our calculations for the cost of our proposal, since the proposal’s goal is to provide benefits large enough so that the average earner has a retirement income “floor” of 60 percent of her/his pre-retirement income. We chose this number

table as well.

By working backwards, we can determine how to calculate the flat benefit needed to meet our goal of a retirement income of 60 percent of the medium earner's AWI. From the data in Figure B.2, we calculate that a medium earner's career average salary in 2035 will be \$24,987/0.409 = \$61,093. Thus, Social Security A and B together should provide a medium worker with a benefit of 60 percent of this, or \$36,656.

Social Security A will provide this medium earner \$24,987. To supplement this income to reach \$36,656, Social Security B would need to be \$11,669. To reach a 50 percent replacement rate, Social Security B would need to be \$5,559.

Figures B.3 and B.4 below detail the replacement ratios and benefit levels for Social Security A and B for the same four different types of earners detailed in the Trustees' Report:

a low-earning (career average 40 percent of the AWI); medium-earning (100 percent AWI); high-earning (160 percent AWI); and maximum-earning (250 percent AWI, which earns her the maximum Social Security benefit). Figure B.3 shows the numbers for a 60 percent replacement and B.4 for a 50 percent replacement.

To determine the comparative levels of spending as a share of GDP as shown in Figure 5 in the text, we worked backwards from figures in the Trustees' Report Table IV.B1. This table shows that the cost rate of OASI as a share of taxable payroll is 15.22 in 2035. From Table VI.F5, which shows taxable payroll as share of GDP, we know that in 2035 it will be 0.365. Thus, we can calculate that the cost share of GDP is 5.56 in 2035.

Our estimates of the levels of spending on private plans under the current system in 2035 come from the CBO report, "Tax-Deferred Retirement Savings in Long-Term

Revenue Projections." Figures 2 and 4 (pages 17 and 19, respectively) estimate distributions out of defined contribution plans to be 4.5 percent in 2035 and distributions out of defined benefit plans to be about 3 percent. Thus, in total, the amount of spending from private plans is 7.5 percent of GDP. We chose distributions, rather than contributions, to be our metric of "cost" because that is the closest equivalent to expenditures, and all of these disbursements are publicly-sponsored because they are subsidized or tax-favored by the government. For a fair comparison, the cost for the Expanded Social Security plan's optional third tier also refers to distributions, not contributions.

The cost of Supplemental Security Income (SSI) is estimated to be about 0.1 percent for all aged units (aged only and aged disabled) in 2035, according to the annual report from

Figure B.2: Future Scheduled Social Security Benefits for an Average Worker

Year attain age 65 <sup>b</sup>	Retirement at normal retirement age			Retirement at age 65		
	Age at retirement	CPI-indexed 2012 dollars <sup>c</sup>	Percent of earnings	Age at retirement	CPI-indexed 2012 dollars <sup>c</sup>	Percent of earnings
<b>Scaled low earnings:<sup>d</sup></b>						
2012	66.0	\$11,390	57.8	65.0	\$10,648	55.0
2015	66.0	11,327	53.7	65.0	10,582	51.4
2020	66.2	12,481	53.9	65.0	11,503	50.4
2025	67.0	13,643	55.5	65.0	11,827	49.2
2030	67.0	14,347	55.3	65.0	12,436	49.0
2035	67.0	15,161	55.2	65.0	13,134	48.9
<b>Scaled medium earnings:<sup>e</sup></b>						
2012	66.0	18,771	42.9	65.0	17,534	40.8
2015	66.0	18,667	39.8	65.0	17,441	38.1
2020	66.2	20,575	40.0	65.0	18,966	37.4
2025	67.0	22,498	41.2	65.0	19,492	36.5
2030	67.0	23,644	41.0	65.0	20,491	36.3
2035	67.0	24,987	40.9	65.0	21,652	36.3
<b>Scaled high earnings:<sup>f</sup></b>						
2012	66.0	24,891	35.5	65.0	23,255	33.8
2015	66.0	24,745	33.0	65.0	23,124	31.6
2020	66.2	27,252	33.1	65.0	25,122	30.9
2025	67.0	29,817	34.1	65.0	25,836	30.2
2030	67.0	31,337	34.0	65.0	27,159	30.1
2035	67.0	33,110	33.9	65.0	28,694	30.0
<b>Steady maximum earnings:<sup>g</sup></b>						
2012	66.0	\$29,902	28.7	65.0	\$27,762	27.4
2015	66.0	30,115	26.5	65.0	28,002	25.3
2020	66.2	33,338	26.5	65.0	30,619	24.7
2025	67.0	36,667	27.3	65.0	31,545	24.0
2030	67.0	38,600	27.2	65.0	33,207	23.9
2035	67.0	40,803	27.1	65.0	35,109	23.9

Source: Social Security Administration, 2012 Trustees' Report, Page 142.

the Social Security Administration.

To determine the estimated cost of an additional third-part safe private savings mechanism, we assume a 3 percent real return for maximum savings (\$5,000 under the proposed cap) for half of the whole elderly population. Because incomes are low and replacement rates are high for lower

and lower-middle income earners, they will either not have to or not be able to save, so we believe our estimate is a conservative one. An individual investing the maximum amount, compounded and annuitized over 37 years, will get an approximate disbursement of \$20,238. The total cost will be \$805.5 billion, or 3.2 percent of GDP.

Figure B.3: Replacement Rates and Benefit Levels, Social Security A and B, 2035, 60% AWI Replacement Level

Replacement Rate/Benefit Level	Category of earner (multiple of AWI)			
	Medium (100%)	Low (40%)	High (160%)	Maximum (250%)
Career Average Earnings (AWI)	\$61,093	\$27,466	\$97,670	\$150,565
Social Security B	19.1%	42.48%	11.95%	7.75%
<i>\$ per year</i>	\$11,669	\$11,669	\$11,669	\$11,669
Social Security A	40.9%	55.2%	33.9%	27.1%
<i>\$ per year</i>	\$24,987	\$15,161	\$33,110	\$40,803
<b>Total</b>	<b>60.0%</b>	<b>97.7%</b>	<b>45.9%</b>	<b>34.9%</b>
<i>\$ per year</i>	\$36,656	\$26,830	\$44,779	\$52,472

Figure B.4: Replacement Rates and Benefit Levels, Social Security A and B, 2035, 50% AWI Replacement Level

Replacement Rate/Benefit Level	Category of earner (multiple of AWI)			
	Medium (100%)	Low (40%)	High (160%)	Maximum (250%)
Career Average Earnings (AWI)	\$61,093	\$27,466	\$97,670	\$150,565
Social Security B	9.1%	20.2%	5.7%	3.7%
<i>\$ per year</i>	\$5,559	\$5,559	\$5,559	\$5,559
Social Security A	40.9%	55.2%	33.9%	27.1%
<i>\$ per year</i>	\$24,987	\$15,161	\$33,110	\$40,803
<b>Total</b>	<b>50.0%</b>	<b>75.4%</b>	<b>39.6%</b>	<b>30.8%</b>
<i>\$ per year</i>	\$30,546	\$20,720	\$38,669	\$46,362

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35. Natixis Global Asset Management, “[U.S. Lags Europe, Less Affluent Nations in Retirement Security](#),” Press Release, March 7, 2013.

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37. OECD (2011), “[Architecture of National Pension Systems](#)”, in *Pensions at a Glance 2011: Retirement-income Systems in OECD and G20 Countries*, OECD Publishing.

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39. Because the exhaustion of the trust fund will only allow Social Security to pay out 75% of scheduled benefits after 2033, maintaining benefits would require policy changes to meet this shortfall. For the purposes of this paper, we assume that this shortfall will be bridged; if it is not, and benefits drop, Social Security B’s flat benefit would have to be increased to maintain a replacement rate of 60 percent.

40. All dollar amounts in this report are in constant 2012 dollars, unless otherwise noted. For details on these calculations and specific tables from the Trustees' Report, see Appendix B.
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54. Social Security Administration, "[Annual Report of the Supplemental Security Income Program](#)," 2012, Table IV.B6.
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56. In Canada, for example, the universal program (Old Age Security, or OAS), is financed from general revenues. For more, see: Michael Wiseman and Martynas Ycas, "[The Canadian Safety Net for the Elderly](#)," *Social Security Bulletin*, Social Security Administration, Vol. 68, No. 2, 2008.
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# The Next Priority for Health Care: Federalize Medicaid

*Greg Anrig, Vice President of Policy and Programs, The Century Foundation*

In 1982, President Ronald Reagan proposed a grand bargain: the federal government would become entirely responsible for financing Medicaid in exchange for giving states responsibility for more than 40 other federal programs, including Aid to Families with Dependent Children – the primary welfare program that President Clinton and Congress would radically reform 14 years later.

Previously, in 1969, 1977, and 1981, the U.S. Advisory Commission on Intergovernmental Relations, which comprised officials in all levels of government, had recommended that the federal government assume full financial responsibility for all public assistance programs, including Medicaid. The Commission argued that its ideas would greatly improve an intergovernmental system that had grown “more pervasive, more intrusive, more unmanageable, more ineffective, more costly and above all, more unaccountable.”

Reagan’s plan entailed basically the opposite of what the commission suggested, moving programs to the states, with the important exception of Medicaid. The motivation behind Reagan’s proposal was ideological — the promotion of what he called “a quiet federalist revolution” aimed at removing the federal government from a wide range of domestic activities while discouraging states and localities from replacing Washington’s efforts. Even so, there was widespread agreement that radical change was needed to fix the nation’s deeply dysfunctional system of federalism.

The “sorting out” idea never gained much traction, however, largely because of opposition from state officials. Reagan ended revenue sharing, reduced grants to state and local governments, and slowed spending on Medicaid and other safety net programs. In addition, the large deficits created by his 1981 tax cuts and generous defense spending became an ongoing rationale for austerity.

More than three decades later, federal-state relationships remain no less dysfunctional. The tumultuous legal and political battles over implementation of the Patient Protection and Affordable Care Act (known as Obamacare or the ACA), which is scheduled to take full effect in 2014, have laid bare why America’s highly decentralized system of federalism impedes effective responses to national challenges.

## Where We Stand: Obamacare and the Move Toward Medicaid Centralization

The health care legislation extends coverage to the uninsured through two main channels, both of which were intended by Congress to intimately involve the states. One of these is an expansion of Medicaid, the state-administered insurance program for low-income Americans and nursing home residents that is jointly financed by the federal and state governments. The other is through the creation of so-called insurance exchanges, which are governmentally organized and regulated marketplaces where uninsured Americans and small businesses can shop for health plans while paying premiums that will be partially covered by the federal government.

On both the Medicaid and insurance exchange fronts, unforeseen developments have greatly bogged down progress, and the decentralized system has exacerbated some

of the issues. The Supreme Court erected the surprise Medicaid hurdle in Chief Justice John Roberts' ruling upholding the constitutionality of the Affordable Care Act, allowing states to opt out of the legislation's requirement to extend Medicaid coverage to Americans with incomes up to 138 percent of the poverty level. That decision opened up an escape hatch that at least 10 states have already jumped through and another five are leaning toward – with an additional 12 remaining completely undecided.<sup>1</sup> Even though states would likely end up saving money from expanding Medicaid due to reductions in what they currently owe to medical providers for non-Medicaid uncompensated care,<sup>2</sup> it is possible that as many as half of all the states will fail to adopt that foundational element of Obamacare upon its launch in 2014.

Even worse from the standpoint of feeding public hostility to the law are the roadblocks that have emerged to rolling out the insurance exchanges. In many respects, uninsured citizens will form their judgments of health care reform based on their experiences with those exchanges, much as taxpayer views about government are shaped by their interactions with motor vehicle departments, the Internal Revenue Service, and post offices. While exchanges have often been analogized to commercial websites like Expedia.com, they are far more elaborate operations requiring a regulatory apparatus whose responsibilities include determining about which plans to include and exclude from the exchanges.

Another central problem facing the exchanges is how to minimize “adverse selection,” which arises when certain plans or exchanges enroll a relatively high-cost group of beneficiaries that leads to escalating premiums. Preventing and responding to adverse selection is an enormously difficult regulatory challenge that is essential to keeping the new system from unraveling.

In addition, health insurance plans are inherently complicated, so developing user-friendly interfaces to clearly present options to consumers will be critical to minimizing aggravation and enabling people to make sensible choices. Moreover, the exchanges are the mechanisms by which consumers are supposed to be able to learn the amount of their government subsidies for premiums and whether they are eligible for Medicaid.

All of those responsibilities were expected to be daunting

for the exchanges under the best of the circumstances. Optimists had predicted that governors would have a strong interest in creating and managing their state exchanges effectively to receive credit from their constituents and avoid blame. But instead only 18 states have taken up the challenge so far, with at least 25 defaulting the responsibility to the federal government.<sup>3</sup>

Political opposition has played an important role in many of the decisions to cede responsibility to the federal government, but in some cases administrative obstacles and difficulties in reaching a consensus about how to manage the exchanges have also bogged down the process. As a result of so many states demurring or dithering over whether to create exchanges, the Department of Health and Human Services has been left with an unexpectedly colossal job for which it is ill-prepared and inadequately financed.<sup>4</sup> Notwithstanding all of these unanticipated impediments to its federalist components, the Affordable Care Act remains

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**Full nationalization of Medicaid would greatly enhance both the health of the American population and of the nation's system of federalism.**

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a major step toward a more centralized health insurance system. States that have opted out of expansion, mainly due to ideological opposition, are likely to experience intense political and economic pressure to eventually go along with the broadened eligibility threshold in exchange for federal largesse that would flow to health care providers and beneficiaries. Because the federal government will bear nearly 93 percent of the costs of Medicaid expansion from 2014 to 2022 – a much higher share than it provides for current enrollees – states that continue to resist will be depriving their residents and medical institutions relative to participating states in ways that are likely to become highly visible and difficult to sustain.<sup>5</sup>

As the lion's share of states come to adopt the new broader eligibility threshold and the higher federal matching rate that comes with it, the federal government will gain greater leverage to exert control over additional reforms to the program. The next major medical care legislation should carry

the centralizing shift in control over Medicaid to its logical conclusion – full nationalization of Medicaid – which would greatly enhance both the health of the American population and of the nation’s system of federalism.

## Saving State Budgets

Converting Medicaid into a national program like the superior Medicare model, which covers virtually all of America’s elderly through rules and payment schemes that are consistent throughout the country, would relieve state governments -- even the recalcitrant ones now resisting health care reform -- of what has genuinely become an unmanageable financial burden. Soaring Medicaid costs, driven by rising enrollments and many of the same forces escalating inflation throughout the health care sector, have ensnared most populous states in a chronic budget squeeze that relentlessly forces cuts in education, social services, and other essential state-level functions. Even though state revenues have rebounded somewhat as the slow recovery continues, forecasts show that most states can expect to remain austere indefinitely as they comply with balanced budget requirements that don’t apply at the federal level.

Setting aside the reform bill’s changes to the program, which impose a minimal new burden on states notwithstanding Republican rhetoric, Medicaid as a whole really does threaten to crush state budgets throughout the country unless responsibility for it is further shifted entirely to federal control where it belongs.

Federalization would end the wide disparities among states in the share of the cost they owe per beneficiary relative to the federal contribution – a longstanding historical artifact without logical justification. Although the Affordable Care Act attempts to minimize disparate fiscal impacts among states as they implement the law, large variations will remain in the state share of the cost per Medicaid recipient. Complex administrative difficulties will arise as a consequence of the new federal matching payment schemes, which full nationalization could ultimately eliminate.

In addition, transferring Medicaid’s financial burden and administrative responsibilities from states to the federal level would create major new opportunities for controlling medical costs while enabling a greater share of lower-

income Americans to receive better care. And because the federal income tax is much more progressive than state revenue systems, federalization would move a higher portion of Medicaid’s costs onto Americans who can better afford to bear them while reducing administrative costs through economies of scale.

Politically, state-level unhappiness over both the mandated Medicaid changes in the health care legislation and the program’s central role in the chronic state fiscal quagmire has the potential to eventually unite red and blue state leaders in a push for federalization. With enrollment of non-elderly Americans in Medicaid and the CHIP plan for children projected to increase by about 25 percent, to 43 million, by 2022 even after taking into account the negative impact of the Supreme Court decision,<sup>6</sup> the program’s myriad shortcomings can be expected to attract greater public attention and scrutiny than in the past. While it has long been apparent to most policy analysts that those flaws largely derive from Medicaid’s bifurcated federal-state status, Medicaid’s centrality to the health reform bill may well lead a critical mass of political constituencies to recognize that the unavoidable next step for reform is federalization. States’ rights advocates may come to see that shedding Medicaid obligations through federalization would liberate state governments to pursue their own goals more freely while cutting state taxes. Even some deficit hawks worried about the federal debt, who can be expected to be the strongest opponents of federalization, may be persuaded that Congress can better constrain Medicaid’s costs when it fully controls the program. However the politics of the issue plays out, the changes set in motion by the Affordable Care Act are likely to build an even stronger substantive and political case than previously existed for federalizing Medicaid.<sup>7</sup>

## Following the Money

Obamacare’s heavy reliance on states to carry out reforms to cover the uninsured, including the creation of state-based insurance exchanges along with the Medicaid expansion, perpetuates the nation’s long history of decentralized support for the disadvantaged. Before the New Deal, domestic federal spending was only about 20 percent of state and local outlays.<sup>8</sup> Only the old age pension provisions of the 1935 Social Security Act devised an entirely federal system, while funding and implementation responsibilities

were shared between the national and state governments with respect to unemployment insurance and supports for needy women, children, and the elderly. Race loomed large in the Congressional debates leading up to the creation of America's social insurance system, with representatives of southern states largely winning their demands to retain control over determining eligibility and benefit levels to prevent interference in how they addressed "the Negro question."

That pattern continued as federal support for medical care evolved, beginning with 1950 amendments to the Social Security Act authorizing federal payments for health care expenses of individuals deemed needy by states. The 1960 Kerr-Mills Act, which extended coverage to "medically indigent" individuals over 65 not receiving Social Security's old age assistance, established a "federal matching percentage" ranging from 50 to 80 percent of state outlays, varying inversely with a state's per capita income. That basic formula became enshrined in Medicaid upon its enactment five years later, with a top matching rate of 76 percent for the poorest states, and essentially continues to this day. Arkansas Democrat Wilbur Mills, the fiscally conservative chairman of the House Ways and Means Committee, designed Medicaid to be both independent of Medicare and administered through a joint federal-system in part to prevent Medicare from becoming the "entering wedge" for a nationwide "compulsory" system of health insurance for everyone.<sup>9</sup> The upshot is that the least populous and economically poorest states, which are apt to be most disdainful toward the federal government, also receive a disproportionate share of national support for Medicaid. Indeed, most of the states opting out of Medicaid expansion would receive substantially more per capita from the federal government than those that are adopting the broader eligibility provisions.

The Children's Health Insurance Program (CHIP), created in 1997 to extend coverage to kids from low-income households not eligible for Medicaid, has higher federal matching rates ranging from 65 percent to 83 percent. Those levels have the effect of reducing the cost to a state of covering a child by 30 percent when compared to the regular Medicaid matching rate. Although CHIP is a companion program to Medicaid, it differs in that it makes a capped amount of money available to states as a block grant each fiscal year.

Under the Affordable Care Act, the federal government will pay the entire freight from 2014 to 2016 for individuals who become newly eligible for Medicaid under the mandated standard of 138 percent of the federal poverty level, almost all of whom will be childless adults. That matching rate gradually ratchets down to 90 percent by 2020, where it will remain thereafter. The law also includes provisions providing some financial relief to relatively generous states that already allowed low-income adults without children to enroll in Medicaid. Otherwise, they would essentially be punished for their past generosity with much lower federal matching rates for existing beneficiaries than states that never covered childless adults will receive. At least seven states – Arizona, Delaware, Hawaii, Maine, Massachusetts, New York, and Vermont – will receive enhanced matching rates for childless adults who had been enrolled in Medicaid as of December 1, 2009. (In addition, beginning in October of 2015, states will receive an increase of 23 percentage points -- up to a maximum of 100 percent -- in their CHIP match rate.)<sup>10</sup>

While it's laudable that the health care legislation's much higher matching federal rates for new enrollees includes some supplemental assistance for states that paved the way to reform, the wide assortment of payment levels both among and within states, and from one year to the next, defies any sane non-political justification and poses all kinds of costly administrative headaches. Why, say, should the federal government pay the full cost of a newly eligible 35-year-old man in Arkansas earning 125% of the poverty level while requiring California to foot half the bill for a pregnant woman with the same income?

Greatly compounding the confusion is the fact that many individuals who were already eligible for Medicaid under a state's existing rules but who only sign up later as a result of the legislation's individual mandate, new outreach measures, or some other factor, may not receive the higher federal matching rate. Particularly for enrollees with incomes near a state's previous eligibility threshold as of the December 2009 cutoff date, sorting out the appropriate payment level after the new system takes effect in 2014 will be difficult. The federal Center for Medicaid and CHIP Services has been working with states to develop alternative methodologies to make such eligibility determinations, but there will be no simple solution.<sup>11</sup>

In manipulating the federal matching formulas to induce

much higher Medicaid enrollments and cooperation from states, Congress has twisted the system's always problematic payment scheme into contortions that may no longer be workable. One undeniable argument for complete federalization is that it would in one fell swoop eradicate the impossible-to-defend, difficult-to-implement variations in state financial responsibility for Medicaid enrollees across the country. That the health care act initially provides full federal funding for new enrollees in order to maximize state cooperation and recruit as many beneficiaries as possible in its own right suggests that eliminating the state financing obligation altogether is the path toward making the entire system work better.

## Medicaid's Flaws

In addition to Medicaid's wide variations in matching rates and eligibility criteria, the program has long been plagued by other shortcomings that the Affordable Care Act attempts to redress to some extent, but which would much more effectively be resolved under full federalization. Those problems include states failing to enroll residents who are eligible for coverage, constraints that limit the access of Medicaid beneficiaries to decent care, rapidly rising costs that are the single biggest cause of chronic state budget shortfalls, and poor coordination of services for high-cost individuals covered by both Medicare and Medicaid. Briefly, here's why building on the health care reform act to move further toward full federalization would be even more effective at overcoming those problems:

### Enrollment Gaps

Before welfare reform in 1996, eligibility for Medicaid was linked to qualifying for Aid to Families with Dependent Children, which stigmatized Medicaid and connected it to an enormously cumbersome application process and hostile bureaucratic culture. Although some states have made great strides since then in streamlining Medicaid's sign-up procedures and reaching out to enroll eligible low-income pregnant women and children, a large proportion of those who qualify for coverage remain uninsured.

A 2008 study by the National Institute for Health Care

Management Foundation concluded that about one in four non-elderly Americans without health coverage, or about 12 million people, were eligible for Medicaid or CHIP but not enrolled in them.<sup>12</sup> Another report by the Kaiser Commission on Medicaid and the Uninsured, which focused on 13 states, found wide variation in enrollment rates among them, with Mississippi at the low end covering only 36 percent of residents eligible even under its very limited criteria.<sup>13</sup>

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**Medicaid has long been plagued by shortcomings that the Affordable Care Act attempts to redress to some extent, but which would much more effectively be resolved under full federalization.**

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The health care bill includes reforms intended to substantially increase Medicaid take-up rates, including the individual mandate requiring everyone to sign up for some kind of coverage to avoid a fine. Other constructive provisions in the legislation include elimination of asset tests that many states still apply in determining eligibility of adults, adoption of a uniform method for determining income eligibility (called modified adjusted gross income) in contrast to widely varying systems among states, and greater state discretion to presume individuals are eligible with minimal paperwork. In addition, the law requires states to establish a website through which residents can apply for Medicaid or CHIP as well as the coverage offered in state-based exchanges.

In the aftermath of health care reform's enactment, Kaiser and Lake Research Partners interviewed Medicaid program directors and other experts on questions related to improving outreach and enrollment in the program. The consensus view was that the legislation presented an opportunity to foster a new "culture of coverage" and recast the program as the source of affordable coverage for working people and families -- in contrast to its stigmatized past. Some states, thanks largely to CHIP and its extension of coverage to children from families with incomes significantly above the poverty level, made important progress in simplifying Medicaid enrollment and renewal processes

for children. Doing the same for adults, the Kaiser report argues, will require a “culture shift...to reorient Medicaid management, systems, and caseworker training away from welfare-style ‘gatekeeping’ and toward encouraging participation.”<sup>14</sup>

Transforming any culture, particularly in a state governmental bureaucracy, is inherently slow and uncertain work that at a minimum requires leadership committed to changing the ways that employees view their jobs. Notwithstanding all of the sound reforms in the health care bill intended to streamline the Medicaid enrollment process, many states, especially those balking at Medicaid expansion, may not be dedicated to undertaking changes in their bureaucratic culture because their top officials resent everything about the law. The federal government can try to encourage those states to reach out to newly eligible low-income adults, and even finance almost the entire cost, but there’s every reason to expect recalcitrance that will leave large gaps between Medicaid eligibility and actual enrollment. Only full federalization could overcome that basic problem by transferring ultimate responsibility for administering the program to federal authorities.

### Limited Access to Quality Care

Because federal rules define categories of services that Medicaid must cover, and because the stimulus and health care bills have temporarily prohibited states from weakening their eligibility criteria, states facing budget shortfalls are left to reduce Medicaid spending mainly by squeezing the rates they pay to medical care providers and cutting back coverage of non-mandatory services. In the years following the Great Recession, most states significantly cut Medicaid provider rates and benefit packages. Only in fiscal 2013 has that pressure on reimbursement levels and benefits finally begun to abate.<sup>15</sup> Those reductions and constraints have had the effect of limiting the treatment options available to many Medicaid beneficiaries.

A study by Sandra L. Decker of the National Center for Health Statistics found that in 2011, 31 percent of physicians were unwilling to accept any new Medicaid patients, compared to 17 percent unwilling to accept new Medicare patients and 18 percent privately insured patients. Controlling for other factors, acceptance rates of new Medicaid patients were lower in states with lower Medicaid

to Medicare fee-for-service fee ratios. The state with the lowest percentage of physicians accepting new Medicaid patients was New Jersey (about 40 percent), which also has the nation’s lowest Medicaid-to-Medicare fee ratio.<sup>16</sup>

Other studies have determined that the care of Medicaid patients has become increasingly concentrated among a relatively small proportion of doctors who tend to practice in large groups, hospitals, academic medical centers, and community health centers. Some of those hospitals receive higher reimbursements provided by the federal government for treating a “disproportionate share” of Medicaid and uninsured patients. Researchers Peter Cunningham and Jessica May didn’t assess the quality of care in those centers, but concluded, “If these Medicaid providers experience increased financial pressures and rising patient demand, quality of care and access to some services could be negatively affected.”<sup>17</sup>

In 2008, Medicaid’s reimbursement levels to health care providers nationwide were only 72 percent of those for Medicare. In New York, New Jersey, and Rhode Island, they were less than half of Medicare’s rates. Not coincidentally, New York also ranked dead last among the states in preventable hospitalizations and poorly on other measures of health care quality by the Commonwealth Fund, even though its Medicaid program covers a broader array of services than most states offer. A variety of forces contribute to New York’s bad record, but low reimbursement rates are an important factor partly because they lead many Medicaid patients to be treated in overcrowded institutional settings that often fail to offer adequate individual attention.<sup>18</sup>

Many states also have been cutting back Medicaid support for particular services, leaving low-income individuals with special needs in the lurch. Among the most vulnerable are the disabled and those with mental health issues. Even though the average cost for disabled Medicaid patients has declined relative to inflation over the past 15 years as institutional care for them became supplanted by less costly in-home services, many states desperate for savings have reduced coverage of home-based care. In addition to creating hardship for the patients, those reductions ultimately could boost Medicaid costs by forcing some of those individuals to return to institutions.<sup>19</sup>

The health care bill includes a number of constructive changes aimed at helping to address these access problems

for Medicaid patients. For example, it requires states to pay full Medicare rates for primary care services in 2013 and 2014, with the payment increase entirely financed with federal money. It also provides additional funds for community health centers, which provide care for many Medicaid patients. Typically, they are found in low-income areas, are open “after hours,” and can serve as an alternative to the emergency room. When a Medicaid patient receives basic care in an emergency room, the bill is needlessly inflated by the costs of ER’s technological equipment -- which may not be needed for patients suffering from relatively minor problems. Community clinics can save money while giving Medicaid patients continuity of care in a setting better suited to their needs. Unfortunately, these clinics are also highly vulnerable to federal and state budget cuts, as Congress demonstrated in 2011 by reducing the money initially made available in the Affordable Care Act for new centers.

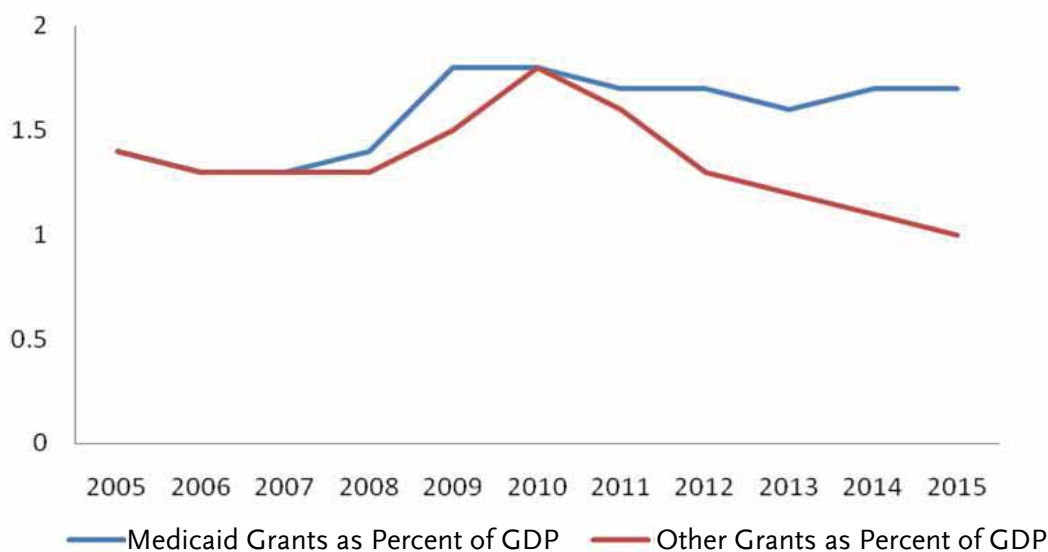
In and of itself, the sizeable and sometimes yawning gaps between Medicare and Medicaid reimbursement rates to health care providers sustains Medicaid’s status as a second-tier welfare program. With states likely to remain under relentless budgetary pressures, they can be expected to continue to look for savings through relatively blunt and painful Medicaid cuts that primarily affect low-income residents who lack political clout.

Federalization wouldn’t eradicate those political forces by any means. But it would help to greatly reduce the fragmentation in the health care system that creates so many inefficiencies and inequities, including the poor access to high-quality care available to Medicaid beneficiaries in many states. Setting reimbursement levels at the federal level has helped Medicare to sustain a much higher degree of provider participation and enthusiasm than Medicaid has experienced. Federalization would greatly increase the probability that Medicaid reimbursement levels would be linked nationally to Medicare’s, reducing state-to-state variability in access to quality care while broadly improving it across the country.

### Soaring Costs

Like private health insurance and Medicare, Medicaid has experienced cost increases well in excess of overall inflation during most years of the past few decades. In part, the same forces that have driven soaring medical inflation throughout the U.S system are responsible, including rapid adoption of expensive new technologies and the prevalence of fee-for-service compensation that rewards the performance of procedures that are often not medically necessary or appropriate. But Medicaid’s costs also climbed rapidly before leveling off because of large enrollment increases arising from the recession, which knocked

Figure 1: State and Local Government Grants, as a Percentage of GDP



Source: Historical data are from the Bureau of Economic Analysis, NIPA. GAO simulations are from 2010 - 2015 based on current policy.

incomes beneath eligibility thresholds for a larger share of the population.

The improving economy in fiscal 2012 helped to reduce the overall increase in total Medicaid spending to 2.0 percent as enrollment growth plummeted and health care costs generally flattened out.<sup>20</sup> While some analysts have expressed optimism that industry-wide adjustments in anticipation of the Affordable Care Act's full implementation are already helping to contain costs, broader economic forces seem most likely to be responsible for the recent lull in medical inflation.

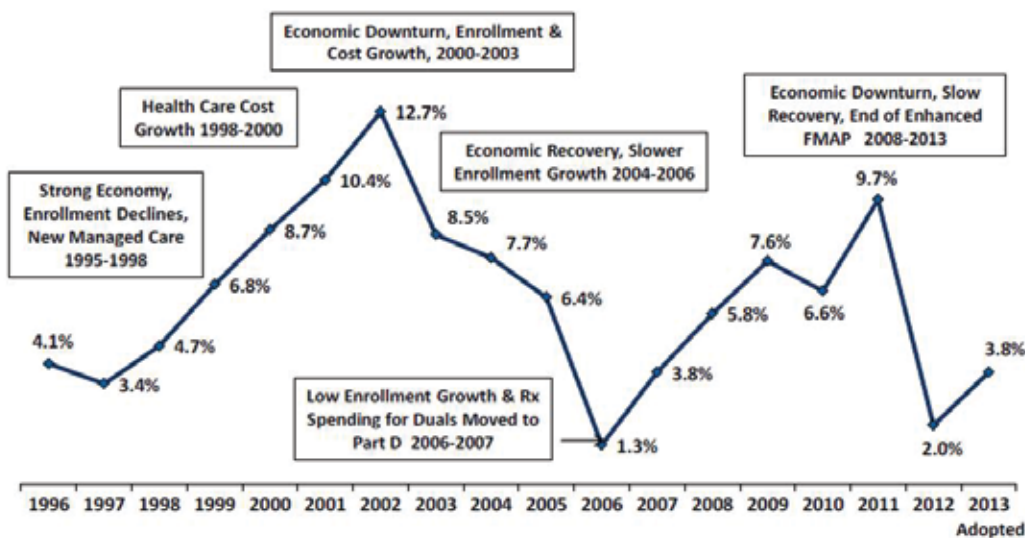
One of the most universally praised elements of Obamacare, even from some Republicans who opposed it, is its inclusion of provisions intended to simultaneously control costs while enhancing the quality of care. Those changes largely focus on Medicare, since it's the program over which the federal government can exert the most control. Innovations like the creation of an Independent Payment Advisory Board to make cost-effectiveness recommendations for Medicare, adjustments to Medicare payment changes tied to the productivity of providers, and numerous other large and small experiments have the potential to help achieve the Obama administration's goal of "bending the health care cost curve."

Whichever of those cost-control strategies turn out to

work best would be much more powerfully transmitted throughout the health care sector if they could be applied nationwide to Medicaid as well (some states are emulating various cost-savings ideas). One long-standing difficulty with the nation's past unsuccessful efforts to rein in costs has been the system's propensity to react like a squeezed balloon: controlling spending in one realm can lead to expanding outlays somewhere else in the system. For a time in the 1990s, the increased adoption of managed care plans by private insurers helped to hold down their costs, but Medicare simultaneously experienced more rapid inflation. Before that, changes in Medicare that succeeded in constraining its costs coincided with soaring spending in the private insurance market. If successful cost-control tactics could be carried out together by Medicare and Medicaid, the federal government would have greater leverage over the entire balloon. But that would only be possible to implement in earnest if Medicaid were to be fully federalized.

In the absence of federalization, projections by the Government Accountability Office show that state governments will be squeezed in an ever-tightening budgetary vise even after the economy fully recovers. Even though the new health care bill in its own right won't add much pressure, the ongoing Medicaid responsibilities for states (as well as their pension and medical insurance commitments to current and former state workers) will be so bur-

Figure 2: Total Medicaid Spending Growth, FY 1996 - FY 2013



Source: Kaiser Family Foundation, "Medicaid Today." Data for FY 2000-2011 - Historic Medicaid Growth Rates, KCMU Analysis; FY 2012-13, KCMU survey conducted by Health Management Associates, 2012, <http://www.kff.org/medicaid/upload/8380.pdf>.

densome as to leave them in a perpetual austerity mode. With all states but Vermont legally obligated to maintain balanced operating budgets each year, the GAO calculated that closing the projected fiscal gaps would require action to be taken today and maintained each and every year going forward equivalent to a 12.7 reduction in state and local government expenditures – or comparable tax increases.<sup>21</sup> For state budgets, health care commitments are like Otto, the relentlessly expanding pet goldfish in the children’s book.

The Congressional Budget Office projects that state spending for Medicaid and CHIP would amount to about \$2.6 trillion from 2014 through 2022 without health care reform plus another 2-3 percent more to be added because of the legislation.<sup>22</sup> But while deficit hawks will recoil at the thought of shifting that burden from the states to the federal government, keep in mind five realities: 1) Americans have to pay the Medicaid bill one way or the other, whether out of their federal or state taxes; 2) because state sales, “sin,” and flat income taxes are regressive, low- and middle-income Americans bear a greater share of that cost than they would if it were paid through the much more progressive federal income tax; 3) constraining costs would be much more manageable under a system in which

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**In the absence of federalization, state governments will be squeezed in an ever-tightening budgetary vise even after the economy fully recovers.**

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one level of government bears full responsibility for the program’s success, in contrast to the divided federal-state accountability responsible for Medicaid’s myriad shortcomings; 4) because the federal government is not bound by balanced budget requirements that govern states, the widespread public health problems that worsen during economic downturns can be much more effectively mitigated; and 5) by relieving state budgets of Medicaid, governors would regain the flexibility to much more effectively manage their states.

If federalizing Medicaid seemed like a good idea to Ronald Reagan, who proposed it in 1982, Republicans and other

deficit hawks ought to think harder about the possibility rather than dismissing it out of hand.

## The “Dual-Eligible” Challenge

About 8.9 million Medicaid beneficiaries are enrolled in Medicare as well, according to the most recently available figures from 2007. About 60 percent of those “dual-eligibles” are frail elderly Americans with very low incomes, many of whom live in nursing homes. Most of the remainder are low-income individuals with disabilities. Although dual-eligibles constitute only about 15 percent of Medicaid enrollees, around 40 percent of the program’s spending is devoted to these especially unhealthy and impoverished individuals.<sup>23</sup> Medicaid pays for their Medicare premiums and cost sharing, as well as important benefits that Medicare does not cover like long-term care services.

Because dual-eligibles are among the costliest of Americans for the federal and state governments to insure, and because both payment structures and medical care for them tend to be highly fragmented, they are an important focal point for reform. The health care bill included numerous provisions intended to streamline care and coverage for dual-eligibles, including higher federal matching payments to states for creating a “single entry point system” for access to long-term care systems and supports, and applying standardized methods for determining eligibility for non-institutional services. Additional federal money is also available to states for facilitating the transition of nursing home residents to home- and community-based systems of care, among other incentives. Moreover, the legislation established a new office in the Centers for Medicare and Medicaid Services charged with improving coordination between the Medicare and Medicaid programs on behalf of dual-eligibles.<sup>24</sup>

While all of those reforms are constructive, their reliance on incremental increases in federal matching rates to induce changes in state policies toward dual-eligibles is a cumbersome, highly uncertain, and administratively costly lever to rely on. Some states will no doubt ignore the incentives entirely, while others will pick and choose among them, once again yielding highly scattershot outcomes across the country. Here, too, the legislation moves in the right direction while underscoring that Medicaid

federalization would be a much more reliable, effective, and cheaper way to achieve the desired results.

## The Road to Federalizing Medicaid

Unfortunately, debates over America's fiscal condition invariably focus on the outlook for the federal budget while neglecting how any sensible accounting of governmental revenues, outlays, and debt ought to integrate states and localities as well. In America's highly decentralized system of government, federal and state budgets are inextricably intertwined in myriad complex ways. But one basic reality is quite simple: the central fiscal problem confronting both the federal government and the states is the prospect of a continuation of rapidly rising health care costs. Viewing that challenge through the rarely used lens of federalism rather quickly clarifies that one of the most promising strategies for controlling those costs in ways that would ultimately strengthen the fiscal condition of both levels of government would be to federalize Medicaid. For the states, relieving them of the number one obligation causing their financial distress would enable them to regain the capacity to function much more effectively. For the federal government, taking over Medicaid would entail large new outlays, but it would also create much greater leverage in directly confronting the underlying problem of soaring medical inflation. In the process, the cost of providing health care to lower-income Americans would shift toward those who can most afford it under the federal government's more progressive tax structure. Not incidentally, more citizens would be likely to receive better care in good times and bad regardless of what state they live in.

The Affordable Care Act, which pushed Medicaid in the direction of federalization across the broad array of fronts summarized in this brief, demonstrates that there is political support to at least move in that direction. And the opposition of many conservative states to the legislation's Medicaid mandates suggests that at least some conservatives might be persuaded that, from a state's rights perspective, complete federalization would be preferable to more mandates. The primary political challenge will be to convince deficit hawks that federalization is one of the most promising strategies for controlling health care costs, which in turn is far and away the best way to improve the long-term fiscal outlook at all governmental levels. In that

context, a politically acceptable approach for financing the added federal costs would need to be agreed upon, as it was for the health care bill with its higher taxes on investment income and costly employee health insurance plans. Part of that sales job will include emphasizing the corresponding reductions in state taxes relative to what they would otherwise need to be.

Logistically, there are two primary approaches that should be pursued to phase in federalization of Medicaid. One entails federal assumption of the full cost of dual-eligible Medicaid and Medicare beneficiaries, and the other involves ratcheting up federal matching payments for Medicaid and CHIP until the 100 percent threshold is reached. In both cases, a variety of alternative steps could be pursued to make the transition as the federal government takes over increasing responsibility for the program's implementation:

### Assuming the Cost of Dual-Eligibles

Researchers from the Urban Institute and the Robert Wood Johnson Foundation calculated that fully 80 percent of the cost of dual-eligibles is already covered by the federal government, with the states paying \$62.7 billion of the \$319.5 billion spent on those individuals in 2011. More than 70 percent of the state outlays are directed toward long-term care services.<sup>25</sup>

In and of itself, federalizing only the dual-eligible population would provide substantial financial relief to the states while greatly enhancing opportunities to improve coordination of the care of these especially unhealthy and poor individuals. And because they are unusually expensive as well, implementing cost-effectiveness strategies nationwide – especially with respect to long-term services – could help to make a significant dent in overall health care inflation. The Medicare Payment Advisory Commission estimated that shifting dual-eligible patients from Medicaid-financed nursing benefits to Medicare-financed hospital and skilled nursing facility benefits could potentially reduce costly rehospitalizations between 18 percent to 40 percent.<sup>26</sup> Concentrating accountability at the federal level would create a much more transparent and robust regulatory environment for improving the system over time.

## Ratcheting up Matching Rates

The health care reform bill's full federal funding for newly eligible Medicaid beneficiaries from 2014 through 2016 puts a foot in the federalization door that the Obama administration and Congress should try to walk through with the next round of reforms. Instead of implementing the slight reduction in federal support for those individuals beginning in 2017, the 100 percent rate for newly eligible enrollees should be made permanent. And to rationalize Medicaid's jerry-rigged payment system at long last, matching rates for everyone else should also be increased over time so that ultimately the federal government pays full freight for everyone.

One way to do that would be to restore the higher matching rates that were temporarily put into effect in the stimulus legislation that Congress enacted during the financial crisis. Then, after a period of time, those rates could be further increased until every state's beneficiaries were fully covered by the federal government. Raising the existing baseline rates across the board by the same number of points would help to minimize infighting among the states. Alternatively, Medicaid matching rates could be raised to the higher post-health care reform CHIP levels as a next step, and then increased from there until full federal funding is reached.

Although states are projected to spend about \$2.7 trillion on Medicaid from 2014 through 2022, the price tag of federalization could be reduced significantly below that figure by gradually phasing in the changes beginning in that period and extending into the next decade. Still, the cost to the federal government will be significant, just as the savings will be to the states.

Financing the transition to Medicaid's federalization and then sustaining a sufficient level of support going forward should probably entail some combination of an additional source of revenue deriving from upper income taxpayers coupled with a modest payroll tax increase on all workers that would be earmarked for services provided to current dual-eligibles. Because taxing income from investments at the same rate as income from work would enhance both the fairness and simplicity of the tax code, and would emulate changes made under President Reagan in 1986, that reform would be sensible policy in its own right and would go a long way toward financing the transition to Medicaid

federalization. The recent tax code changes reducing the favorable treatment of capital gains and dividend income are an important step in that direction, though the additional revenue is not earmarked for any purpose.

Although raising the existing Medicare payroll tax to help finance the transition to Medicaid federalization would be an arduous sell politically, targeting an increase to pay for long-term care services would be more plausible than a hike to cover the broader Medicaid population. Since literally anyone can end up near destitution due to a disease like Alzheimer's or other severe disabilities, the rationale for requiring all workers to pay into the long-term care protections in the social insurance system is similar to that underlying the universal coverage of Social Security and Medicare. A payroll tax rate increase of about 0.5 percent would be roughly sufficient to cover the costs of merging dual-eligibles into Medicare, which in turn is a little less than half the cost of full federalization of Medicaid.

All Americans would ultimately benefit from a much more effective system for providing health care to its most vulnerable citizens, including low-income children, because today's jerry-rigged, scattershot approach is a drain on the economy and is killing state budgets. Increasing federal revenues to pay for the transition would ultimately produce widely shared benefits extending far beyond Medicaid's current and future beneficiaries. By helping to bring overall medical inflation under control, federalizing Medicaid would ultimately pay for itself by squeezing out much of the rampant waste in the existing system.

## Conclusion

Federalizing Medicaid would by no means be sufficient to repair all that ails America's health care system, which will remain deeply flawed even after the Affordable Care Act is fully implemented. But it's an essential next step to further move toward reducing the fragmentation that lies at the heart of the dysfunction. If Medicaid were to be federalized, that would create new possibilities for later merging it with Medicare, or a new public insurance plan that would be made available to everyone on the state insurance exchanges. Reducing the isolation of Medicaid's stigmatized population by integrating them into a system that serves the non-poor as well has the potential to improve their health and overall cost-efficiency even more.

Sooner or later, America's historical enthusiasm for decentralized governance will give way to the recognition that our system of federalism has become broken and unsustainable. Health care is the one realm of public policy

where fairly straightforward, if politically challenging, reforms could make all levels of government work better while restoring their fiscal health.

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# Front Line of Defense

## Building a New Unemployment Insurance System

*Steven Attewell, PhD Student in Policy History, University of California - Santa Barbara*

One of the first casualties of the 2007 recession was in the realm of ideas. Prior to the economic collapse, Fed Chairman Ben Bernanke had confidently proclaimed an end to economic catastrophes. The advent of modern central banking and the liberalization of financial markets, he argued, had ensured that the kinds of systemic failures last seen in the Great Crash of 1929 would never happen again. Future recessions would be mild and short-lived, as central banks would spring into action to head off panicking markets, and the “automatic stabilizers” of the welfare states of the developed nations would kick in to prevent a panic from turning into a long-term slump in demand.

The last six years have taught us many lessons to the contrary. One of the things we have learned from the Great Recession is that America’s hybrid state/federal unemployment insurance (UI) system is essentially broken. The unusually sharp job losses – some eight million jobs lost from the outset of the recession in 2007 to the nadir of job losses in 2009 – caused a sharp decline in consumer spending of all kinds. For example, sales of motor vehicles and parts fell by an average of 10.3% during 2008 and 2009, furnishings fell by an average of 6.3%, and transportation services by an average of 7.55%.<sup>1</sup> One of the purposes of our UI system is to prevent sudden downturns in employment in particular sectors, like construction or financial services, from turning into sudden declines of consumer demand that lead other sectors to start mass layoffs of their own.

And yet our UI system largely failed to counteract this slump. Most workers are not eligible, and many of those who are eligible do not get enough to keep themselves and their families out of poverty. States routinely exclude millions of workers from coverage and deliberately underfund UI systems that they are structurally incapable of operating in the midst of a recession.

If the U.S. is to truly recover from our current Great

Recession, and prepare for future downturns, we need to take action to reform UI now.

### What is Wrong with UI?

When the architects of the Social Security Act designed our unemployment insurance system in the winter of 1934, they were hampered by structural constraints that do not exist today. They sought to cover a very different workforce, in which 10 million workers still worked in agriculture and 14 million or more workers flocked into ever-growing factories. In addition, the members of the Committee on Economic Security (CES) were vividly aware that they had to design a system that could pass review by a Supreme Court that had already struck down minimum wage and maximum hours laws as violations of “liberty of contract,” and was currently considering doing the same to the Agricultural Adjustment Act and the National Recovery Act.

In the face of this expected hostility, CES staff members could not design a simple unemployment insurance (UI) system, financed by a single federal tax and managed solely

by a national Social Security Board. Instead, they designed a complicated workaround in which a federal “regulatory” tax would be forgiven if states enacted their own unemployment insurance systems. This elaborate system was deemed acceptably federalist by the Supreme Court.

The system that we know today – where 50 states operate their own UI systems, each setting a different payroll tax rate, eligibility standards, and benefit levels – was not a decision made on principle by all-knowing Founding Fathers. Rather, it was a nakedly tactical choice made by Roosevelt administration officials who would have preferred to design their system along the same national lines as Old Age Insurance (Social Security). Unlike the new program of Old Age Insurance, however, unemployment insurance had to deal with state institutions already in place. Concerns about a separate federal system that might override or conflict with existing state systems being constitutionally suspect in the eyes of the Supreme Court led to the complicated “forgiven” regulatory tax system to fund UI.

From the beginning this design created a dangerous vulnerability within the UI system. Because 49 states have a constitutional requirement for balanced budgets and 27 states have constitutional limits on borrowing, states lack the federal government’s ability to resort to deficit spending in recessions.<sup>2</sup> When recessions hit, states find themselves in an impossible bind. As consumption declines, sales tax revenue plummets; as businesses shed jobs and go out of business, corporate income tax revenue declines; as workers find themselves without steady paychecks, individual income tax receipts fall; and when millions of homes and business offices go into foreclosure and the real estate market collapses, so too does revenue from property taxes. While state governments stagger under the burden of sudden deficits, millions of previously-employed workers desperate for protection against total destitution increase the demands on unemployment insurance, thereby emptying state treasuries at a time when they are least able to respond.

What makes this worse is that the state-run nature of the UI system creates powerful incentives for states to underfund their UI Reserve Funds. Because states must fund their UI system with payroll taxes on local employers, reducing payroll taxes is often the first bargaining chip that states offer when trying to compete with one another to attract new

firms from out of state. The lower the payroll tax rate, the cheaper it is to hire workers. Corporations respond to the leverage they have over furiously bidding states to extract concessions so that they do not have to pay in at all, with the state covering their contributions.<sup>3</sup>

The result is a dangerous depletion of UI reserves. 35 states and the U.S. Virgin Islands had to borrow to cover UI payments during the period from 2008 through 2011, with total outstanding loans that “peaked at more than \$47 billion in mid-2010,” because they let their UI funds run dry.<sup>4</sup> Three years after the peak, twenty-three states still owe a combined \$28 billion.<sup>5</sup>

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### The state-run nature of the UI system creates powerful incentives for states to underfund their UI Reserve Funds.

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Many states have responded to their vulnerable position by restricting the number of workers who are eligible for UI.<sup>6</sup> This reduces the drain on the system at the expense of workers who will have no protection when they lose their jobs. By keeping contributing requirements high, and by requiring longer “Base Periods” (the length of time one has previously worked in order to be eligible for UI), states are able to keep lower-paid workers and temporary workers from gaining eligibility for state funds.

Similarly, by restricting eligibility to full-time direct employees, states exclude part-time workers and so-called “independent contractors” from coverage. To reduce labor costs, employers have responded to these changes by accelerating their project of replacing full-time workers into contingent ones by chopping full-time jobs into part-time jobs and by re-defining their workers as “independent contractors” even when they are working 100% of the time for one company. Looking to further reduce their costs in the current recession, employers have increasingly turned to professional UI claim-challenging firms.<sup>7</sup>

In addition to restricting eligibility, one of the ways that states have attempted to limit their exposure to sudden increases in UI costs is to keep their benefits as low as possible, replicating the insidious patterns of pre-New Deal poor relief. At the moment, Mississippi, Alaska, Arizona,

Delaware, Florida, Louisiana, Missouri, Puerto Rico, Tennessee, and Alabama pay average benefits that are below the federal poverty line for a single individual, and every state pays an average benefit less than the poverty line for a family of four with two children. Such low levels of unemployment benefits are clearly unable to support previous levels of consumer spending, meaning that these states' UI systems are failing as "automatic stabilizers" both for people who get benefits and people who do not. Liberal states like Massachusetts lack the fiscal capacity to do much more, paying an average benefit that falls nearly \$100 per week below the poverty line for a family of four.

The result of these dodges is a safety net that is mostly made up of holes. This means that a UI system that is supposed to protect everyone does not, which causes dramatic increases in recession-induced poverty; and a system that is meant to keep consumption from falling too far in recessions is fighting with one hand tied behind its back, which leads to dramatic slumps in consumer spending. When consumer spending falls faster than expected, businesses suffer and respond with frantic layoffs, which creates a downward spiral as newly unemployed workers cut back spending faster than employers can reduce labor costs.

This is unacceptable from a policy standpoint. Even in the best of circumstances, our current UI system is incapable of keeping consumer spending level – let alone increasing consumption to stimulate the economy. If we want a system that can really protect American workers from job losses and our economy from sudden collapse of demand, we are going to have to do a total refit of our unemployment insurance infrastructure.

## Bringing UI Up to Scratch

Luckily, much of the machinery required for creating a functioning unemployment insurance system already exists: Title III of the Social Security Act, which structures the current UI system, can be used to enact changes through the regular amendment process. We already have a federal unemployment insurance payroll tax system in the form of FUTA (which is a 6.2% "regulatory" payroll tax that is offset by state UI taxes down to 0.8%). We have federal agencies that are familiar with the program and how it works. In this, we have an advantage over the creators of

the Social Security system, who had to create this machinery *ab nihilo*.

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## Much of the machinery required for creating a functioning unemployment insurance system already exists.

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Our reconstruction of the unemployment insurance system should start from three basic principles. First, unemployment is a national problem for our single, national economy, and requires a nation-wide system to respond to it. Second, in order to protect the entire workforce from the sudden shock of wage loss and the economy from the sudden shock of consumer spending collapse, all workers need to be inside the system, contributing and protected. Third, unemployment benefits should be set at a sufficient level to keep individuals and families from falling into poverty and should be automatically extended in periods of economic decline and job losses when normal expectations that people can find new jobs no longer apply.

## One National System

In public policy, everything begins with financing. In order to save the UI system from the inherent weaknesses of state-level government, the federal contribution to unemployment insurance should be gradually increased. As it stands, the federal government contributes the entire cost of running state UI agencies and employment bureaus, as well as 50% of the cost of extended UI benefits (the stimulus bill has temporarily increased the federal contribution to 100% of extended benefits). This federal contribution could be increased in a series of steps from 25% of the regular UI to 50%, 75%, and eventually 100%. All that is needed to do this is to reduce the share of FUTA that is offset by state UI taxes, while decreasing state UI taxes in step until we have a national FUTA tax of 6.2%. At the same time, we can make the FUTA more progressive by eliminating the current wage cap (FUTA is only paid on the first \$7,000 in wages, which disproportionately burdens low-paid workers while giving the rich a much lower tax burden), and by varying the rate of taxation according to income level.<sup>8</sup>

By replacing 50 different state taxes with one national tax, UI would be greatly stabilized. Federalization would remove the incentive for states to compete for jobs by offering a lower UI tax rate and, by sourcing the financing of UI inside the federal government, would also give the system access to the federal government's ability to engage in deficit spending in a time of crisis. Likewise, establishing a single national UI Reserve with clear reserve requirements to prevent the fund from running dry in an emergency would be an enormous improvement in the program's stability. Ideally, in good economic years the UI system would accumulate positive balances that could be spent in recession years, allowing for counter-cyclical spending without large deficits.

It is important to note that making the UI system nationally-funded does not necessarily mean that the program has to be fully nationalized. A number of options are open: states could continue to administer a federally-financed and regulated UI program, UI programs could be run through joint federal/state agencies, or the program could become purely federally-administered.

### Universal Coverage of Workers

The extension of UI coverage to all workers would be the final culmination of a long historical process of inclusion. When the system was first established in 1935, the majority of workers were not eligible for unemployment insurance – notably, agricultural and domestic workers and seamen were not included.<sup>9</sup> While these exclusions disproportionately affected women and African-American workers, it was also the case that a majority of white workers were not eligible for UI at the outset. Eligibility was gradually expanded through a series of Social Security Act amendments over the years.

Most recently, the 2009 stimulus act included a provision known as the “Unemployment Insurance Modernization Act.” It offered \$7 billion in incentive money for states that adopted “Alternate Base Periods” that allow workers to claim eligibility for UI by counting their most recent earnings as opposed to the previous year's earnings, and agreed to cover part-time workers who are looking for full-time work and workers who leave work due to family emergencies. The ultimately-futile opposition of some conserva-

tive governors (not coincidentally from states with low UI taxes, underfunded UI systems, and low benefit levels) had as much to do with states trying to preserve a competitive advantage of low taxes and low labor costs as it did with presidential hopefuls looking to appeal to the conservative base through public defiance of President Obama.

This incremental process of expansion should be accelerated, with the ultimate goal being the inclusion of all hourly workers in the UI system, including full and part-time, temporary and permanent, and self-employed and “independent contractor” workers. At the very least, part-time and temporary workers should be able to claim benefits proportionate to what they would have been entitled to had they been working full time at their hourly rate.

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**The extension of UI coverage to all workers would be the final culmination of a long historical process of inclusion.**

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In addition to the participation eligibility standards, the current requirement that workers must accept any offer of work to remain eligible for benefits needs to be altered to prevent two abuses. First, claimants should be entitled to refuse work that is substantially below their current income. This is needed to prevent abuses by which employers engage in mass layoffs, offer to hire back their workforce at reduced wages shortly afterwards, and then use the ensuing refusals as evidence that their former workers have voluntarily refused employment and thus the employer is no longer obliged to cover their UI costs.

Second, claimants should be entitled to refuse work if they are in a bona fide labor dispute. This is needed to prevent abuses by which employers deliberately incur strikes and then threaten strikers with the loss of their UI benefits if they refuse to work as scabs and break the picket line. Our unemployment insurance was meant to be a system that lifted up American workers and gave them a sense of security so that they would not be completely vulnerable to unilateral decisions of their employers. To allow these abuses to continue would make a mockery of the spirit of the Social Security Act.

## A National Minimum Benefit

In order to prevent recession-induced poverty and to ameliorate recession-induced declines in consumer spending as much as possible, a minimum benefit should be established at the minimum wage rate of \$290 a week (\$13,920 a year).<sup>10</sup> At the peak of the Great Recession, a UI system that provided all of the 15 million officially unemployed with a minimum benefit of \$290 a week would have pumped in an additional \$226 billion into consumers' pockets, boosting consumer spending by 2.5%. The existing UI system, which includes state benefits and federal support programs, is only supporting 5.9 million workers.<sup>11</sup>

Providing benefits for all of the 12.3 million people who are currently officially unemployed (to say nothing of the 10-12 million additional unofficially unemployed) would increase consumer spending and spur job growth, making recessions shorter and less steep, thereby reducing the number of workers who would spend extended periods on unemployment benefit and the ultimate drain on our UI system. In addition, eligibility beyond the initial 26 weeks of benefits should be automatically extended during recessions or periods of widespread unemployment.

A further improvement that could be studied is the creation of an additional, contributory benefit for families on UI with children, in order to make up the \$237 per week difference between a minimum benefit that keeps a single individual out of poverty and a minimum benefit that keeps a family out of poverty. Such a program would provide a badly needed protection against families falling into poverty and requiring TANF assistance.

## Conclusion

If these three principles are enacted – nationalized funding, universal coverage, and higher minimum benefits – the U.S. will have a UI system that is up to the task of protecting workers from destitution and the economy from sudden shocks to consumer demand. However, we should be very realistic about what an “automatic stabilizer” can and cannot do – a revamped UI system will make recessions shorter and shallower, but it cannot prevent them; it will make layoffs less painful and should prevent some second-order job losses caused by falling consumer demand, but it cannot keep people from losing their jobs.

And in an economy that is increasingly structurally disposed to shed jobs in recessions and rely on productivity increases, casualization, mechanization, and off-shoring rather than rehiring during recoveries, even a high-quality UI system will only be a tourniquet on an open wound.

What would be needed for that larger problem is a system that can provide genuine economic security by creating incentives for employers to avoid or reduce mass layoffs. Seventy-three years ago, FDR spoke of the hopeful belief that “the Nation, seeing and understanding the injustice” was “determined to make every American citizen the subject of his country’s interest and concern.” The same challenge that FDR posed to the America of his day – “whether we provide enough for those who have too little” – remains unanswered today, and it remains to be seen whether we share the determination to grapple with injustice. 22 million Americans lack for work – and only six million of them have any kind of protection. Unless we act to protect the other sixteen million, and soon, we will have failed the test of progress.

## Notes

1. Bureau of Economic Analysis, National Income and Product Accounts, “Table 2.3.1. Percent Change From Preceding Period in Real Personal Consumption Expenditures by Major Type of Product,” <http://www.bea.gov/iTable/iTable.cfm?reqid=9&step=1&acrdn=2#>
2. “[NCSL Fiscal Brief: State Balanced Budget Provisions](#),” National Conference of State Legislatures, October 2010; “[State Debt Limits](#),” Montague DeRose, 2011.
3. Louise Story, “[As Companies Seek Tax Deals, Governments Pay High Price](#),” *The New York Times*, December 1, 2012.
4. Chad Stone and William Chen, “[Introduction to Unemployment Insurance](#),” Center on Budget and Policy Priorities, Updated February 6, 2013.
5. “[Trust Fund Loans](#),” U.S. Department of Labor, Employment & Training Administration, UI Budget, as of February 4, 2013.
6. For example, in 2011 alone, Arkansas, Florida, Indiana, Missouri, Pennsylvania, Rhode Island, South Carolina, and Wisconsin adopted new laws that increased minimum earnings standards and work-search requirements, stiffened disqualification provisions, excluded seasonal workers, and most famously if they refused to take drug tests. Source: Claire McKenna and George Wentworth, “[Unraveling the Unemployment Insurance Lifeline: Responding to Insolvency, States Begin Reducing Benefits and Restricting Eligibility in 2011](#),” National Employment Law Project, Legislative Update August 2011.
7. Peter Whoriskey, “[More Employers Fight Unemployment Benefits](#),” *Washington Post*, February 12, 2009.
8. Note: the ultimate outcome does not necessarily have to be a 100% federal contribution rate, although that would be the most successful at avoiding the structural limitations discussed above. UI could be reorganized similarly to Medicaid, with a 50/50 split, or with any other ratio.
9. Jyotsna Sreenivasan, *Poverty and the Government in America: A Historical Encyclopedia*, Vol. 1 (Santa Barbara, CA: ABC-CLIO), 2009.
10. Which is also 115% of the poverty line for an individual.
11. “Unemployment Insurance Weekly Claims Report,” U.S. Department of Labor, Employment & Training Administration, January 31, 2013, <http://www.dol.gov/opa/media/press/eta/ui/current.htm>; Bureau of Labor Statistics, “Table A-15, Alternative Measures of Labor Underutilization,” Household Data, Economic News Release, February 1, 2013, <http://www.bls.gov/news.release/empsit.t15.htm>.

# Paid Family Leave

*Lauren Damme, Former Senior Policy Analyst, Next Social Contract Initiative, New America Foundation*

Today's public policies to support working families are inadequate and out of date.<sup>1</sup> A system of social support designed for an era when the family with a single breadwinner and a homemaker was the norm is anachronistic in a time when most parents work outside the home. A central element of a new American social contract should be a new addition to the existing U.S. system of social insurance: a universal federal program of paid family leave.

In 1975, only 37 percent of families had two working parents; in 2008, that percentage had risen to 62% of families.<sup>2</sup> Today, there are over between seven and eight million single parents in the American workforce<sup>3</sup> and only a third of workers over 25 have been with their employer for over 10 years, but our safety net has not changed to support working single parents or workers who no longer have one lifelong employer.<sup>4</sup>

Even before these demographic changes occurred, support for working families was insufficient. Until the 1990s, Americans had no protection from losing their jobs if they had to take time off to care for a newborn or adopted child, a sick parent, spouse or sibling, or if they became ill themselves.

The Family and Medical Leave Act (FMLA) of 1993, passed by the Clinton Administration, changed that situation for millions of American workers. The FMLA allows covered employees to take up to 12 weeks of unpaid, job-protected leave per year for: pregnancy complications, caring for a new biological or adopted child, caring for a seriously ill immediate family member (including spouses, children, or parents), and as medical leave for themselves.<sup>5</sup> While the FMLA was a welcome addition to American labor regulations, it fell far short of addressing the needs of contemporary American families.

One problem is that a number of exclusions limit the cov-

erage of American workers. Workers must have been with their employers for 12 months and have worked at least 1,250 hours in order to be covered by the FMLA. In addition, employers with fewer than 50 employees within a 75 mile radius are not mandated to provide FMLA-protected leave. Employers with more than 50 employees can therefore avoid FMLA coverage by hiring short-term contractors and temporary workers who are not only ineligible for FMLA-protected leave, but are often unprotected by basic labor standards as well, such as overtime pay, minimum wage, and health and safety protections addressed in the Fair Labor Standards Act.

As a result of these shortcomings in coverage, almost half of the American workforce lacks job protection for FMLA-covered leave. According to the most recent estimate from the Department of Labor, in 2012, only 59% of all workers are eligible for FMLA protections.<sup>6</sup> Low-income workers are especially unlikely to be protected by the FMLA. According to the last comprehensive evaluation of the FMLA conducted in 2000, known as the Westat survey, only 38.6 percent of workers with an annual family income of less than \$20,000 were covered and eligible for FMLA leave, while 64 to 74 percent of families earning \$20,000 or more were covered and eligible.<sup>7</sup>

Even among those who are covered, the number of workers who take FMLA-protected leave is low. The Wage and Hour Division believes that between 3.2 and 17.1 percent of cov-

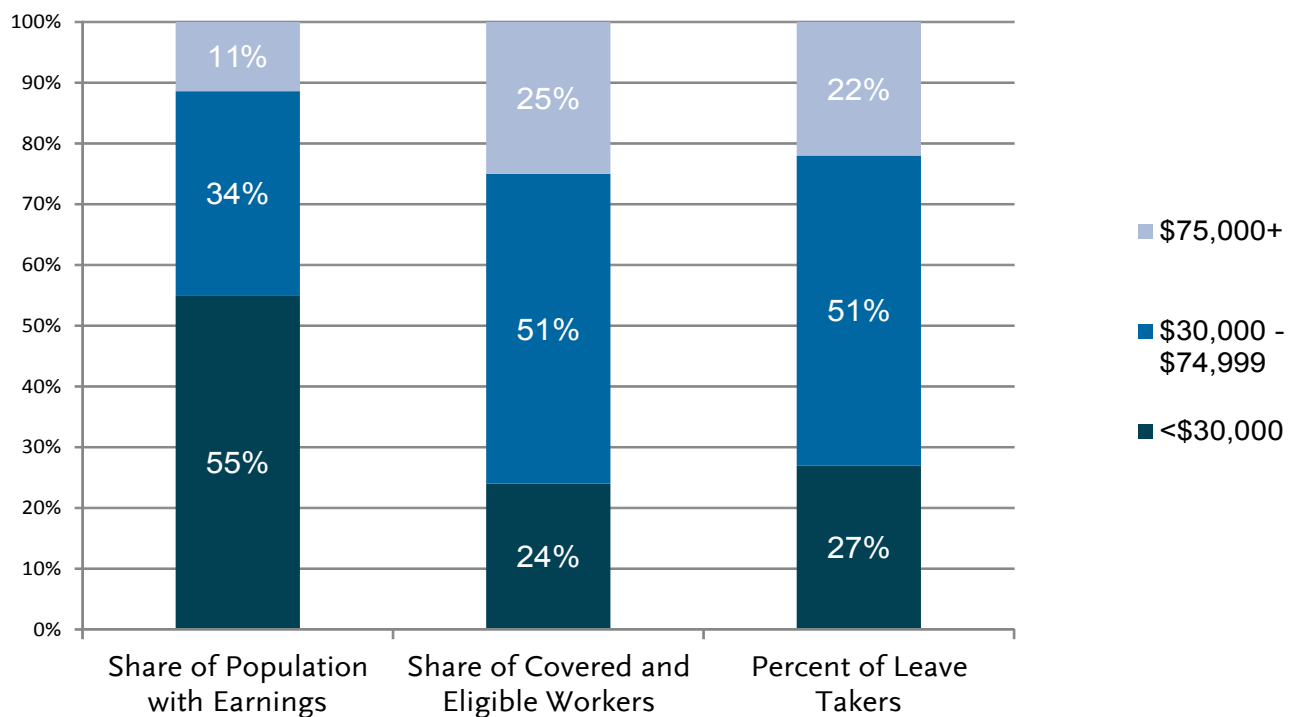
ered and eligible workers take FMLA leave, although the percentage of workers using leave varies by gender as well as the industry and size of the firm in which employees work.<sup>8</sup> The low percentage of leave-takers is not surprising in light of the significant evidence that employees are regularly discriminated against for taking time off to bear children – especially those with multiple children – or to care for frail family members.<sup>9</sup> The Department of Labor’s Wage and Hour Division enforces these protections, but as enforcement is based upon complaints rather than random evaluations, the odds of protection against unscrupulous employers are stacked against workers. One study found that between 18 to 21 percent of covered employers are not in compliance with the FMLA.<sup>10</sup>

Aside from issues of coverage and enforcement, the fact that FMLA leave is unpaid is its biggest weakness. This problem often makes coverage issues irrelevant for the many workers who, even if eligible, cannot afford to take unpaid leave.<sup>11</sup> Among those covered employees who need FMLA leave and don’t take it, 78 percent don’t take it because they can’t afford it.<sup>12</sup> Those low-income workers who *are* covered by the FMLA are the covered group

least likely to be able to afford to take unpaid time off.<sup>13</sup> For example, although those earning under \$30,000 per year represented 55 percent of the total U.S. earning population in 2000, this group represented only 27 percent of leave takers.<sup>14</sup> According to one survey, nine percent of leave-takers who receive less than their full pay during long leave were actually forced onto public assistance to make ends meet: a terrible situation for workers fulfilling duties to their newborn children or seriously ill family members.

Many single, low-income mothers fall into the group of those unable to afford unpaid leave. Leave-taking by all women with infants rose an estimated 23 percent after the FMLA came into effect,<sup>15</sup> and the FMLA has had large, positive effects on leave-taking among married women and women with a college education.<sup>16</sup> However, the FMLA has had no significant impact on leave-taking among single mothers or mothers without any college education.<sup>17</sup> This is not because single mothers and lower-income mothers need less time to care for their children and families; it is because they cannot afford to take unpaid leave which may also endanger their jobs.

Figure 1: Those Earning Under \$30,000 Per Year Less Likely to Take FMLA-Protected Leave



Source: Department of Labor, *Balancing the Needs of Families and Employers: Family and Medical Leave Surveys, 2000* ; U.S. Census Bureau, *Current Population Survey, 2010*

Because the FMLA leave covers parental leave, sick leave, and caregiving leave, new parents who take FMLA leave as parental leave forfeit their ability to take leave for their own serious illness or to caregive should they need time to care for a sick parent, sibling, or spouse. Of the 154million Americans in the civilian workforce in 2009,<sup>18</sup> 26 million (about 17 percent) had children under age 18 in 2009,<sup>19</sup> and about 37.5 million Americans over 18 years of age – about a quarter of the workforce – were estimated to be full or part time caregivers in addition to full or part time workers 2009.<sup>20</sup>

The need for caregiving, including caregiving by family members, will increase monumentally as the number of over-60 Americans grows from the current 18.4 percent of the population to 25.5 percent of the population by 2050.<sup>21</sup> As the demand for caregiving increases, more and more working parents will be torn between their jobs, being a good parent to their children, and caring for their own aging parents.

Although the Family and Medical Leave Act provided welcome protections for workers who need to provide care for their families or themselves, it is unpaid, poorly-enforced, and leaves far too many Americans – especially lower-income workers – uncovered or unable to take advantage of the job-protected leave it provides.

## Family Policy in Global Context

The U.S. is the only wealthy country in the world without a public system of statutory paid leave for workers who become parents. The Work, Family and Equity Index states that 169 countries of 173 countries studied offer paid maternity leave, and 98 countries offer at least 14 weeks of paid leave.<sup>22</sup> The U.S., along with Liberia, Papua New Guinea, and Swaziland are the only countries without paid maternity leave. In addition to maternity leave, 66 countries provide paid paternity leave, while the U.S. again offers none. The graph below compares the total weeks of leave available to new families with two working parents, including both unpaid leave and the ‘full-time equivalent’ (in terms of wage replacement levels) paid parental leave.

On average, countries belonging to the Organisation for Cooperation and Development (OECD) provide about

18 weeks of paid maternity leave, and many offer at least two weeks of non-transferable paid paternity leave.<sup>23</sup> This paid leave is often supplemented by optional, job-protected unpaid leave for prolonged periods of at least several years. In contrast, the U.S. offers new parents just 12 weeks of unpaid, job-protected leave through the Family and Medical Leave Act.

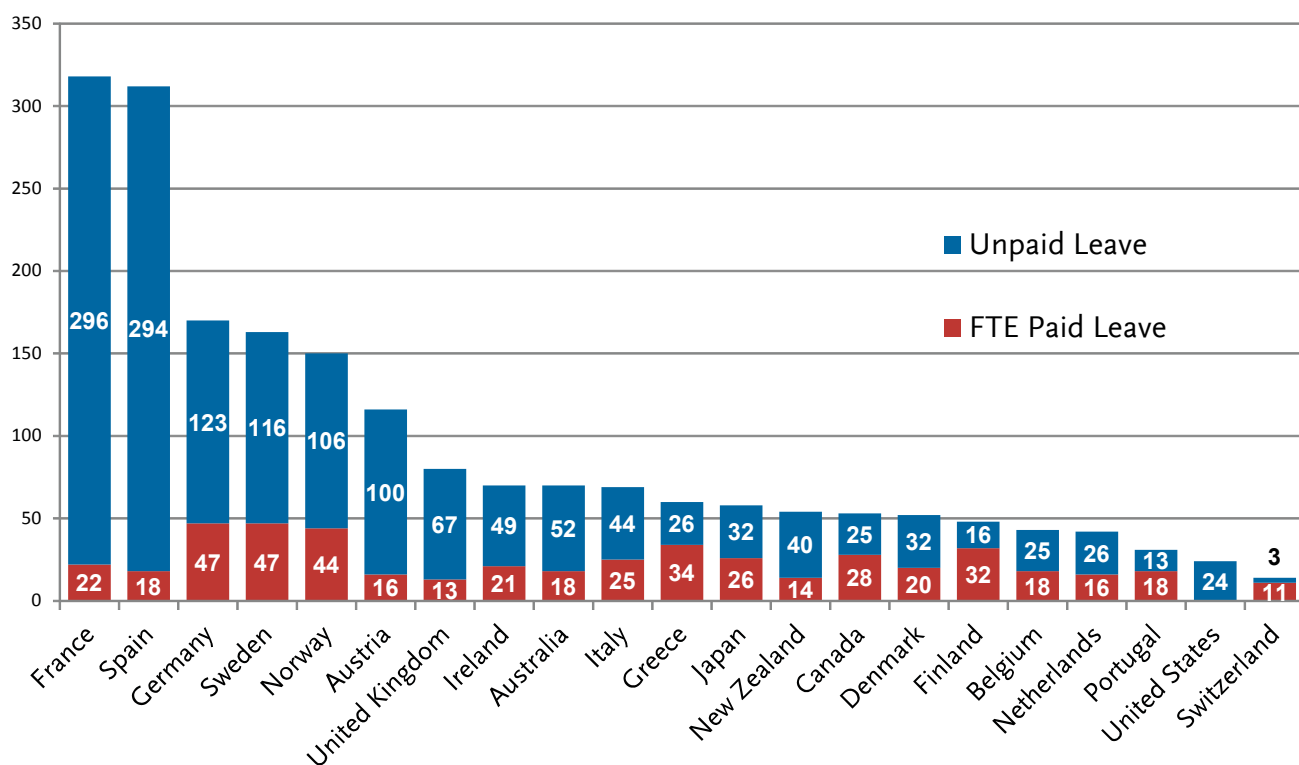
Most of the above paid leave systems are social insurance programs funded through payroll taxes (contributions), sometimes supplemented by general tax revenues – a system that allows for portable benefits and universal coverage without placing disproportionate burdens upon individual businesses while reducing incentives to discriminate against women.<sup>24</sup> For example, Austria, Belgium, Canada, Finland, France, Germany, Iceland, and the Netherlands all use social insurance programs to provide paid maternity leave.<sup>25</sup>

In addition to paid leave – or instead of paid leave for those excluded from the system (often the self-employed) – many countries assist new parents with the costs of children through allowances or grants. Allowances are scheduled payments to parents for a specific period of time after the birth of a child. For example, new mothers in Belgium who are self-employed receive 889 Euros (\$1,203 USD<sup>26</sup>) per month for three months after childbirth. In addition to their paid leave supports, Australia has a means-tested program for which 95 percent of new parents are eligible to receive a “baby-bonus” of 5,000 Australian dollars (\$5,004 USD<sup>27</sup>) paid in 13 installments.<sup>28</sup>

Grants are one-time payments to new parents to help offset the costs of childbirth. For example, France provides a means-tested grant for which 90 percent of families qualify that provides a one-time payment of 840 Euros (\$1,136 USD<sup>29</sup>) at the birth of a new child. Norway provides women not entitled to statutory parental leave a one-time grant of NOK 33,584 (\$5,729 USD<sup>30</sup>).

Americans, in contrast, do not have paid parental leave as a foundation of support, nor do they receive a generous supportive allowance or grant. Instead, families receive up to \$1,000 through the Child Tax Credit,<sup>31</sup> and varying amounts via the regressive dependent tax exemption, which was \$3,650 in 2010. A person in the low 10 percent tax bracket gained \$365 from this exemption, while a higher earner in the 25 percent tax bracket gained \$912.50 per dependent.<sup>32</sup>

Figure 2: Unpaid and Full-Time Equivalent Paid Parental Leave for 2-Parent Families Across OECD



Source: Center for Economic and Policy Research, “Parental Leave Policies in 21 Countries: Assessing Generosity and Gender Equality”

The lack of paid parental leave is part of the larger picture of antiquated American paid leave policies. For most countries in the world, the parental leave outlined above is *in addition to* general mandated paid annual leave provided.<sup>33</sup> At least 160 countries worldwide have paid annual leave, and the majority of countries belonging to the OECD require at least four weeks (20 days) per year.<sup>34</sup> This leave may be used for vacation, care of dependents (sometimes specifically allotted to caring for the elderly), or career breaks for personal reasons, such as accidents or injuries. It is also separate from public holidays, which average about 10-15 days, for a total of 30-35 days of paid leave per year.<sup>35</sup> In fact, the U.S. is the only OECD country that does *not* have a federally-mandated legal minimum of paid annual leave.

In sum, U.S. policymakers have not delivered policies or programs that support working American families at a level comparable to those in the rest of the world. It is also worth noting that family supports in other countries are not only provided at a higher basic level, but are delivered within

a more generous environment of social welfare benefits compared to those received by Americans. While the most important benefit is probably access to healthcare, free or subsidized childcare and eldercare services also account for considerable cost savings for individual families.

## Building on the FMLA

American voters, both Democrat and Republican, overwhelmingly support paid leave benefits, including paid parental leave, paid sick days, and more generally, expanding the FMLA to provide paid family and medical leave.<sup>36</sup> Perhaps in response to voter preferences, states have started to address the limitations of the FMLA protections with their own legislation. A number of states have built upon the FMLA by creating broader coverage, and a few have formed their own paid family and disability leave insurance programs.

In an attempt to make the FMLA more inclusive, several states have extended FMLA coverage by lowering the mini-

Table 1: States Broaden FMLA Protections by Increasing Number of Covered Employers

State	Provision
Maine	15 or more employees (private employers) and 25 or more (city or town employers)
Minnesota	21 or more employees (parental leave only)
Oregon	25 or more employees
Rhode Island	50 or more employees (private employers) and 30 or more employees (public employers)
Vermont	10 or more employees (parental leave only) and 15 or more employees (family and medical leave)
Washington	50 or more employees (FMLA reasons besides insured parental leave) ; all employers are required to provide insured parental leave
District of Columbia	20 or more employees

Table 2: States Broaden FMLA Protections by Expanding the Definition of Family

State	Provision
California	Domestic partner and domestic partner's child.
Connecticut	Civil union partner, parent-in-law.
Hawaii	Grandparent, parent-in-law, grandparent-in-law or an employee's reciprocal beneficiary.
Maine	Domestic partner and domestic partner's child, siblings.
New Jersey	Civil union partner and child of civil union partner, parent-in-law, step parent.
Oregon	Domestic partner, grandparent, grandchild or parent-in-law.
Rhode Island	Domestic partner of state employees, parent-in-law.
Vermont	Civil union partner, parent-in-law.
Wisconsin	Parent-in-law.
District of Columbia	Related to the worker by blood, legal custody, or marriage; person with whom the employee lives and has a committed relationship; child who lives with employee and for whom employee permanently assumes and discharges parental responsibility.

Source: For a full list of sources, see endnotes 37 through 61.

imum number of employees in FMLA-covered businesses or expanding definitions of covered family members. For example, in Maine, only companies with 14 or fewer employees are exempted from complying with FMLA protections.

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## American voters, both Democrat and Republican, overwhelmingly support paid leave benefits.

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States have also extended the coverage of FMLA protections by expanding the definition of family members for whom workers provide care under FMLA-protected leave. Grandparents, in-laws, same-sex partners, and grandchildren are now able to receive care from their FMLA-eligible relatives in a handful of states, as shown in Table 2.

## States Provide Paid Family Leave

A handful of states have established paid temporary disability leave insurance systems that cover pregnancy complications, thus providing some paid maternity leave, including California (1946), Hawaii (1969), New Jersey (1948), New York (1949), and Rhode Island (1942).<sup>62</sup>

Three states have built upon their existing disability insurance systems to provide paid family leave insurance to residents. California (2002) and New Jersey (2009) have enacted laws for paid family leave via state-wide insurance programs, and Washington passed a paid family leave law in 2007, although it has not yet come into effect because it lacks a funding mechanism. The New Jersey paid family leave insurance system is modeled closely upon the California program. As it is the best-studied American example of paid family leave insurance, we examine the experience of California below.

### California Pioneers Paid Family Leave

In September of 2002, California became the first state to create a paid family leave insurance program, and as such, it has been the most thoroughly evaluated in terms

of usage and impacts on both individuals and businesses. Since serious illness and disability, as well as disability due to pregnancy or childbirth, are already covered by California's Disability Insurance program to provide up to 52 weeks of wage replacement, the Paid Family Leave (PFL) program provides up to six weeks of additional paid leave during any twelve-month period for the following:

Bonding with the employee's new biological or adopted child or the new child of the employee's spouse or registered domestic partner.

Caring for a seriously ill child, spouse, parent, or registered domestic partner.

The PFL program is administered through the pre-existing State Disability Insurance Program, and is entirely funded by worker contributions through payroll deductions. Workers became eligible for benefits in July 2004. About 13 million Californians paid the mandatory PFL contribution of 1.2 percent of their wages (on wages up to \$93,316), with a maximum withholding of \$1,119.79 in 2011.<sup>63</sup> Benefits are taxable, meaning that workers on paid family leave still accrue Social Security benefits. This is important for reducing the 'mommy penalty' women with children pay when they leave the workforce to bond with a new child.

To be eligible, employees must have earned at least \$300 from which SDI deductions were withheld in any quarter of the five to seventeen months prior to their PFL claim. All employers are covered, and the self-employed can elect to opt in or not. The benefits pay up to 55 percent of employee earnings, and range from \$50 per week to the maximum weekly benefit of \$987.<sup>64</sup> Workers cannot claim Disability Insurance and Paid Family Leave payments at the same time.

Three years into the PFL program:<sup>65</sup>

Nearly 90 percent of all claims were made to bond with a new child, and the other 10 percent of claims were for family caregiving.

Women filed 80 percent of all paid family leave claims.

Low-wage workers, especially female low-wage workers and low-wage workers caring for ill fam-

ily members, filed claims at much lower rates than any other workers.

Employees of large (1,000+ employee) firms represented 14 percent of the California workforce yet accounted for almost half of all claims, indicating that fewer employees in smaller firms were taking advantage of paid family leave.

Six years into the PFL program:<sup>66</sup>

Employer concerns about the costs of the program were unfounded; about 90 percent of employers reported that the PFL program had either “positive” or “no noticeable” effects upon business operations, including turnover, morale, profitability and performance.

Employer concerns about abuse of the program through false caregiving claims were unfounded; most (91 percent) of employers reported that they were not aware of any employee abuse of the PFL program.

Smaller businesses (under 100 employees) reported even fewer negative effects than larger businesses, challenging the argument that small businesses cannot afford to participate in paid leave programs.

About 60 percent of employers coordinated their own benefits with the PFL program, which allowed them to save money as employees used PFL instead of the employer-provided paid leave.

The PFL program increased retention of employees (reducing costly turnover for employers), increased employee satisfaction with leave time, and doubled the duration of breastfeeding for new mothers (breastfeeding can improve both baby and maternal health and bonding, have positive effects on child development, and decrease instances of post-partum depression).<sup>67</sup>

More than half of workers who had a recent life experience that qualified for PFL did not know the program existed. Latinos, low-wage workers, and immigrants were the least likely to be aware of the

program.

Employees who did not take advantage of the PFL program either: 1) did not know about the program, 2) were worried that their employer would react negatively or fire them, or 3) thought that the level of wage replacement was too low.

## National Paid Leave Legislation

At the federal level, there have been a number of proposals for a paid family leave program.<sup>68</sup> Policymakers in both the House and Senate have recommended building upon the Family and Medical Leave Act (FMLA) to broaden coverage and provide paid leave, parental or otherwise. Appendix A summarizes relevant legislation from the 110th and 111th Congresses.<sup>69</sup>

### Three Models of Paid Leave

Paid family leave proposals, like those in the Healthy Families Act of 2009 or the Balancing Act of 2009, fall into three types of models, each with its own advantages and disadvantages.

*Unfunded mandates upon businesses in which the employer is required to pay wages during qualified leave for a specified period of time, thus directly increasing the cost of labor.* For example, The Healthy Families Act of 2009 (H.R. 2460/S.1152) proposed that employers with 15 or more employees allow their workers to accrue at least one hour of paid sick leave for every 30 hours worked, up to 56 hours per year.

Combined with our system of insufficient enforcement, unfunded mandates upon businesses can often lead to discrimination in hiring and firing employees who get ill, not to mention those with chronic illnesses (this can be related to age discrimination) or those who may be responsible for a dependent family member. At the national level, this discrimination can lead to higher unemployment rates – and exclusion from employment-related benefits – among those who may most need a safety net. Costs of these mandates may also be pushed upon workers in the form of lower wages and cuts in other employer-sponsored ben-

efits as companies strive to cut costs.

*Hybrid federal-state programs, in which both federal and state governments contribute to the cost of leave.*

For example, the 2009 Family Income to Respond to Significant Transitions Act (H.R. 2339) proposed that the Secretary of Labor award grants to states to help pay for state programs providing wage replacement to individuals who take leave for reasons identified by the FMLA.

This avoids placing greater demands upon businesses, but hybrid programs have their own problems. Federal-state programs are vulnerable to significant cuts during the economic downturns for the same reason that any partially- or fully state-funded program faces cutbacks when tax revenues dry up: all states (except Vermont) must adhere to balanced budget requirements and cannot borrow during downturns.<sup>70</sup> Any hybrid federal-state paid leave program will therefore fluctuate in its ability to support the workforce.

*Federal social insurance programs, such as Social Security and Medicare, have been more successful and less controversial than jointly-funded state-federal programs such as Medicaid. At the same time they minimize demands upon businesses because the full costs of benefits are not borne solely by individual employers.*

There have been two recent proposals to establish social insurance programs to support paid leave: the Balancing Act of 2009 (H.R. 3047) and the less extensive Family Leave Insurance Act of 2009 (H.R. 1723), both of which proposed the establishment of a federal Family and Medical Insurance Program. In addition to legislative proposals, the Georgetown Law Workplace Flexibility 2010 and Berkeley Law Center on Health, Economic & Family Security programs released a detailed proposal for “Family Security Insurance,” which includes a paid parental leave insurance program proposal, in December 2010.<sup>71</sup>

The California Paid Family Leave insurance program provides several lessons for the design of a simple, universal federal family leave program.

Opponents of paid leave argue that it will raise the cost of labor for businesses, discouraging job creation and encouraging outsourcing.<sup>72</sup> However, evaluations of the

California Paid Family Leave program show a very different picture. First, 86.9 percent of employers, including small businesses, found that the PFL program resulted in no cost increases, and a further 8.8 percent stated that the program had generated cost savings through reducing employee turnover and reducing employer-sponsored benefit payments when paid leave was taken through the PFL program. Overall, after six years of experience with a paid leave system funded by payroll contributions and delivered through an existing insurance system, the vast majority – over 90 percent – of both small and large employers found that the insurance program had either no impact or positive impacts upon their business.<sup>73</sup>

At the same time, the California PFL program highlights the need for a few design improvements in creating a federal paid family leave insurance program. First, replacement rates must be high enough for low-wage workers to be able to afford to take advantage of a program to which they automatically contribute. For example, California’s PFL wage replacement rate is 55 percent of earnings. However, 55 percent of the minimum wage in any part of the U.S. does not constitute a living wage, making the paid leave just as unaffordable as unpaid leave and therefore inaccessible for low-wage earners.

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**After six years of experience with a paid leave system, over 90 percent of both small and large employers found that the insurance program had either no impact or positive impacts upon their business.**

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Second, evaluations of the California PFL insurance program found that employees in small and medium businesses and those working in low-wage industries were much less likely to be aware of or take paid family leave. Outreach and dissemination efforts must therefore be especially targeted at small and medium businesses and, more broadly, at low-wage industries.

Third, almost 40 percent of workers who were aware of the PFL program but did not take PFL when they needed it did so because they were afraid of being punished or fired at work. In the U.S. labor system, where workers have

little power compared to their employers, programs like paid family leave insurance must be proactively enforced by the government to protect vulnerable workers' rights to care for a new child or ill family member. Oversight and enforcement should especially target low-wage industries with vulnerable workers.

Funding paid parental leave in the form of universal social insurance based on employee contributions and using the administrative capacity of the very-efficient Social Security Administration minimizes costs to employers, besides the cost of temporarily replacing some employees. Even these costs may be low, though – 96.6 percent of businesses in the California PFL evaluation temporarily shifted the work of employees on leave to other workers instead of hiring temporary replacements. Indeed, costs associated with paid leave may be somewhat offset by the savings gained from increased employee productivity in a healthy workplace, retention of valuable skills, and avoiding the cost of hiring and retraining new employees.

Social insurance programs are more stable than state-based and hybrid federal-state programs. At their best, they offer portable, individual benefits independent of specific employers, which may also help to balance power between workers and employers and improve flexibility in the labor

market, as workers become less likely to hold on to poorly-matched jobs simply to keep benefits.

## Conclusion

Policymakers have failed to address the needs of hard-working American families, and the lack of access to paid parental leave hurts children, frays family bonds, and can lead to poorer outcomes for our society as a whole. The average American employee has no access to paid parental leave; what is a 'benefit' for the lucky few in the U.S. is considered a basic right in most of the world.

Although the FMLA was a step in the right direction, we must do more to enable workers to be good parents to their children without risking their jobs. The California Paid Family Leave program shows that not only is it possible to support working families, but that it is possible to do so with virtually no negative short-term economic impacts on individual businesses. A federal paid parental leave insurance program would impose limited costs on business—while the benefits to newborns and their parents would be truly priceless.

## Appendix A

Legislative Activity Related to the Family Medical Leave Act of 1993, 110th and 111th Congress		
Date	Name of Bill	Summary
January '08- Signed	National Defense Authorization Act of FY2008, P.L. 110-181.	12 workweeks of unpaid leave for private sector employees in companies with 50 + workers and public agencies (FMLA Title I workers) dealing with issues arising from family members in the Guard or Reserves being called to active duty and 26 workweeks of unpaid leave to care for seriously injured or ill servicemembers.
October '09-Signed	National Defense Authorization Act of FY2010, P.L. 111-84	Extends NDAA FY2008 (above) to civil service (FMLA Title II) employees, allowing them to take leave due to foreign deployment of regular and reserve members of the Armed Forces, and allows military family caregiving leave to care for recent Armed Forces veterans.
December '09- Signed	Airline Flight Crew Technical Corrections Act, P.L. 111-119	Airline flight crewmembers who have worked or been paid for not less than 60% of their total monthly guarantee for the prior 12 months and who have worked or been paid for not less than 504 hours in the prior 12 months will be considered to have fulfilled the FMLA's hours-of-work requirement.
1/9/2009	H.R. 389 - Family Fairness Act of 2009	Eliminate the hours-of-service requirement, thereby entitling both part-time and full-time employees who worked for a covered employer for at least 12 months to 12 workweeks of FMLA leave.
1/22/2009, 1/29/2009	H.R. 626/S. 354 - Federal Employees Paid Parental Leave Act of 2009	Would (1) allow federal employees to substitute paid leave for unpaid leave available for the birth or adoption of a child, and (2) amend the Congressional Accountability Act and the FMLA to allow the same substitution for covered congressional employees and employees of the GAO and the Library of Congress.
2/3/2009	H.R. 824 - Family and Medical Leave Enhancement Act of 2009	Would amend FMLA to cover employees at worksites employing 25+ employees and allow employees to (1) take "parental involvement leave" and (2) take "family wellness leave" for routine family medical care needs, including eldercare, not to exceed four hours in any 30-day period, or 24 hours in any 12-month period.
3/25/2009	HR 1723 - Family Leave Insurance Act of	Creates national insurance program for paid family and medical leave, allows for equivalent state or private programs.
4/28/2009, 7/30/2010	H.R. 2132/S. 3680 - Family and Medical Leave Inclusion Act	Extends FMLA leave to care for a same-sex spouse, domestic partner, parent-in-law, adult child, sibling, or grandparent with a serious health condition.
4/29/2009	H.R. 2161 - Family and Medical Leave Restoration Act	Repeals DOL regulations effective in January 2009, including paid leave substitution, employee notice requirements for leave, and clarification of medical certification, reinstating the provisions promulgated in 1995. Employers permitted to require one medical recertification after the expiration of the period indicated in the original certification. Deletes requirements for a specific number of visits to a health care provider when the employee has a serious health condition or a chronic condition.
5/7/2009	HR 2339- Family Income to Respond to Significant Transitions Act	Directs the Secretary of Labor to award grants to states to pay for the federal share of the cost of programs that provide wage replacement for eligible individuals to take leave to respond to caregiving needs resulting from the birth or adoption of a child, and other FMLA-covered purposes.
5/18/2009, 5/21/2009	H.R.2460/S. 1152- Healthy Families Act	Requires employers with 15 or more employees to permit each employee to earn at least one hour of paid sick time for every 30 hours worked (max 56 hours per year). Leave can be used for employee illness, to address domestic violence, and for caregiving duties for family members.
5/20/2009	H.R. 2515- Domestic Violence Leave Act	Permits FMLA leave to address domestic violence, sexual assault, or stalking and their effects. Includes domestic partners and same-sex spouses.
6/9/2009	H.R. 2776- Living Organ Donor Job	Would amend the FMLA to permit employees to take leave to make organ donations.
6/25/2009	H.R. 3047 - Balancing Act of 2009	Amendments to the FMLA include: covering all employers with 15 or more workers, reducing the hours-of-work requirement to 1,050 in a 12-month period, extending the eligible groups for whom leave could be taken to care for serious health conditions (see H.R. 2132), and authorizing parental involvement and family wellness leave (see H.R. 824) as well as domestic violence leave (see H.R. 2515).

## Notes

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**FOUR**

**Paying for The Next Social  
Contract**

**Dean Baker**

**Bruce Bartlett**

**Peter Lindert**

# Debt, Deficits, and Demographics

## Why We Can Afford the Social Contract

*Dean Baker, Co-Director, Center for Economic and Policy Research*

### Introduction

For much of the last three decades, policy debates in the United States have been dominated by a quixotic concern about deficits, debt, and demographics. This concern has distracted policy from fundamental economic issues that have much more direct bearing on economic well-being, most notably the growth (and bursting) of the housing bubble in the last decade. While large deficits can have a negative impact on economic growth, this impact has been hugely misrepresented in public debates.

In fact, contrary to what political figures often assert, it is almost impossible to envision a scenario in which deficits and debt prevent future generations from on average enjoying higher standards of living than we do today. Many households have seen a decline in living standards in recent years, but this has been due to increasing inequality, not a decline in the nation's productive capacities. The trend towards increasing inequality poses a far greater threat to the living standards of future generations than the potential negative impact of deficits. Unfortunately, discussions of the debt and deficit often distract from discussions of the factors affecting the distribution of income.

The first section of this paper discusses the economy's recent growth and projected future growth. It compares the projected gains from continued growth and contrasts these with the impact of an aging population. Under any plausible scenario, the benefits from growth will swamp any negative impact on living standards from an aging population.

The second section examines how deficits can pose a drain on the economy. Specifically, it will point out the distinction between a deficit when the economy is near full employment and a deficit run when the economy has a large number of unemployed workers and a large amount of excess capacity. In the latter case, there is really no way

that the deficit can be seen as imposing a drain on the economy. In fact, deficits in the latter case are likely to increase the well-being of future generations.

The third section points out that the debt does not in any way provide a measure of inter-generational equity. The debt is a commitment from the public as a whole to the owners of the debt. This can present distributional issues within a generation, but there is no way in which the debt in any way measures the extent to which current generations have made future generations worse off. In fact, the debt as conventionally reported is an arbitrary number that tells us very little about anything.

The fourth section examines the long-term deficit projections that have caused so much panic in policy circles. Specifically, it examines the projections for Social Security and Medicare. It shows that the projected shortfalls in Social Security can be relatively easily filled, especially if the pattern of upward redistribution of income that we have experienced over the last decade is stopped. Addressing the projected shortfall would be even easier if upward redistribution of the last three decades were reversed.

Instead, the main reason that deficits are projected to rise to dangerous levels is that private sector health care costs are projected to continue to hugely outpace the rate of economic growth. If these projections for health care

costs prove accurate, it will have a devastating impact on the economy regardless of what is done with public sector-financed health care programs. Given this fact, an honest discussion would focus on ways to reform the health care system, not just containing public sector spending on health care. Discussing this projected explosion of health care costs as a deficit problem is fundamentally misleading.

The conclusion explains that we need to focus directly on the issues that will affect the future state of the economy if we care about the well-being of future generations. The deficit is very much secondary in this picture.

### Productivity Growth Versus Demographics: There is No Competition

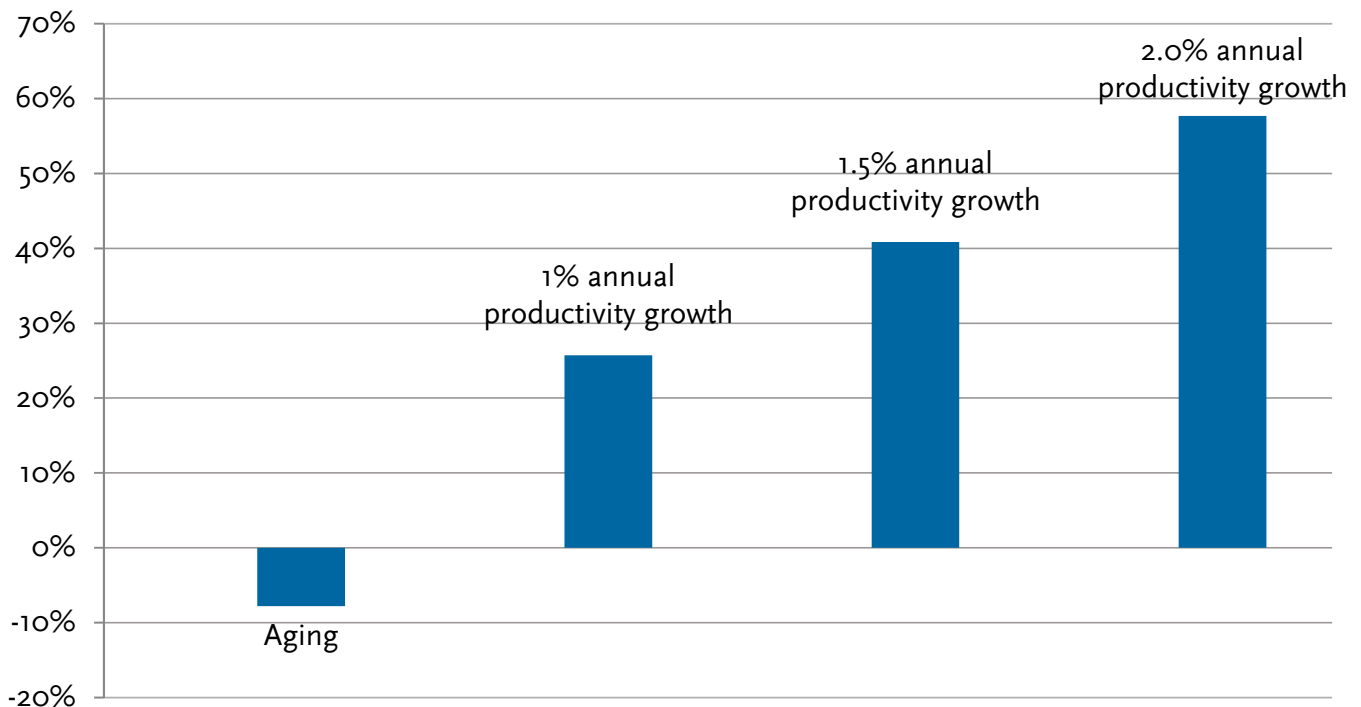
The often expressed concern that the aging of the population will lead to a decline or stagnation in living standards has no basis in reality. While an increase in the number of retirees relative to the number of workers can slow the increase in living standards through time, productivity

growth will speed it up. Even slow rates of productivity growth will have an impact through time in raising living standards that will swamp the effect of even the most adverse demographic changes.

Figure 1 contrasts the impact of the increase in the number of retirees to workers on reducing living standards over the period from 2012 to 2035, the peak years of the baby boomers' retirement, with the impact of annual productivity growth of 1.0 percent, 1.5 percent, and 2.0 percent in raising living standards. As is shown, the decline in living standards due to the increased number of retirees per worker is 8.5 percent. This corresponds to a projected decline in the ratio of workers to retirees from 2.8 in 2012 to 2.0 in 2035.<sup>1</sup> The implication of this number is that the decline in the number of workers to share in the burden of supporting each retiree over this period would lead to a decline of 8.5 percent in the living standards of workers if there was no increase in productivity growth. (This assumes that consumption of retirees is equal to 85 percent of the consumption of the working age population. See the technical notes at the end of the paper for a full explanation of the construction of all figures and tables.)

Of course, there will be increases in productivity growth

Figure 1: Changes in Living Standards Due to Aging and Productivity, 2012-2035



over this 23-year period. The first bar shows that a 1.0 percent rate of annual productivity growth will compound to a 25.7 percent increase in output per hour over a 23-year period.<sup>3</sup> The cumulative gain from a 1.5 percent increase in productivity growth would be 40.8 percent, and from a 2.0 percent rate of productivity growth 57.7 percent. Even in the most pessimistic case, which roughly corresponds to the weak growth during the period of the productivity slowdown from 1973-1995, the gains from higher productivity are more than three times as large as the decline in living standards that would result from the declining ratio of workers to retirees. In the middle scenario, which shows productivity growth that is roughly in line with the period since 1995, the gains from productivity growth are almost five times the losses calculated from the decline in the ratio of workers to retirees. In the case of 2.0 percent annual productivity growth, which corresponds to the growth rate of the economic golden age in the three decades following World War II, the impact of productivity growth in raising living standards would be almost seven times as large as the impact of demographics in reducing living standards.

It is worth noting that even these numbers seriously overstate the impact of demographics relative to productivity growth in four important ways. First, they focus exclusively on the rise in the ratio of elderly dependents to workers. They ignore the projected decline in the number of children per worker. While there is projected to be little change in the ratio of people under age 20 to people between the ages of 20-64 between 2010 and 2030, there has been a sharp decline in this ratio since 1965. In fact, the drop in this ratio more than fully offsets the projected rise in the ratio of people over the age of 65 to the working age population.<sup>3</sup> The Social Security trustees project that the ratio of total dependents (young and old) to the working age population will never exceed the level it reached in 1965 when the baby boomers were all still under the age of 20.<sup>4</sup>

The second reason that just looking at the ratio of the over-65 population to the prime working age population overstates the impact of demographics is that the percentage of prime age people who are employed is not fixed. The share of the prime age population in the workforce has been increasing over the last five decades due to the increase in the share of women who enter the paid workforce. While this process has been largely completed by 2012, there

is still likely to be at least some marginal increase in the share of women entering the labor force.

It is also possible that many workers will opt to work longer hours. While it would be a negative development if workers felt that they had to work longer hours to maintain their standard of living, there is also the possibility that if real wages rise in response to a shortage of labor, many workers may respond by putting in more hours over the course of the year. This means that the rise in the ratio of dependents to workers will be larger than the rise in the ratio of dependents to working hours.

The third reason is that more people over the age of 65 may opt to continue working later in their lives, even assuming no further legislated changes in the age at which workers become eligible for normal retirement benefits under Social Security or for Medicare. (Workers who reach age 62 after 2022 will not be able to get normal retirement benefits under Social Security until age 67.) Improvements in the health of the population will leave many workers able to work until older ages. Some workers will clearly take advantage of this opportunity, especially if a labor shortage pushes up wages.

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**The impact of even small differences in productivity growth sustained over a long period of time will far exceed the negative effect on living standards of the projected increase in the ratio of retirees to workers.**

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Finally, the scenario described in Figure 1 shows the absolute worst period for the impact of demographic change on living standards. The ratio of retirees to workers is projected to barely increase and then level off for the rest of the century. This means that all of the projected gains in productivity growth can be translated into higher wages and improvements in workers' living standards. As a result, workers can expect real wages that are 10.5 percent higher by 2045 than they were in 2035 in the slow productivity growth scenario and 21.9 percent in the fast growth scenario. By 2055, real wages would have increased by 22.0 percent in the slow productivity growth scenario and 48.6

percent in the fast productivity growth scenario from their 2035 levels. In the fast growth scenario, they will be more than double their current level by 2055 even assuming that a larger portion of wages must be diverted to support the living standards of a growing population of retirees.

For these reasons, Figure 1 exaggerates the actual impact of the aging of the population on the well-being of the working age population. Clearly productivity growth will have far more impact on the living standard of future generations. The impact of even small differences in productivity growth sustained over a long period of time will far exceed the negative effect on living standards of the projected increase in the ratio of retirees to workers.

Of course, wages for most workers have not been rising in step with productivity growth, but this raises a completely different set of policy issues. The focus of policy on deficits has been a distraction from policies that might reverse the upward redistribution of income that we have seen over the last three decades. This shift has had much more impact on the living standards of young people today than our budget policy, and if the pattern of upward redistribution is allowed to continue, its impact on the living standards of most of our children and grandchildren will swamp the impact of any plausible budget path over the next two or three decades.

## The Impact of Deficits on Productivity Growth

At this point there is a large body of research on the impact of deficits on living standards.<sup>5</sup> The conclusion of most of this research is that the effect of deficits is generally limited and, depending on the timing and the purpose of the deficit, it could actually increase growth. The standard argument for how deficits reduce growth is that they do so by pushing up interest rates and thereby crowding out private investment. This argument is only plausible when the economy is near full employment, however, since otherwise there would be no reason a budget deficit would need to result in higher interest rates. In a period in which the economy is operating below its full employment level of output, like the present, the economy is not supply constrained. Additional demand from a deficit can be met by additional output, so there is no reason that it must crowd

out private investment.

As a financial matter, the additional borrowing by the government can be accommodated by the increased supply of money from the Federal Reserve Board. Typically this just means lowering short-term interest rates by enough to offset any impact that increased government borrowing has in raising interest rates. In the current downturn, with the Fed engaged in quantitative easing, it is effectively directly buying up much of the new debt being issued by the government to finance its deficit.

When the Fed acts to prevent the deficit from raising interest rates, there is no plausible mechanism through which deficits can reduce future growth.<sup>6</sup> If interest rates do not rise, then there is no reason that investment should decline. In fact, the increase in demand from the deficits is likely to boost investment. There is considerable research that shows that the growth of demand and corporate cash flow are important determinants of investment, and generally have more impact than interest rates, especially with new and fast growing firms.<sup>7</sup> For this reason, deficits in periods of high unemployment are more likely to increase investment than reduce it, even if they did lead to some increase in interest rates.

Sustaining high levels of demand in a downturn can also have other positive long-run effects on growth. Most immediately, by keeping workers employed it can reduce the likelihood that workers might become difficult to employ or even drop out of the labor force as a result of long periods of unemployment. There are also important generational effects. The children of unemployed workers are likely to suffer in school and have poorer subsequent career prospects. If deficit spending can sustain higher levels of employment, it can mean higher potential GDP in the near future by keeping down the structural rate of unemployment, and also higher GDP in the long-term, as children of otherwise unemployed workers would be better prepared to be productive workers. In short, there is little reason to believe that deficits in periods of high unemployment should be cause for concern. They not only have the potential for increasing GDP in the short-term but will likely boost the future output of the economy as well.

Even deficits that are run when the economy is close to full employment are likely to have fewer negative effects than is generally believed. If a deficit is run when the

economy is near full employment, it can be expected to lead to higher interest rates. However, only a portion of the resulting crowding out occurs in investment. Much of the crowding out is likely to be in consumption, either directly – by making various forms of borrowing more expensive – or indirectly, through a negative wealth effect. If higher interest rates lead to lower stock and/or house prices, then it would be expected that consumption would drop due to the resulting decline in household wealth.

In recent years it is likely that most of the crowding out or crowding in associated with higher or lower deficits has been in consumption rather than investment, as shown in Figure 2.

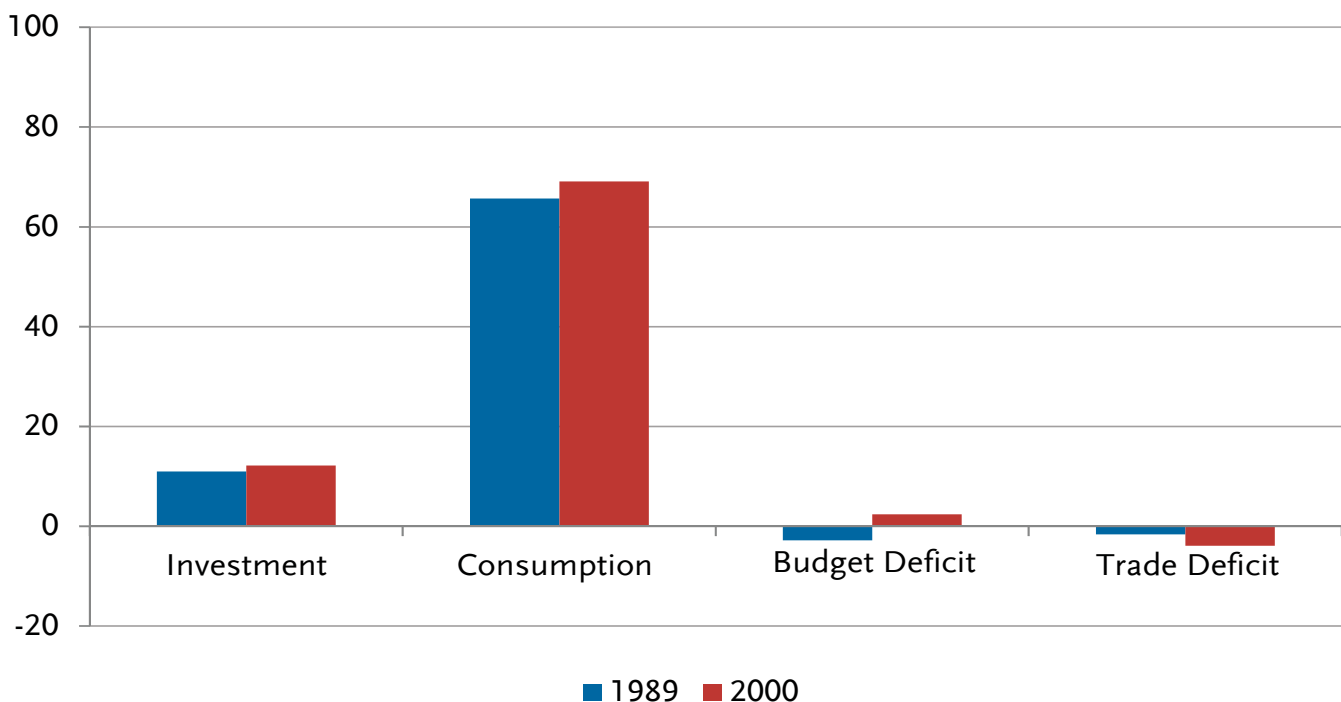
At the peak of the business cycle in 1989 the deficit was equal to 2.8 percent of GDP. At the business cycle peak in 2000 the deficit had turned to a surplus of 2.4 percent of GDP, a shift of 5.2 percentage points. However, the non-residential investment share of GDP increased by just 1.2 percentage points between these two cyclical peaks. The largest increase in share of GDP was consumption, which rose by 3.4 percentage points from 65.7 percent of GDP in 1989 to 69.1 percent of GDP in 2000. Insofar as the reduction in the deficit can be attributed to reduced government consumption (government investment will be discussed

shortly), government consumption was simply replaced by private consumption. While this may lead to more satisfactory outcomes if government consumption is generally valued less than private consumption, it does nothing to increase future growth.

The other component of GDP that should be affected by deficits is the trade balance. In principle, higher interest rates can lead to a higher valued dollar as foreign investors seek out dollar-denominated assets to take advantage of the relatively better returns available in the United States. The higher dollar then leads to a larger trade deficit as imports become cheaper for people in the United States and U.S.-made goods become more expensive for people living in other countries. In this textbook case, a higher budget deficit then can translate into a higher trade deficit.<sup>9</sup>

Contrary to the standard theory, however, the link between the budget deficit and the trade deficit has proven to be weak or non-existent, primarily because the value of the dollar has not moved in the direction predicted by economic theory. The dollar actually rose strongly in the late 1990s even as the budget moved to surplus. This led to a trade deficit of 3.9 percent of GDP in 2000, compared to 1.6 percent of GDP in 1989.

Figure 2: Component Shares of GDP: Business Cycle Peaks



This rise in the dollar was largely the result of political and strategic decisions made by developing countries in response to the bailout from the East Asian financial crisis in the early 1990s. The harsh terms that the International Monetary Fund (IMF) imposed on the countries of the region led developing countries to begin to accumulate massive amounts of foreign exchange reserves, which mostly meant dollars.<sup>10</sup> These reserves were insurance for developing countries against ending up in the same situation as the East Asian countries, needing a bailout from the IMF.

However this development broke the link between budget deficits and trade deficits. With the value of the dollar largely a function of political decisions by developing countries, there is no reason to believe that a lower budget deficit would imply a lower valued dollar. With the channel connecting budget deficits and trade deficits largely dysfunctional in the current world economic environment, the crowding out or in from larger or smaller budget deficits at full employment will mostly be felt on domestic consumption and investment.

Even assuming that the impact of deficits at full employment follows the textbook story, the impact of deficits on

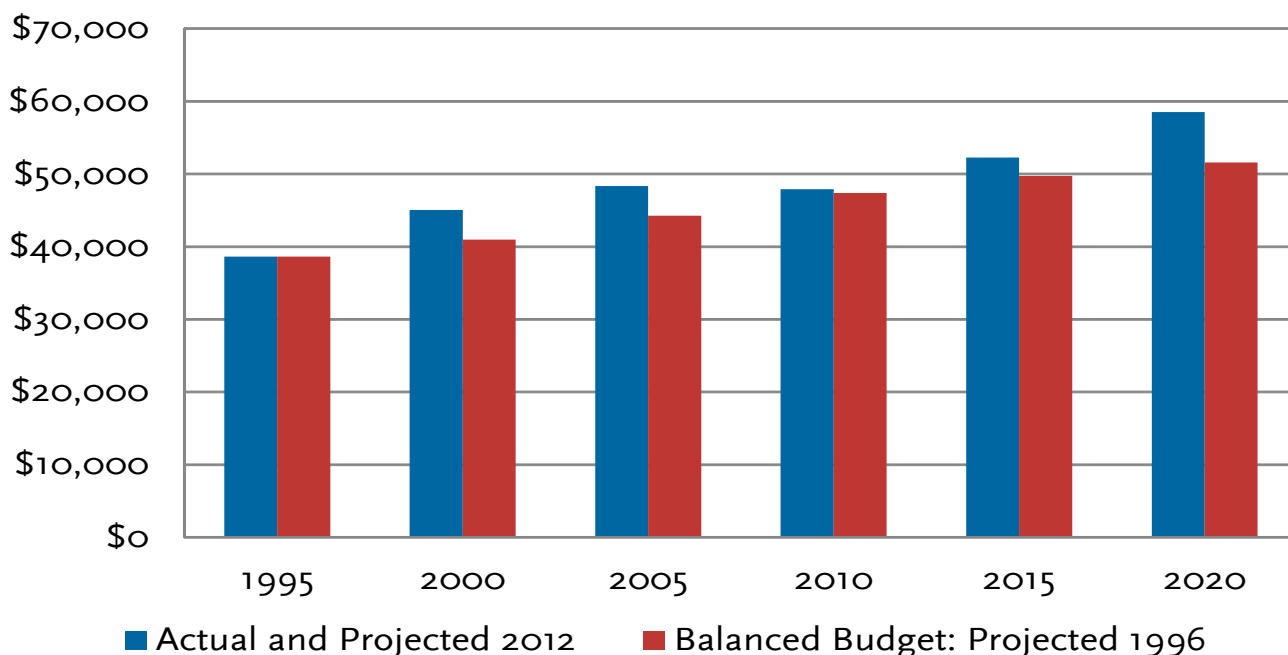
growth is considerably less than is generally believed. In 1996, the Congressional Budget Office projected future GDP growth under three alternative budget scenarios, one of which specified that the government would run a balanced budget every year through 2030.<sup>11</sup>

Figure 3 shows the projected growth in the balanced budget scenario (red) compared with the actual growth through 2010 and CBO's projected growth through 2020 (blue).

As can be seen, the economy has actually done far better through 2010 than the projected balanced budget path. This is in spite of the fact the government has run substantial deficits for the last decade, and the economy plunged into the worst slump since the Great Depression following the collapse of the housing bubble in 2007.

Furthermore, the CBO projections show the economy bouncing back over the rest of this decade. Its most recent projections imply that by 2020 per capita GDP will be 13.4 percent higher than the balanced budget scenario that it had projected back in 1996. In other words, if the point of balancing the budget in 1996 was to make the country richer in the future, more was accomplished in terms of increasing growth without having balanced bud-

Figure 3: Per Capita GDP: 1996 CBO Projection with Balanced Budget and Actual Growth as of 2012 (in 2011 Dollars)



gets through most of this period than would have been accomplished had the economy had balanced budgets each and every year over the subsequent quarter century. Put another way, we did far better in terms of growth than the advocates of balanced budgets of that period ever could have hoped. If they considered the balanced budget path projected for 2010 and 2020 to be acceptable, then they should be more than happy with the economic performance we have actually seen.

The final point to be made about deficits is that they may be run to promote various forms of public investment, such as infrastructure spending, education, or research and development. These forms of public capital increase the economy's productive capacity. In fact, several studies have found that on a per dollar basis, public investment increases productivity by more than private investment.<sup>12</sup> This indicates that a deficit that is run to increase public investment will make the economy richer in the future, not poorer.

In fact, the gains from running a deficit to increase public investment are even larger than they may immediately appear. If the economy is running near full employment, most of the crowding out from a deficit will be of private consumption, not investment. This means that a dollar increase in public investment may crowd out just 30-40

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**The gains from running a deficit to increase public investment are even larger than they may immediately appear.**

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cents of private investment. If on a per dollar basis, public investment is anywhere near as productive as investment in the private sector, then investments in public sector capital would be a huge positive from the standpoint of long-run growth even if they are done when the economy is near full employment. Of course the gains are even larger in an economic slump, when there is likely no trade-off in terms of lost private sector investment.

It could be argued that the gains would be even larger if additional public sector investment in a fully employed economy were offset by cuts in government consumption or tax increases. If political considerations make this

impractical, though, the evidence suggests that increasing public sector investment is likely to increase growth even if it raises deficits.

## **The Debt as a Measure of Generational Equity**

It is amazing that many highly-respected people in policy debates use the national debt as a measure of intergenerational equity, implying that it represents an obligation imposed on future generations. This is a fallacy at every level.

Most obviously it is a fallacy because the debt doesn't tell us anything about the distribution between generations. The debt is currently held by people who are alive; at some point everyone who is alive today will be dead. That means that whatever bonds that they hold will be passed on to future generations.<sup>13</sup> At that point the interest and the principal on the bonds will constitute payments within generations, not between generations. There could be important distributional issues: for example, if there is a large public debt and the bonds are concentrated among a small number of people. But that is a question of intra-generational equity, not intergenerational equity.

There are also issues of efficiency, since the taxes needed to pay the interest on the debt will inevitably be associated with some economic cost. This would arise even if the bonds were equally distributed among the population, since it would still be necessary to raise the taxes needed to pay the interest. But the efficiency costs of taxation are substantially smaller than the annual interest burden. Furthermore, this is just one of many ways in which past arrangements can impose a burden on the economy in the future. To fully understand intergenerational equity, we need to look at all of the ways that current policies affect the future of the economy.

For example, the government has claim to literally tens of trillions of dollars of assets that could, in principle, be sold off to private individuals or corporations. Insofar as these assets are sold off, it creates a burden on future generations in much the same way as does the debt. This is most evident in the case of physical assets that can be readily privatized like a highway. If the government sells

off a highway to the private sector, it can use the proceeds to reduce its current debt. (Several state and local government have made such asset sales in recent years for exactly this purpose.) However, if future generations must pay tolls to use a highway that otherwise would have been free then they are not obviously better off than if they had a higher tax burden and the highway was still owned by the government.<sup>14</sup>

There are a wide range of physical assets held by the government, such as waterfront property, national parks and other areas of scenic beauty. A government can reduce its debt burden by selling off such assets. This will lessen the need for government revenue, but it will mean that people who will want to use these resources in the future will in effect be taxed by the private parties who own them.

Governments can also sell off claims to assets that are not strictly physical, such as use of the airwaves. This effectively allows private parties to tax the public for use of the airwaves. In the same vein, but of much greater consequence, the government can sell off, or award as prizes, patent and copyright monopolies in a wide range of areas. This means that the government will stop competitors in order to allow private actors to earn monopoly profits in various sectors of the market. The cost to consumers and the deadweight loss to the economy can be enormous, yet this issue is never raised in discussions of intergenerational equity.

This point can be seen most clearly in the case of prescription drugs. As a result of the fact that companies have patent monopolies, drugs that would sell as generics for between \$5.00 and \$10.00 per prescription can sell for hundreds or even thousands of dollars each. The difference between patent-protected prices and the free market price is on the order of \$270 billion a year and will likely come to more than \$3.5 trillion over the next decade.<sup>15</sup> Obviously the total cost to the economy of all patent and copyright protection is considerably larger.

It is also important to recognize that one set of burdens can be traded off for the other. If we only focus on debt as a measure of intergenerational equity, then it can encourage trade-offs that are very much to the disadvantage of future generations. To build on the prescription drug example, suppose that we could easily replace the research that is currently financed through the patent system with a mechanism for directly financing research with gov-

ernment spending. Let's assume that this would require an amount of additional funding equal to 0.5 percent of GDP.<sup>16</sup>

If this led to a situation where all drugs could be purchased at their free market price, the projected net savings to patients over the next decade would be well over \$2 trillion. However, if these savings all accrued to the private sector (much of the savings would actually be in the form of lower costs to Medicare and Medicaid and other public programs, but for purposes of this analysis we will assume that all the savings go to the private sector), then a commitment to lowering the deficit could lead the government to replace a more efficient mechanism of funding with patent supported research, since the latter doesn't require direct payments from the government. While patent financed research would unambiguously make future generations worse off under the assumptions used in this discussion, it would nonetheless lead to lower government spending and therefore lower future deficits and debt. If policy is driven solely by the desire to reduce the debt than it would end up taking a route that lowered the debt by making future generations considerably worse off.

Similarly, as noted previously, deficits can be run to finance public investment. If the government chooses not to invest in long-term improvements like infrastructure because of worries about deficits, it will hinder the economy and leave future generations worse off. As a measure of intergenerational equity, then, not financing necessary productive investments is as much of a burden on future generations as debt is. For example, if the government saves money

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**If we only focus on debt as a measure of intergenerational equity, then it can encourage trade-offs that are very much to the disadvantage of future generations.**

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by not maintaining highways then future generations will bear this cost in terms of higher transportation costs and more time spent commuting. If the savings are on education then output in the future will suffer due to a less productive workforce.

There is one final aspect to the debt discussion that is tremendously misleading. The true burden of the debt is the economic distortions that result from the taxes needed to make the interest payment on the debt. This suggests that interest, rather than debt, is the better measure of the burden. To see why this matters, it is worth noting that the United States is presently issuing large amounts of debt at very low interest rates. The reason that the interest rates are so low is that the economy remains extraordinarily weak. As a result, even the ratio of debt to GDP is projected to hit levels not seen since the years immediately following World War II, the ratio of interest payments to GDP is near a post-war low, as shown in Figure 4.

A brief thought experiment shows why it is interest burden and not debt itself that is the relevant factor in assessing the burden of the debt. CBO and other forecasters project that the economy will recover over the next several years. When it does, interest rates will return to more normal levels. When the interest rate rises, the price of long-term bonds falls. Table 1 shows the market price of a 30-year bond, with 27 years left until maturity, at various interest rates. The calculations in the table assume that the bond was initially issued with a 2.75 interest rate, roughly the prevailing interest rate in August of 2012.

As can be seen, the price of the bond falls sharply as interest rates rise. If the interest rate on 30-year bonds rises to 6.0 percent, somewhat below its average in the late 1990s, then the price of the bond would fall to \$57.00, little more than half of its initial value. If the interest rate on 30 year bonds rose to 8.5 percent (the average in the late 1980s), then the price of the bonds would fall to \$39.80, less than 40 percent of its initial value.

This means that if the concern were simply over the size of the government's debt, and not the amount of interest that it pays, there is an easy remedy. The government could simply take advantage of the rise in interest rates projected by the Congressional Budget Office and virtually all other forecasters to buy up large amounts of debt at sharp discounts. For example, if the government bought \$3 trillion worth of 30-year bonds that were issued at near a 2.75 percent interest rate, when the interest rate rises to 6.0 percent, it can instantly eliminate almost \$1.3 trillion worth of debt.

If all that matters is the size of the debt, then the widely expected rise in interest rates in future years would provide the government with an opportunity to hugely reduce its debt burden. There is no obvious reason that the government should bother buying up debt in this sort of exer-

Figure 4: Interest as Share of GDP

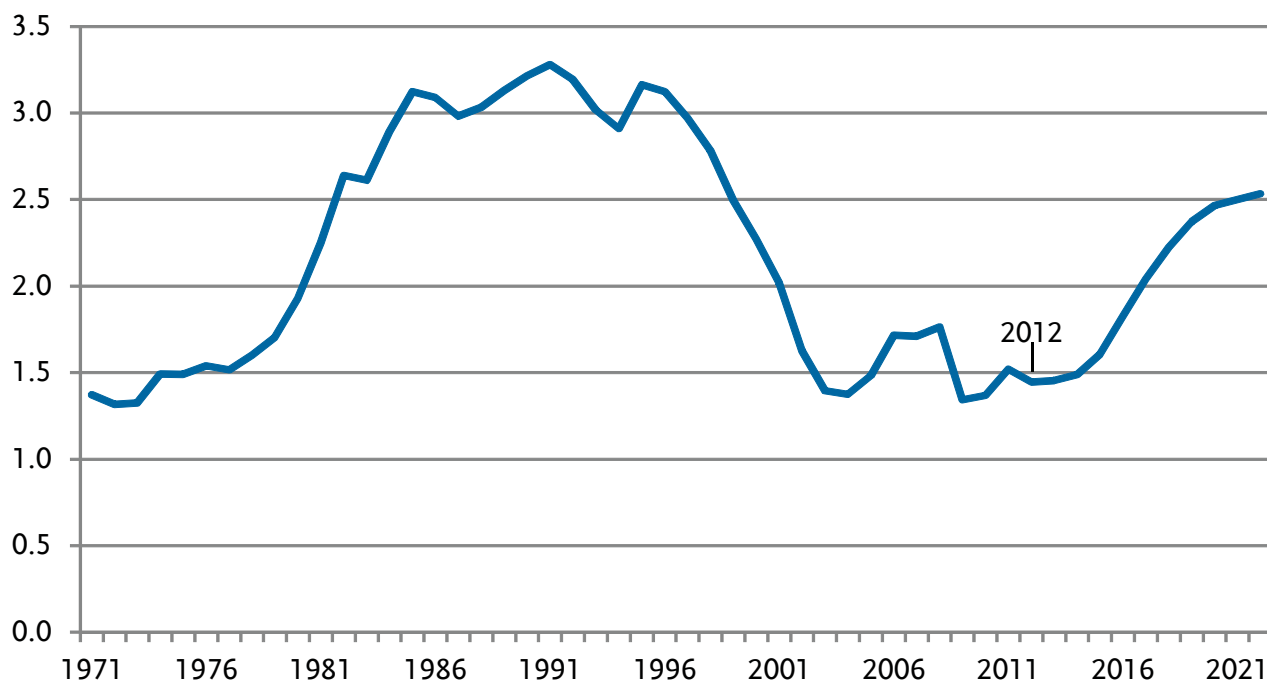


Table 1: Price in 2015 of a 30-Year Bond Coming to Maturity in 2042 (coupon = 2.75%)

Current Interest Rate	Bond Price
2.75%	\$100.00
6.0%	\$57.00
8.5%	\$39.80
12.0%	\$26.56

Source: Smart Money Bond Calculator

cise, since it will not reduce the interest burden it faces, but if for some reason we need to reduce our debt to GDP ratio, then this is an obvious mechanism for accomplishing this result.<sup>17</sup>

This point can even be taken a step further. If the problem of the debt is somehow measured by the debt and not the interest burden, then if the U.S. government were to ever face the Greek style meltdown of which many deficit hawks have warned, it presents an enormous opportunity. If the concerns over the country's solvency sent interest rates on existing debt soaring, the bond prices would plummet. As Table 1 shows, if the interest rate rose to 12.0 percent, then the price of a 30-year bond issued at 2.75 percent interest rate with 27 years left to maturity would be just \$26.56. This means that the Treasury could buy up its outstanding debt at a huge discount, sharply reducing its debt burden. Again, this would not change the interest burden, but if the concern is the amount of debt outstanding, this would be a quick way to make progress by this metric.

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There is one other important point that should be noted about the burden of the debt. At present, the Federal Reserve Board holds close to \$3 trillion in assets, primarily government bonds and mortgage backed securities. There are substantial interest earnings on these assets, most of which end up being refunded back to the Treasury. In 2011, the Fed refunded \$83 billion back to the Treasury.<sup>18</sup> This means that the actual interest burden to the Federal government was considerably lower than the 1.5 percent of GDP shown in Figure 4. Subtracting the amount refunded

from the Fed to the Treasury, the net interest burden in 2011 was just over \$140 billion, or less than 1.0 percent of GDP. This is a lower interest burden than at any other point in the post-War era.

The projections from the Congressional Budget Office and other authoritative sources assume that the Fed will soon sell off these assets so that its payments to the Treasury will fall sharply over the next decade. The reason for this assumption is that it is believed that the Fed will want to withdraw reserves from the system to head off the threat of inflation. While this is one route that the Fed could go to limit the potentially inflationary effects of excessive reserves in the banking system, it does have other options. For example, it could increase banks' reserve requirements. An increase in reserve requirements can be every bit as effective in reducing the money supply as directly pulling reserves out of the system. (China's central bank relies heavily on changes in reserve requirements for controlling the money supply.) Increasing reserve requirements would allow the Fed to keep more of its assets and thus continue to refund money to the Treasury.

It is generally believed that changing the reserve requirement is a less desirable tool for conducting monetary policy than changing the amount of reserves in the system because changes in the reserve requirement can be a blunt instrument with unpredictable effects. However, in the current context, where it is likely that there will be a prolonged period in which the Fed will want to gradually reduce the money supply, it might be quite reasonable for the Fed to lay out a schedule of increases in the reserve requirement over a set number of years. This would remove the problem that unpredictable changes in the reserve requirement could lead to instability in the system. Also, the additional controls over the financial system more generally provided by Dodd-Frank should mean that financial regulators could limit the extent to which non-bank financial institutions attempt to circumvent the higher reserve requirements imposed on banks.

Table 2 shows the year by year impact on the deficit if the Fed were to continue to hold its current level of financial assets so that it is able to refund \$80 billion a year to the Treasury over the next decade. The cumulative savings to the Treasury compared with the baseline scenario used by CBO is over \$340 billion after factoring in the interest savings over this period.

Table 2: Impact of Federal Reserve Board Rebates on the Deficits (in billions of \$US)

	Constant Rebate	Projected Rebate	Annual Difference	Cumulative Difference
2013	80.0	78.0	2.0	2.0
2014	80.0	66.0	14.0	16.0
2015	80.0	51.0	29.0	45.4
2016	80.0	43.0	37.0	84.0
2017	80.0	41.0	39.0	126.2
2018	80.0	37.0	43.0	174.6
2019	80.0	40.0	40.0	222.2
2020	80.0	47.0	33.0	264.9
2021	80.0	52.0	28.0	304.5
2022	80.0	54.0	26.0	343.8

Source: Congressional Budget Office, 2012 (a) and author's calculations

A higher reserve requirement would imply an increased wedge between the rate at which money is lent out and the interest rate paid on deposits. In this sense, the proposal to increase the reserve requirement to head off inflationary pressures can be seen as equivalent to imposing a tax on the banking system. While that is true, it is worth noting that there had been higher reserve requirements in place in the decades immediately after World War II, with the reserve requirement exceeding 20 percent of checking deposits for major money center banks for most of the decade immediate following World War II. (It is now 10 percent and 0 for non-transactions accounts.)<sup>19</sup> At that time, no one discussed higher than necessary reserve requirements as a tax and it is certainly not treated as a tax in historical accounts of federal taxation, which would have to show a higher level of taxation in those decades. At present the data only includes taxes that are explicitly identified as such.

As a practical matter, this is yet another situation in which the government's direction of resources goes far beyond its formal taxing and spending authority. Just as the power to sustain patent and copyright monopolies can involve payments for serving public purposes that are quite large relative to explicit tax flows, reserve requirements that are higher than necessary for prudential purposes can also

imply a large implicit tax that is not counted in standard budget numbers.

### Long-Term Cost Nightmares: Aging Is Not the Problem

As noted earlier, the horror story in long-term deficit projections is almost entirely the story of the projected explosion of health care costs. While it is widely believed that the aging of the population is the main culprit, the additional costs associated with aging can be met without major disruptions to the economy. However, if health care costs unrelated to aging follow the path in the baseline projections, then it will present nearly insoluble budget problems.

Of course, if health care costs follow this projected path it would also take a devastating toll on the rest of the economy, too. Families would face enormous difficulties covering their health care costs, and companies that are unable to avoid paying for the health care benefits of their workers might follow the path of General Motors and Chrysler into bankruptcy.

The fact that the aging of the population is not a major

factor in future deficit projections can be seen from examining the projections for Social Security, a program whose costs are driven almost entirely by aging.<sup>20</sup> The projected cost of Social Security rises from 5.0 percent of GDP in 2012 to 6.2 percent of GDP by 2033. It then stabilizes at this level for the next quarter century before gradually rising to 6.7 percent of GDP by 2087, the end of the CBO projection period.<sup>21</sup> The increase in spending of 1.2 percentage points of GDP projected for the next two decades is a considerably slower pace of increase than the 0.9 percentage point increase in spending on Social Security that we actually experienced from 2000 to 2012.

Insofar as the cost of Medicare and Medicaid are driven by aging, the rate of increase would be no more rapid than for Social Security, since the rate at which aging increases the number of beneficiaries for both programs will be roughly the same.<sup>22</sup> The much more rapid rate of cost growth in Medicare and Medicaid is due to the growth of per person health care costs, not aging.

If Social Security is viewed as a standalone program, as it is structured under current law, the projected shortfall in the program is relatively modest. According to the Congressional Budget Office's projections, the program faces a shortfall that is equal to 1.6 percent of taxable payroll over its 75-year planning horizon.<sup>23</sup> If this shortfall were fully closed by simply raising the payroll tax, the increase in the tax would be equal to 4.1 percent of projected wage growth over the next 30 years. (Real wage growth is projected to average 1.1 percent annually.)

Furthermore, much of the projected shortfall is not due to aging, but rather due to the upward redistribution of income over the last three decades. When the formula for the cap on taxable wages was last changed in 1983, 90 percent of wage income fell under the cap. In recent years, the share of wages under the cap has hovered between 82 percent and 85 percent. CBO projects that the proportion of wages subject to Social Security taxes will fall back to 82 percent between now and 2032.<sup>24</sup>

According to the Social Security Administration's calculations, if the tax were raised enough to again cover 90 percent of wages, it would reduce the projected shortfall by 0.80 percent of taxable payroll, enough to cover half of the shortfall projected by CBO. (This assumes that benefits are increased accordingly.)<sup>25</sup> If the cap on wages subject to

the payroll tax was eliminated entirely, SSA projects that it would lead to a net increase in revenue of 1.91 percent of payroll -- more than enough to fully eliminate the 75-year shortfall projected by the Congressional Budget Office.<sup>26</sup> In short, closing the projected shortfall in Social Security does not pose a daunting task. If it were to be done entirely on the revenue side, the amounts needed are well within the range of past tax increases for Social Security and can be spread over long periods of time.

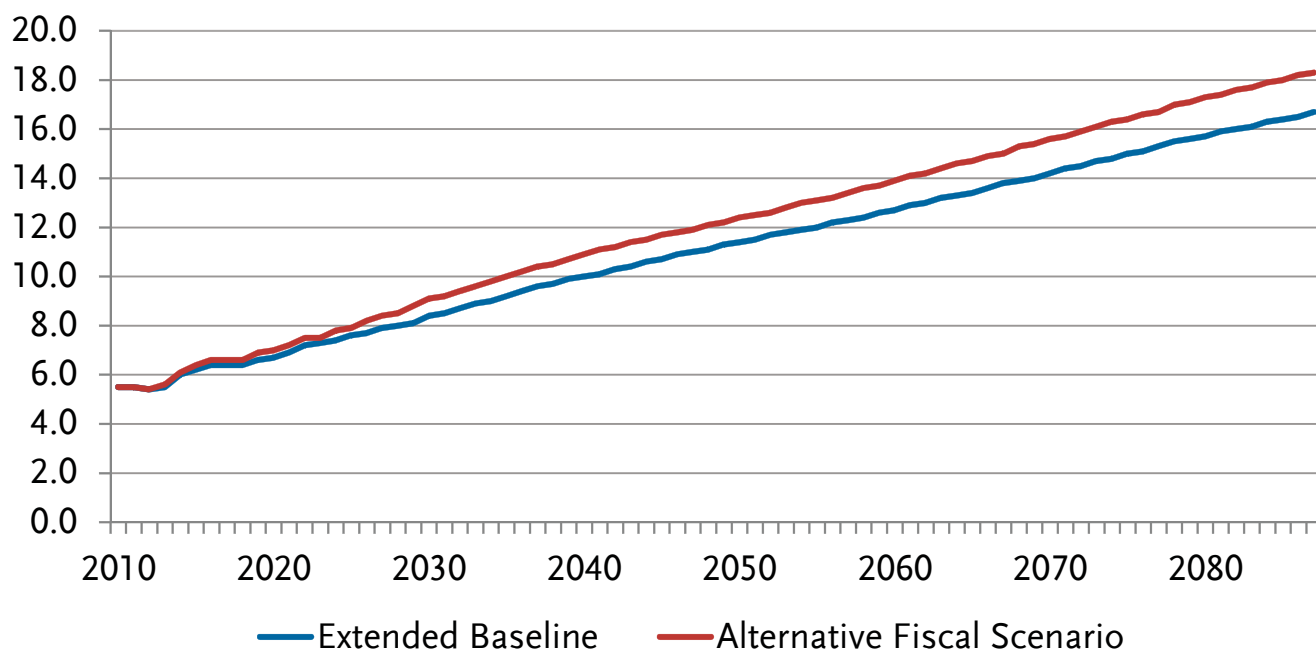
## The Health Care Horror Story

Figure 5 shows the CBO projections for federal government health care spending as a share of GDP under both a baseline scenario and a somewhat more pessimistic alternative fiscal scenario. In the former case, CBO assumes that annual age-adjusted spending increases at a rate of 1.6 percent more than per capita GDP growth in 2011 in all government health care programs.<sup>27</sup> The difference between the rate of growth of age-adjusted spending and per capita GDP growth is projected to eventually fall to zero by 2087 for Medicaid and the health care exchanges. This measure of excess cost growth is projected to fall to 1.0 percent by 2087 in Medicare. The baseline scenario assumes a slower rate of cost growth through 2030 in Medicare than the alternative fiscal scenario.<sup>28</sup>

It is important to note that these projections do not assume that public sector health care costs rise more rapidly than private sector costs. These projections are based on the assumption that the growth of health care costs for the economy hugely outpaces the growth rate of the overall economy. In these projections, even in the more conservative baseline scenario, health care costs would be more than 36 percent of GDP by 2087. With per capita GDP projected to be over \$171,000 by 2087, this implies per capita health care spending of more than \$61,000 a year (both figures are in 2012 dollars).<sup>29</sup>

To assess the plausibility of these projections, it is worth noting that the United States already pays more than twice as much per person as the average for other wealthy countries even though the United States has little obvious advantage in terms of outcomes. It actually ranks near the bottom in life expectancy and its record is mixed in most other outcome measures. Figure 6 shows per capita health

Figure 5: Federal Government Health Care Spending as a Share of GDP



care spending (adjusted for purchasing power parity) in the United States and several other wealthy countries.

As can be seen, the United States already spends close to twice as much per person as Canada and Germany, two of the higher cost countries. It spends close to two and half times as much per person as Japan and the U.K. The assumption that age-adjusted health care costs will continue to outpace per capita GDP growth implies that health care spending will continue to rise as a share of GDP. It also means that the gap between per person spending in the United States and in other countries would continue to grow.<sup>30</sup> This would mean that there would be enormous potential savings if people from the United States could take advantage of the more efficient health care systems in other countries.

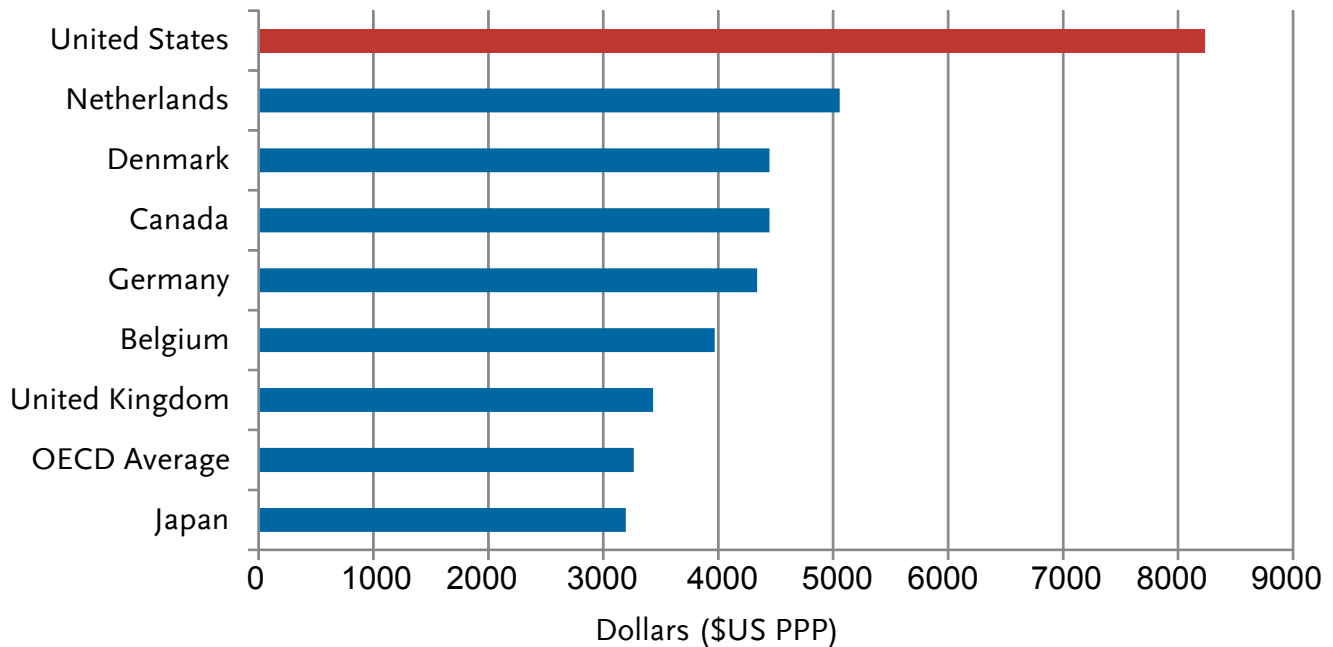
One way in which this could be done would be to negotiate arrangements with other OECD countries under which Medicare beneficiaries would be allowed to buy into other countries' health care systems. They would get their health care from the system in Canada, Germany or whatever country they chose rather than the United States. The beneficiary and the government would split the savings, which would quickly run into the tens of thousands of dollars per beneficiary per year, according to current projections.<sup>31</sup> The potential gains are sufficiently large that it would be possible to offer countries a premium of 10-15

percent above current costs, while still leaving a large gap to be shared.

There are many other potential mechanisms for controlling costs. The point is that if costs for the U.S. health care system can be brought in line with costs in other wealthy countries then the United States would not face serious long-term deficit problems. If per person health care costs in the United States could be brought near the level of other wealthy countries, the United States would be looking at long-term budget surpluses, not deficits.<sup>32</sup>

Given the nature of the problem, a serious discussion should focus on fixing the U.S. health care system. It is misleading to discuss this as a deficit problem, as though the government is somehow spending too much money or not raising enough tax revenue. An honest discussion would focus on the inefficiencies of the U.S. health care system and the need to get costs under control. Reducing or eliminating the public sector commitment to provide health care is beside the point; the public sector was initially given this responsibility because of the failure of the private sector to provide adequate health care for large segments of the population. The real policy goal is fixing the health care system so that the public can be assured of decent care at a reasonable cost. It is not simply reducing the budget deficit to an acceptable level.

Figure 6: Total Health Spending Per Capita, 2010, Selected OECD Countries



## Conclusion: Where the Debate Needs to Be

The emphasis on budget deficits in national policy debates over the last three decades has badly distorted national priorities. There has been an enormous amount of fundamentally confused thinking on budget deficits that has made its way into mainstream political debates.

This paper shows that it is implausible that future generations of workers will see a decline in living standards due to the effects of an aging population. Even using pessimistic assumptions, the average standard of living 25-30 years from now will be far higher than it is today, in spite of the projected rise in the ratio of retirees to workers.

Furthermore, the potential harm from budget deficits has been seriously misrepresented. If a budget deficit occurs when the economy is below full employment, as is the case presently, it will almost certainly make future generations of workers better off, rather than worse off. Even deficits that are run when the economy is near full employment are likely to be less harmful than is generally believed. Also, if the deficit is run to increase public investment it is likely to be a net positive for future generations.

There are also serious misunderstandings in the national

conversation about the nature of the burden imposed by government debt. The debt is not a measure in any way of intergenerational burdens. It is simply one of many ways in which the government commits flows of income in the future.

In addition, it is important to recognize that the real burden of debt is measured by the size of annual interest payments, not the size of the debt. As of 2012, the ratio of interest payments to GDP was near its post-war low.

Finally, the long-term deficit horror stories that appear frequently in public discussions are driven almost entirely by projections of exploding health care costs. If health costs actually follow the current projected path, it will have a devastating impact on the economy regardless of what is done with public sector health care programs like Medicare and Medicaid. This points to the urgency of fixing the health care system itself. Treating the projected explosion of health care costs as a budget problem conceals the true nature of the problem.

The economy and the country do face many real problems going forward; the deficit, however, is not one of them. By misdirecting attention toward debts and deficits, our policy focus has been diverted from the issues that will truly have the largest impact on the standard of living of future generations.

## Technical Notes

### Tables

Table 1: The Smart Money Bond Calculator was used to construct the table. It is available at <http://www.smart-money.com/calculator/bonds/bonds-calculator--bonds-bond-funds-1309988621833/>.

The calculations show the current price of a bond issued at a 2.75 percent interest rate with 27 years until maturity. The record of past yields on 30-year bonds can be found at the [Federal Reserve Board's web site](#).

Table 2 takes the Congressional Budget Office's projected rebates from the Federal Reserve Board (CBO, 2012(a) Table 4-1) and contrasts it with a situation where the Federal Reserve Board continued to rebate \$80 billion a year to the Treasury for the rest of the projection period. The calculation in column 4 applies the average of the projected interest rate on 10-year and 30-day Treasury debt to the past savings and adds the current year's interest rate savings as calculated in column 3.

### Figures

Figure 1 assumes that an amount equal to 85 percent of workers' consumption goes to support the consumption of retirees. This calculation is not directly related to the size of the payroll tax. Retirees must be supported out of current production. If it is assumed (generously) that the average retiree consumes 85 percent as much as the average worker then at a point in time, it matters little whether the income for retirees comes through a payroll tax or through other claims to income, even though higher payroll taxes may have an impact on slowing growth compared to other mechanisms. (As a practical matter, it almost certainly will be the case that a substantial portion of retiree income will come through mechanisms other than programs supported by the payroll tax.) The projected rise in the ratio of retirees to workers is taken from the 2012 Social Security trustees report, Table IV.B2. The projected growth figures are obtained by taking 1.0, 1.5 and 2.0, respectively to the 23rd power.

Figure 2 shows the shares of GDP at the business cycle peaks in 1989 and 2000. The budget deficit figures are taken from CBO (2012(a)) Table E-2. The shares for investment, consumption, and net exports are taken from Bureau of Economic Analysis National Income and Product

Accounts, Table 1.1.5. The investment and consumption figures differ slightly from the data in this table since they were adjusted for the rise in car leasing over this period. This rise distorts the data since a leased car counts as an investment by leasing company whereas a car purchased by a consumer counts as consumption. Car leasing was less than 0.1 percent of GDP in 1989. It rose to more than 0.4 percent of GDP by 2000.

The adjustment for car leasing subtracts the amount paid out for leasing of motor vehicles, National Income Product Accounts, Table 2.4.5U, Line 190 from investment. This amount represents the flow of services coming from leased vehicles in a given year. This should approximate the amount of investment recorded in NIPA accounts for vehicles purchased to be used for leasing. This amount is added into the number for consumption.

Figure 3 uses the projections for per capita GDP in the balanced budget scenario from CBO (1996), Table 4-8. The numbers were converted to 2011 dollars used the GDP deflator from National Income and Product Accounts, Table 1.1.4, Line 1. The actual GDP numbers through 2010 are taken from the Economic Report of the President, Table B-31. The projections for 2015 and 2020 were based on taken from CBO's projections for real GDP (CBO 2012(a), Table A1, available at [http://www.cbo.gov/sites/default/files/cbofiles/attachments/Jan2012\\_EconomicBaseline\\_Release.xls](http://www.cbo.gov/sites/default/files/cbofiles/attachments/Jan2012_EconomicBaseline_Release.xls)) and the Census Bureau's projections for population growth (Census Bureau, 2009, Summary Table 1, available at <http://www.census.gov/population/www/projections/files/nation/summary/NP2009-T1-C.xls>).

Figure 4 uses the data from Table F-3 in CBO 2012 (a) and includes the projections from Table 3-1.

Figure 5 uses the projections from CBO 2012(d), Supplemental Data.

Figure 6 uses the OECD Health Care Statistics 2012, Total Expenditures Per Capita Table, available at <http://stats.oecd.org/Index.aspx?DataSetCode=SHA> (Expenditures for Japan for 2010 apply the average growth rate over the prior 5 years to the 2009 estimate, and the OECD average is calculated with 2010 or the nearest year.)

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## Notes

1. “The 2012 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds,” Social Security Administration, Table IV.B2.
2. These rates of productivity growth can be seen as comparable to the growth of “usable productivity” as described in Dean Baker, “The Productivity to Paycheck Gap: What the Data Show,” Center for Economic and Policy Research, 2007. Usable productivity is growth that can be translated into higher wages and therefore higher standards of living. These growth rates are adjusted for differences in deflators, the increasing share of depreciation in output, and the growing share of employer provided health care in compensation.
3. The expense to the government of caring for young people is less than for older people, so the lower ratio of young dependents will not fully offset the impact of the rise in the ratio of elderly dependents. However, this gap is not as large when considering all the expenses that parents must directly bear, most importantly in the form of child care, both paid and unpaid. When considering workers’ living standards, this burden must be taken into account.
4. Social Security Trustees Report 2012, Table V.A2.
5. For example, see: Laurence Ball and N. Gregory Mankiw, “[What do Budget Deficits Do?](#)” *Proceedings*, Federal Reserve Bank of Kansas City, 1995: 95-119.
6. S. Baker et al (2011) finds a large impact of uncertainty on investment and growth. However, this study does not directly include deficits as one of the items causing uncertainty. Hence the use of this study to support claims that current deficits have slowed growth are somewhat misleading.
7. For a summary of the literature, see: Robert S. Chirinko, “Business Fixed Investment Spending: A Critical Survey of Modeling Strategies, Empirical Results, and Policy Implications,” *Journal of Economic Literature* (December 1993): 1875-1911; and Steve Fazzari, R. Glenn Hubbard and Bruce Peterson, “Investment, Financing and tax Policy,” *American Economic Review*, (May 1988) V. 78, 200-205.
8. See John Irons, “Economic Scarring: The Long-term Impacts of the Recession,” Economic Policy Institute, 2009; and Kerwin Charles and Melvin Stevens, “Job Displacement, Disability and Divorce,” National Bureau of Economic Research, Working paper 8578, 2001.
9. Rudiger Dornbusch, *Dollars, Debts, and Deficits*, Cambridge, MA: MIT Press, 1985.
10. Dean Baker and Karl Walentin, “Money for Nothing: The Increasing Cost of Foreign Reserve Holdings to Developing Countries,” Center for Economic and Policy Research, 2001.
11. “[The Economic and Budget Outlook: Fiscal Years 1997-2006](#),” Congressional Budget Office, 1996, Table 4-8.
12. See: David Aschauer, “Is Public Expenditure Productive?” *Journal of Monetary Economics*, V. 23, March 1989: 177-200; Alicia Munnell “Why Has Productivity Growth Declined?: Productivity and Public Investment,” *New England Economic Review*, January 1990: 3-22; Douglas Holtz-Eakin, “Solow and the States: Capital Accumulation, Productivity, and Economic Growth.” NBER Working Paper W4144, 1992; and James Heintz, “The Impact of Public Investment on the U.S. Private Economy,” *New Evidence and Analysis*, *International Review of Applied Economics*, 2010.
13. There is an issue about debt owed to foreigners, but this is a function of the trade deficit, not the budget deficit. Those who are concerned about foreign indebtedness should be pushing for a reduction in the value of the dollar, which is the main factor determining the size of the trade deficit. A reduction in the budget deficit will have little effect on the trade deficit unless it is accompanied by a fall in the value of the dollar. Furthermore, payments to foreigners will depend on their ownership of U.S. assets in general, not just government bonds. Future generations will be no better off if foreigners hold \$5 trillion of private debt and equity than if they hold \$5 trillion of U.S. government bonds.
14. It is possible that the private sector can maintain the highway at a lower cost than the government, even after accounting for the costs associated with collecting

tolls. In this case there would be some economic gain, but it would almost certainly be at least an order of magnitude smaller than the taxes or tolls in question. Of course the private sector may actually be less efficient, especially when the necessary public sector monitoring costs are factored in (see: David Sappington and Joseph Stiglitz, “Privatization, Information and Incentives,” *Journal of Policy Analysis and Management*, Vol. 6, No. 4, 1987: 567-585).

15. This calculation is based on the Center for Medicare and Medicaid Services National Health Expenditure Projections, 2011-2022, Table 2. (The number for 2022 imputes the growth rate for the prior decade to the 2021 number.) These calculations assume that without patent protection or other forms of intellectual property, drugs would sell for one-tenth of their current price. This would come to around \$40 per prescription on average over this period.

16. For examples of alternative funding mechanisms, see: Dean Baker, “Financing Drug Research: What are the Issues?” Center for Economic and Policy Research, 2004.

17. The argument that high levels of debt to GDP are a major impediment to growth is most associated with Carmen Reinhart and Kenneth Rogoff. See: Carmen Reinhart and Kenneth Rogoff, *This Time is Different: Eight Centuries of Financial Folly*, (Princeton University Press, 2008); and Carmen Reinhart and Kenneth Rogoff, “Growth in a Time of Debt,” *American Economic Review*, May 2010, vol. 100(2), 573-8.

18. Congressional Budget Office, 2012, Table 4-1.

19. A history of reserve requirements can be found in Appendix Tables A1-A4 of Joshua Feinman, “Reserve Requirements: History, Current Practice and Potential Reform,” *Federal Reserve Bulletin*, June 1993: 570-589.

20. The disability portion of the program is affected by aging but also other factors.

21. “The 2012 Long-Term Budget Outlook,” Congressional Budget Office, 2012, Table 4-1.

22. Actually, there are differences in cost for Medi-

care beneficiaries by age. This fact actually slows the rate of growth of Medicare costs relative to Social Security since at least initially the baby boomers entering the program will be in the relatively low cost age cohorts.

23. The 2012 Social Security Trustees Report shows a somewhat larger shortfall. While the difference between the projections matter little to this argument, there are three reasons why the CBO projections should be preferred. First, they are consistent with the other numbers used in this analysis. Second, CBO’s projections are done by its professional staff. The projections of the trustees are in fact from the trustees, not the professional staff of the Social Security Administration. Four of the six trustees are political appointees of the president. Third, the CBO numbers are fully explained in their methodology. The Social Security Administration does not provide any information on the basis for changes in assumptions from year to year. The memos prepared by the professional staff for the trustees are not made available to the public.

24. Congressional Budget Office, 2011, p 7.

25. [“Summary Measures and Graphs: Increase Taxable Maximum Such That 90 Percent of Earnings Would Be Subject to Payroll Tax”](#) Social Security Administration, based on 2011 Trustees Report.

26. [“Summary Measures and Graphs: Eliminate the Taxable Maximum,”](#) Social Security Administration, based on 2011 Trustees Report.

27. Age-adjusted health care spending measures the changes in health care spending across time or between countries assuming that the age-distribution of the population did not change.

28. [“The 2012 Long-Term Budget Outlook \(Supplement\),”](#) Congressional Budget Office, 2012, Table 5.

29. These calculations apply the rate of excess cost growth from the CBO 2012 Long-Term Budget Outlook for non-Medicare spending (Supplement, Table 6; see previous note), to all non-Medicare spending in the economy. The latter is projected to be 16 percent of GDP by the Center for Medicare and Medicaid Services in 2022. Projected Medicare spending for 2087 from Table B-1 is then added

to this number. The per capita GDP number for 2087 is taken from Table 3.

30. This would happen if spending in other countries grew at the same rate as in the United States, which for the most part it has not. If spending in the United States doubled from 17 percent of GDP to 34 percent of GDP and spending in the U.K. also doubled from 9.6 percent of GDP to 19.2 percent of GDP, then the gap in spending would rise from 7.4 percent of GDP to 14.8 percent of GDP.

31. Dean Baker and Hye Jin Rho, “Free Trade in Health Care: The Gains from Globalized Medicare and Medicaid,” Center for Economic and Policy Research, October 2009.

32. David Rosnick, “Health Care Budget Deficit Calculator,” Center for Economic and Policy Research, 2012.

# Tax Reform That Works

## Building a Solid Fiscal Foundation with a VAT

*Bruce Bartlett, Columnist, Tax Notes and the Fiscal Times; Author, The Benefit and the Burden: Tax Reform -- Why We Need It and What It Will Take*

Tax reform is like the weather – everyone talks about it, but no one ever does anything about it. But unlike inclement weather, the problems of the tax system don't go away; they continue to fester and compound. Today there are a number of unpleasant trends in the federal tax system that are crying out for attention:

Taxes are too low to finance the level of government people appear to demand. Federal revenues are just 15.8 percent of GDP. They have averaged 18.5 percent of GDP in the postwar era, but only reached that level once in the last 10 years; every other year revenues have been well below that level, contributing heavily to the budget deficit and growth of the national debt.<sup>1</sup>

The tax code is getting harder and harder to understand and administer and desperately needs radical simplification. Yet Americans show no appetite for giving up cherished deductions and credits that clutter the tax code, overlap and duplicate each other, and often encourage inefficient and wasteful economic activities.<sup>2</sup>

It is widely believed that the tax code, especially on the corporate side, is a drag on economic growth. While the idea that tax reform is essential to jump-start growth is unrealistic, there is no question that there are potential reforms that would raise the long-term trend rate of growth if implemented properly.

People often point to the Tax Reform Act of 1986 (TRA 86) as an example to follow. It eliminated various tax preferences and lowered statutory tax rates. While in principle this would be worth doing again, there are a number of obstacles, both political and substantive, that make a simple reprise of TRA 86 unrealistic.

First, the Tax Reform Act of 1986 was the culmination of almost two decades of efforts to reform the tax system that previously produced budgets laden with tax expenditures and included the tax reform acts of 1969 and 1976. In many ways, there was an infrastructure in place at that time regarding knowledge of the tax system and a consensus on at least the general outlines of reform that does not exist today.

Second, in advance of the 1986 effort there were two important congressional tax reform proposals – a Democratic bill cosponsored by Sen. Bill Bradley of New Jersey and Rep. Dick Gephardt of Missouri, and a Republican plan cosponsored by Rep. Jack Kemp of New York and Sen. Bob Kasten of Wisconsin – which showed enough similarity that both sides recognized the potential for a bipartisan tax reform effort. Nothing remotely the same exists today, with the two parties deeply polarized on tax policy.

Finally, the ultimate impact of TRA 86 was disappointing, both politically and economically. As early as 1990, critical aspects of it were already unraveling: in particular, the top rate was raised without restoring tax preferences that were eliminated as part of a package deal, and the agreement to tax capital gains at the same rate as ordinary income was broken. Subsequent analysis of the real world economic effects of tax reform showed surprisingly little impact despite widespread expectations that the 1986 act would have large effects.<sup>3</sup> The paucity of meaningful impact suggests that extravagant claims for how tax reform is all that

is needed to jumpstart growth should be taken with many grains of salt.

Earlier tax reform efforts in the 1960s and 1970s were driven largely by liberals wishing to make the tax code more progressive by ending tax loopholes for the rich.<sup>4</sup> This effort was joined in the 1980s by conservatives anxious to cut statutory tax rates, which they believed to be the key to growth, and they were willing to pay for rate reductions with base-broadening. Critically, the budget deficits of that decade imposed a hard constraint on tax reform: rate cuts had to be honestly paid for with real reforms that raised revenues to guarantee a revenue-neutral package.<sup>5</sup>

Additionally, all previous tax reform efforts were strongly supported by the Treasury Department, which was really the central driver. The 1969 and 1976 tax reforms were essentially drafted by Treasury and the 1986 reform grew out of a three-volume report drafted by Treasury economists.<sup>6</sup> However, since the 1990s, under both Republican and Democratic administrations, Treasury has been marginalized in terms of tax policy, with Congress taking the lead role.<sup>7</sup> As a consequence, tax legislation has become increasingly unfocused, with tax bills being little more

than random collections of various tax provisions that often overlap with existing law and may even conflict with each other. Restoring Treasury’s central role in tax policy is a necessary precondition for meaningful tax reform.

Another precondition is strong support by the president. Congress is too divided and heterogeneous to do tax reform by itself. Under the Constitution, tax bills must originate in the House of Representatives and then, if successful, the process must start all over again in the Senate. The president must be actively engaged to make sure they don’t go off in different directions, that the integrity of the effort is maintained, that unintentional subsidies or penalties aren’t inadvertently inserted, and to help overcome resistance through lobbying and political pressure.<sup>8</sup>

Presently, the tax reform effort is in its infancy, with no strong leadership, no framework with the potential for bipartisan support, or even a consensus among tax experts on where to begin.

Republicans are keen to reduce rates further, as they did in 1986, but steadfastly refuse to put many of the largest tax expenditures on the table that they would be willing to

Table 1: Top 10 Tax Expenditures, Fiscal Year 2013

Provision	Cost (Billions of Dollars)
Exclusion of employer contributions for medical insurance	180.6
Deductibility of mortgage interest on owner-occupied homes	100.9
401(k)-type pension plans	72.7
Deductibility of state and local taxes, including property tax	68.6
Capital gains special tax rate	62.0
Employer-provided pension plans	52.3
Exclusion of net imputed rental income	51.1
Charitable contributions	48.9
Exclusion of interest on state and local bonds	36.2
Accelerated depreciation on machinery and equipment	33.2
<b>Top 10 total</b>	<b>796.5</b>

Source: Office of Management and Budget, “The President’s Budget for Fiscal Year 2013,” Table 17-3.

abolish or restrict to pay for lower rates. The reason is simple: meaningful rate reduction in a revenue-neutral reform would require going after one or more of the most popular tax preferences: the exclusion for health insurance or the deductions for mortgage interest, state and local taxes, charitable contributions, or the many provisions for retirement saving.<sup>9</sup> Just the top ten tax expenditures account for 70 percent of the revenue loss from all tax expenditures. Not surprisingly, polls show that people oppose eliminating these tax preferences either to lower tax rates or for deficit reduction.<sup>10</sup>

Given the barriers to a 1986-style tax reform that would trade base broadening for lower rates in a revenue-neutral manner, many tax experts are very skeptical that it is possible to do something similar today.<sup>11</sup>

In my opinion, the greatest potential to break the tax reform gridlock is to get away from the model of cutting popular tax preferences in order to pay for rate reductions. That is the political equivalent of World War I-style trench warfare. I think it makes more sense to adopt a different approach, one more akin to Douglas MacArthur's strategy of leapfrogging Japanese strongholds in the Pacific during World War II, leaving them impotent.

The tax equivalent of MacArthur's strategy would be to leave in place all the existing deductions and credits, but make them irrelevant for most people. Prof. Michael Graetz of Columbia University has devised exactly such a plan.<sup>12</sup> He would institute an exemption of \$100,000 for married couples (\$50,000 for singles, \$75,000 for heads of households). All the existing deductions and credits would remain in place and could still be used by those with incomes above \$100,000, but for the vast bulk of taxpayers they would become irrelevant because they would have no taxable income against which to take them. About 100 million of the 140 million people now required to file federal income tax returns would no longer have to do so.

Graetz would replace the lost revenue with a value-added tax (more below) combined with a rebate mechanism to relieve the regressivity on those with low incomes and also replace refundable tax credits for the poor. A recent analysis of the Graetz plan by the Tax Policy Center concluded that it could be done in a deficit-neutral manner with a VAT rate of 12.4 percent – well below the rates that prevail in Europe.<sup>13</sup>

## The Conservative Case for a VAT

In a recent column, Reuters columnist Reihan Salam, a political conservative, argued that the Graetz plan is the perfect way to accomplish tax reform while simultaneously dealing with the concerns of many conservatives that some 47 percent of tax filers now have no federal income tax liability<sup>14</sup> Said Salam:

Conservatives hate the idea of new taxes. But imagine if every time you bought a cup of coffee, it said on the receipt that you had also just paid a 12.3 percent consumption tax to the federal government. Instead of paying your taxes once a year, you would pay taxes every time you made a purchase. What better way to remind people of all of the money government spends, and all of the money government spends foolishly, than to make them pay for government several times a day?<sup>15</sup>

Nevertheless, conservatives are the principal opponents of a VAT even though many support a very similar proposal called the FairTax that would replace all federal taxes with a national retail sales tax such as those in almost all states. The problem with the FairTax is that it will never work administratively, whereas the VAT has worked well for decades in many countries economically similar to the U.S., such as Britain, Canada and Australia.<sup>16</sup>

For many years, official Republican Party platforms have opposed a VAT for the United States. The 1992 platform said such a tax in Europe “has resulted in higher prices, fewer jobs and higher levels of government spending.”<sup>17</sup> The 2008 platform said, “In any fundamental restructuring of federal taxation, to guard against the possibility of hypertaxation of the American people, any value added tax or national sales tax must be tied to simultaneous repeal of the Sixteenth Amendment, which established the federal income tax.”<sup>18</sup> The 2012 platform repeats the same language.<sup>19</sup>

Fear that a VAT might come on top of the income tax and hence constitute some sort of double taxation is only one of many conservative objections to a VAT.<sup>20</sup> (No country imposing a VAT has ever abolished its corporate or individual income taxes, although excise and other taxes were

often replaced.)

The irony is that the VAT is probably the best tax ever conceived from a conservative point of view. As a broad-based tax on consumption, it creates less economic distortion per dollar of revenue than any other tax – certainly much less than the income tax. Moreover, there is a long history of conservative support for consumption-based taxation dating back at least to the philosopher Thomas Hobbes. In *Leviathan* (1651), he argued that consumption was what people took out of society while saving added to society's wealth. Therefore, consumption was the best base for taxation while saving should be exempt.<sup>21</sup>

Alexander Hamilton, among others, also emphasized that taxing consumption was the method of taxation most consistent with freedom because people could more easily reduce their consumption than their incomes. As he put it in Federalist 21:

It is a signal advantage of taxes on articles of consumption, that they contain in their own nature a security against excess. They prescribe their own limit; which cannot be exceeded without defeating the end proposed, that is, an extension of the revenue. When applied to this object, the saying is as just as it is witty, that, “in political arithmetic, two and two do not always make four.” If duties are too high, they lessen the consumption; the collection is eluded; and the product to the treasury is not so great as when they are confined within proper and moderate bounds. This forms a complete barrier against any material oppression of the citizens by taxes of this class, and is itself a natural limitation of the power of imposing them.<sup>22</sup>

This view has been endorsed by virtually every tax theorist from Hamilton and David Hume in the 18th century, to John Stuart Mill and Alfred Marshall in the 19th century, Irving Fisher and Nicholas Kaldor in the 20th century, and Martin Feldstein and many others today.<sup>23</sup>

A VAT would address a common conservative concern about the growing percentage of the population that pays no federal income taxes. In 2011, 46 percent of all returns had no federal income tax liability according to the Tax Policy Center.<sup>24</sup> It's unrealistic to think that income taxes will be imposed on such people once they have become

exempt. A VAT would be a way of getting all Americans to pay for the federal government's general operations.

Back in the early 1980s, practically every leading conservative economist supported a VAT for the United States. Norman Ture, one of the godfathers of supply-side economics, and Murray Weidenbaum, chairman of the Council of Economic Advisers under Ronald Reagan, wrote many articles, books and papers supporting the VAT. The conservative American Enterprise Institute published a book in 1987 saying that the VAT was the key to deficit reduction.<sup>25</sup>

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## The VAT is probably the best tax ever conceived from a conservative point of view.

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Perhaps the strongest evidence that the VAT was considered *the* conservative tax reform is that it is the foundation of the flat tax, which is still supported by practically every conservative tax reformer.<sup>26</sup> The flat tax, originally devised by Hoover Institution scholars Robert Hall and Alvin Rabushka, is a subtraction-method VAT with one twist; businesses are permitted to deduct cash wages paid from the base on which they calculate the VAT. Workers pay the same rate on their wages less only a personal exemption. The purpose of this adjustment is to create transparency so that everyone sees the tax they are paying, and to redress its regressivity.

This is not the only case of conservatives supporting a VAT when it suited them to do so. When former California Gov. Jerry Brown, a Democrat, proposed a VAT plus a flat rate income tax in 1992, this was widely hailed by supply-side economists such as Arthur Laffer and Gary Robbins.<sup>27</sup> Similarly, conservatives have recently embraced a proposal that would have replaced California's state income tax with a VAT.<sup>28</sup>

In Congress, Rep. Paul Ryan, Republican of Wisconsin, chairman of the House Budget Committee and the Republican Party's nominee for vice president in 2012, received high praise from conservatives for his “Fiscal Roadmap” plan that would eliminate the national debt by slashing spending. But its first version would also have replaced the corporate income tax with what he called a Business Consumption Tax that is, again, a type of VAT.

Sen. Jim DeMint, Republican of South Carolina, generally considered to be the most conservative member of the Senate, cosponsored this legislation.<sup>29</sup>

Nevertheless, whenever a VAT for the U.S. is suggested, conservatives are the first to denounce the idea. It is an article of faith among them that the VAT is a money-machine that must be fought to the death. The *Wall Street Journal*, for example, continually rails against it on the grounds that if we were ever to adopt such an insidious form of taxation we would very quickly become just like Europe, as if the entire continent were one big Gulag instead of a place where by and large the people are just as free and prosperous as Americans.<sup>30</sup>

## Debunking the Money Machine Myth

In the 1970s, there was talk of a VAT for the U.S. Richard Nixon was sympathetic to the idea.<sup>31</sup> But eventually conservatives decided that the VAT's greatest virtue – its efficiency; i.e., its ability to raise revenue at a very low deadweight cost (the burden over and above the revenue collected due to discouraged output) – was a defect rather than a virtue. Their fear is that a VAT would raise too much revenue, too easily.<sup>32</sup> Better to raise taxes as painfully and inefficiently as possible, they concluded, in order to limit the government's tax take. At a press conference on February

21, 1985, Ronald Reagan cemented conservative opposition to the VAT, saying it “gives government a chance to grow in stature and size.”<sup>33</sup>

There are two key points about the money-machine argument.<sup>34</sup> First, it is often implied that the trend of the VAT is continuously upward. This is factually wrong. According to the OECD, 7 of the 33 countries with a VAT have cut VAT rates: Canada, Chile, the Czech Republic, France, Ireland, Israel, and the Slovak Republic. And some countries, such as Australia and Korea, have never increased their VAT rates. The average VAT rate in OECD countries is barely above what it was in 1984: 17.75 percent then versus 18.5 in 2011.

In this respect it should also be noted that the VAT rates commonly referred to are statutory rates that don't necessarily tell us anything about the effective tax rate. Conservatives just assume that the VAT covers everything and has the same structure in every country. In fact, every country with a VAT exempts many items and usually imposes lower rates on some things and higher rates on others. The rates one tends to see, such as those cited above and in Tables 3 and 4 below, are the basic rates that apply to most things that a VAT covers. But the share of consumption covered by the VAT varies enormously from one country to another, as shown in Table 2.

Another problem with the money-machine argument is

Table 2: VAT Efficiency (Percentage)

Country	VAT/GDP	VAT Base/Consumption
Japan	2.6	69
Australia	3.8	51
Germany	6.2	50
Canada	3.1	50
France	7.1	45
United Kingdom	6.5	43
Italy	6.1	39

Source: International Monetary Fund, *From Stimulus to Consolidation: Revenue and Expenditure Policies in Advanced and Emerging Economies* (April 30, 2010): 38.

Table 3: VAT Rates in OECD Countries Establishing VATs Before 1975 (by year of inception)

	Country	Initial Rate	Year	2012 Rate	% Increase
1	Denmark	10	1967	25	150
2	France	16.66	1968	19.6	17.6
3	Germany	10	1968	19	90
4	Netherlands	12	1969	19	58.3
5	Sweden	11.11	1969	25	125
6	Luxembourg	8	1970	15	87.5
7	Norway	20	1970	25	25
8	Belgium	18	1971	21	16.7
9	Ireland	16.37	1972	23	40.5
10	Austria	16	1973	20	25
11	Italy	12	1973	21	75
12	U.K.	10	1973	20	100
	<b>Average</b>	<b>13.3</b>		<b>21</b>	<b>58</b>

Table 4: VAT Rates in OECD Countries Establishing VATs After 1975 (by year of inception)

	Country	Initial Rate	Year	2012 Rate	% Increase
13	Korea	10	1977	10	0
14	Mexico	10	1980	16	60
15	Turkey	10	1985	18	80
16	New Zealand	10	1986	15	50
17	Portugal	17	1986	23	35
18	Spain	12	1986	18	50
19	Greece	16	1987	23	44
20	Hungary	25	1988	27	8
21	Iceland	22	1989	25.5	16
22	Japan	3	1989	5	66.7
23	Canada	7	1991	5	(29)
24	Czech Rep.	23	1993	20	(13)
25	Poland	22	1993	23	4.5
26	Slovak Rep.	25	1993	20	(25)
27	Finland	22	1994	23	4.5
28	Switzerland	6.5	1995	8	23
29	Australia	10	2000	10	0
	<b>Average</b>	<b>14.7</b>		<b>17</b>	<b>15.8</b>

Sources: EU, IMF, OECD, Deloitte, PricewaterhouseCoopers, and national sources

that it fails to note the critical impact of inflation on fueling higher VAT rates in the 1970s. At that time it was absurdly easy for governments to raise VAT rates because they were hardly noticed – what was another one percent rise in the tax rate when the general price level was rising at double-digit rates? Furthermore, to the extent that inflation was a function of budget deficits, higher taxes were a plausible means of reducing it. In the Keynesian model, higher taxes are inherently anti-inflationary because they reduce purchasing power.

Therefore, I think it is essential that any money-machine analysis distinguish between those countries that adopted VATs before the great inflation of the 1970s and those adopting VATs in the era of relative price stability that we have seen since that time. I have done so in Tables 3 and 4. They show that to the extent that there is a valid money-machine argument it is only in the countries that were able to piggyback on inflation to ratchet up their rates in the 1970s. VAT rates show little evidence of a ratchet effect during the era of price stability.

## Political Realities of the Tax System

In my opinion, opposing a VAT means implicitly supporting our current tax system, which imposes a deadweight cost equal to a third or more of revenue raised – at least five percent of GDP – according to various studies.<sup>35</sup> This is insane. The idea that raising taxes in the most economically painful way possible will hold down the level of taxation and the size of government is obviously false. It just means that the total burden of taxation including the deadweight cost is vastly higher than it needs to be. If we raised the same revenue more sensibly we could, in effect, give ourselves a tax cut by reducing the deadweight cost.

A common conservative argument is that holding down taxes will somehow starve the beast and automatically lead to lower spending. Not only is there no evidence supporting this belief, recent research argues that it is perverse. By reducing the tax-cost of spending, starve-the-beast theory has actually caused spending to rise.

Those who oppose big government would do better to concentrate their efforts on actually cutting spending. Holding down taxes or insisting that we keep a ridiculously inef-

ficient tax system because that will give us small government is juvenile and bad for the country.<sup>36</sup> If people want small government, there are no shortcuts. Spending has to be cut. But if spending isn't cut, then I believe that we must pay our bills. I think it's better to do so as painlessly and efficiently as possible.

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## VAT rates show little evidence of a ratchet effect during the era of price stability.

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Those who complain most about the VAT generally oppose all tax increases no matter how large the budget deficit is. They imagine that the fiscal crisis their opposition to higher taxes will help to create will lead to massive spending cuts that would be politically impossible otherwise. This cannot happen, however, because Congress is never going to enact a large deficit reduction package that has no tax increases; historically, such packages have aimed for a 50-50 split between spending cuts and revenue increases.

Moreover, polls consistently show that Americans support a deficit reduction package that includes tax increases and spending cuts over a spending cuts-only approach by better than a 2-to-1 margin. And the trend is away from the latter. According to Gallup, the percentage of people favoring only spending cuts has fallen from 20 percent in 2011 to only 10 percent in 2012. The percent of those favoring equal balance between tax increases and spending cuts rose from 32 percent to 45 percent.<sup>37</sup>

Additionally, when the crunch comes there will be a heavy premium on near-term budget savings, which tends to put entitlements off the table, since significant changes to these programs necessarily need to be phased in. And given that defense and homeland security make up such a large percentage of discretionary spending, it's virtually impossible to achieve sufficient savings by cutting only domestic programs. Therefore, as a practical matter, higher revenues will have to be a major part of any budget deal crafted under crisis conditions.

Unless there is already in place an alternative to existing taxes, Congress will have no choice except to raise income tax rates. Since those who oppose a VAT also tend to be obsessive about holding down tax rates, especially the top

rate, they must ask themselves which is worse: a broad-based consumption tax or confiscatory income tax rates? When that day comes, I think they will choose the former. But that option may not exist unless we act soon to adopt a VAT because it takes two to three years to put it in place.<sup>38</sup> Since in a crisis revenue will be needed immediately, a VAT will effectively be off the table.

Finally, conservative opponents of a VAT must ask themselves what their true goal is. Is it to raise growth and economic prosperity because low taxes generally support those objectives, or is it a dogmatic belief that taxes must never be raised regardless of the circumstances? Unless one believes that budget deficits have no effect on growth and prosperity, one has to accept that there are times when higher taxes are the lesser of evils and can in fact stimulate growth. Conservatives like to pretend that the 1982 and 1993 tax increases never happened, but the obvious fact is that growth was stimulated in both cases because they led to lower interest rates, lower expectations of inflation, and less crowding out in financial markets.

Unfortunately, it is my observation that ideological dogmatism, rather than serious analysis, underlies the vast bulk of opposition to a VAT among conservatives. When, eventually, economic conditions force them to live in the real world, instead of a fantasy world where the budget can be balanced by abolishing Medicare, I think they will support a VAT just as European conservatives did.<sup>39</sup> The longer they wait to do so, the greater the economic pain we will have to go through before conservatives bow to reality and support a VAT.

Even though I think we should enact a VAT as soon as possible, I am under no illusion that it is remotely feasible under current political and economic conditions. But those conditions will inevitably change if projections of future federal deficits are even close to correct and if economists' beliefs about the impact of deficits are remotely true. They mean that sometime in the not-too-distant future we are going to see significantly higher inflation and interest rates than we have today. At some point – I don't know when – they will pass a political threshold and politicians can start to talk honestly about the sorts of fiscal actions that will be necessary to bring inflation and interest rates down to tolerable levels.

Even then, I don't anticipate that a VAT will be among the

first options that will be considered. What I expect is that when there is the inevitable flare-up in financial markets as bond prices crash, the dollar takes an unexpected dip, the price of oil shoots up, or whatever unexpected calamity takes place, Congress and the White House will solemnly vow to cut the deficit because it will be the one thing that everyone will be able to agree upon that might help and at least won't hurt. They will go out to Andrews Air Force Base and after weeks of intense negotiations announce that a deal has been struck to deal with the crisis.

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### Ideological dogmatism, rather than serious analysis, underlies the vast bulk of opposition to a VAT among conservatives.

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Republicans will inevitably agree to some modest tax increases, Democrats will agree to trim Medicare and Medicaid, and both sides will promise that discretionary spending will be slashed. But after the low-hanging fruit has been picked clean, deficits continue to rise and financial markets once again suffer some turmoil we will, after perhaps 10 years of unsuccessful efforts to get our finances under control, eventually reach a point where a VAT is politically viable. Republicans will finally be brought around to it by using the revenue to offset many of the ad hoc tax increases that will have been previously enacted, with a little left over for deficit reduction. This way they can rationalize their surrender to the inevitable as a tax reform rather than a tax increase. But in fact it will simply be a retroactive tax increase.

Based on the experience in other countries, I estimate that a U.S. VAT could realistically tax about a third of the gross domestic product, which would raise close to \$53 billion per percentage point.<sup>40</sup> If we adopted Europe's average VAT rate of 21 percent, we could raise \$1.1 trillion per year in 2012 dollars. Even if all this revenue were used to fund tax reform in a revenue-neutral manner it would be worth doing. There are any number of glaring problems with the Tax Code, such as the Alternative Minimum Tax, that will require significant revenues to fix permanently.

As David Ignatius of the *Washington Post* recently put it, "By ruling out a VAT when it could keep the federal deficit in check, politicians have all but guaranteed that the debt

crisis, when it comes, will be more damaging. But by then, everyone will be clamoring for a VAT, so it will be safe to endorse it.”<sup>41</sup>

Although some liberals have periodically been attracted by the VAT’s revenue potential, none have made a serious effort to enact one since House Ways and Means Committee Chairman Al Ullman, D-Ore., floated the idea in 1979 and was defeated the following year – a loss that was widely attributed to his support for it. Forever afterward, Ullman’s name has been invoked as proof that a VAT is politically suicidal. In the words of Congressman (later Senator) Byron Dorgan, D-ND, “The last guy to push a VAT isn’t working here anymore.”<sup>42</sup>

Politicians are also mindful that foreign leaders imposing VATs often suffered electoral defeat as a consequence. After enacting a VAT in Japan in 1986, Prime Minister Yasuhiro Nakasone was defeated the following year largely because of it. Prime Minister Brian Mulroney imposed a VAT in Canada in 1991, and it was considered the major factor in his 1993 defeat. Although Prime Minister John Howard survived enactment of a VAT in Australia in 1998, his party suffered major losses as a consequence.

However, several factors may now have changed that could make a VAT in the U.S. politically viable. There is widespread recognition that the federal debt is on an unsustainable course. Yet there is no significant political support for sharply cutting major entitlement programs such as Medicare. Republicans tried to make this an issue in 2012 by putting Rep. Paul Ryan on their ticket. He is best known for a budget plan that would essentially abolish Medicare and replace it with a voucher program. Barack Obama’s victory and Democratic gains in the Senate mean that such options are off the table, probably permanently.

As Harvard economist Larry Summers once explained, the reason the U.S. doesn’t have a VAT is because liberals think it’s regressive and conservatives think it’s a money machine. We’ll get a VAT, he said, when they reverse their positions.<sup>43</sup>

I myself long opposed the VAT on money machine grounds.<sup>44</sup> I changed my mind when I realized that there was no longer any hope of controlling entitlement spending before the deluge hits when the baby boomers retire; therefore, the U.S. now needs more revenue, and a VAT is the best way to achieve this.

## Notes

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19. Republican Party Platforms: "[2012 Republican Party Platform](#)," August 27, 2012. Online by Gerhard Peters and John T. Woolley, The American Presidency Project.
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# Social Contract Budgeting: Prescriptions from Economics and History

*Peter Lindert, Distinguished Research Professor of Economics, University of California - Davis*

If there is to be any durable hope for a social contract that transcends left-right partisanship, that contract must rest upon a majority consensus about policies that are efficient, fair, and sustainable. Once the smoke has cleared from this November's battle over the role of government, what will endure are several policy prescriptions kept alive by an objective reading of economic history and a general consensus among economists.

## The Prescriptions, and Their Main Ingredients

Economics and history tend to agree on the need for a social contract reflecting different priorities from those implied by the status quo. At this historical juncture, the United States and some other industrialized countries can raise economic growth while reducing poverty and inequality. Among the key strategies are investing more in the young, making social insurance more universal, and shifting to broader and more uniform taxation. This essay argues for these broad strategies, featuring specific recommendations on four fronts:

### *Education:*

Make increasing public investments in the young, with greater urgency for younger age groups than at the university level.

### *Health insurance:*

Socialized health insurance works better when it covers everybody.

Liberate health insurance from jobs, and from bias toward the elderly.

### *Pensions:*

Keep the share of adult life spent on public pensions from rising, by extending the working age for each benefit rate in proportion to the average

adult life expectancy of people with similar career histories.

Index the retirement benefits for each cohort to that same life expectancy at age 60.

Index annual pension payouts to recent GDP per working-age person.

### *Broad taxes:*

The two best candidates are addition taxes and the value-added tax (VAT), two types successfully applied in virtually all industrialized democracies outside of the United States. These can be progressive as well as pro-growth, as long as they are used to fund universal access to health and education, emphasizing pre-primary education.

## Goals of Economic Policy Design

The task of preparing these prescriptions must start with agreement on a modest list of common economic goals, followed by this essay's proposed budgetary strategies for serving them. I shall focus on the United States, though this country can both import and export some lessons summarized here.

*Make only positive-sum policy changes:* Raise aggregate material wellbeing.

*A Hippocratic Oath:* Distribute those net positive-sum gains from economic efficiency so that we do no net harm to the share of disposable income going to those below the poverty line.

Among rich industrialized countries, the United States stands out for its income inequality, its reluctance to redistribute from rich to poor, and its share in poverty. The first two of these three distinctions are illustrated by **Figure 1**'s international comparison in inequality and redistribution. Of the 28 OECD countries covered in Figure 1, the United States starts with an above-average inequality of primary income (white bar plus black bar) – that is, the gross income one receives before taxes or transfer payments. While all countries redistribute so as to lower inequality (black bars), the United States, like Mexico and Korea, does little to shift income from rich to poor. As a result, we end up with an inequality of final disposable incomes (white bar) that is second only to that of Mexico. Thus we stand out as an unequal-income country, largely because we do so little about inequality.

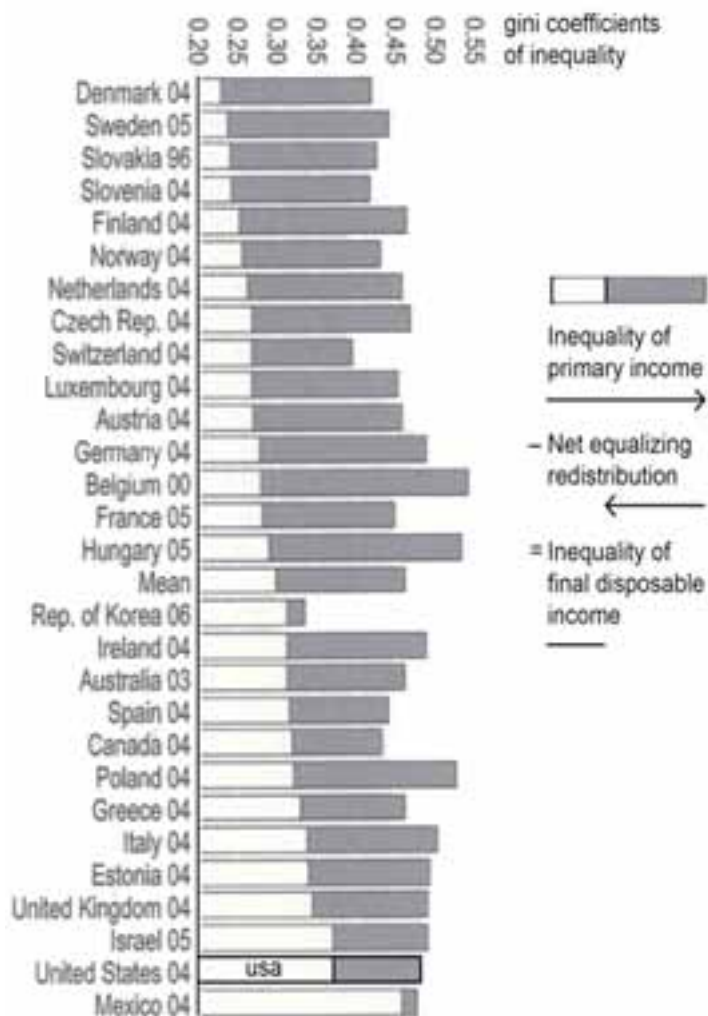
The third distinctive performance, our greater share in poverty, is confirmed by recent studies. This is true on either of two definitions of poverty – relative poverty, meaning the share of the population living in households below half the median income, or absolute poverty, the share living below a real purchasing power defined as the (U.S.) poverty line in a given base year. In terms of absolute poverty, we have a greater share in poverty than most countries, and for children younger than 18 we have the highest share of all the countries studied.

Our Hippocratic Oath against harming the poor could take any of three forms: (1) avoiding any reduction in their *absolute* real disposable income, (2) avoiding any reduction in their *share* of real disposable income, and (3) redistributing income so that the U.S. poverty share of 17.1 percent drops to the OECD average of 10.6 percent. Economic growth would make the first and lowest standard of the three increasingly unpopular, since it allows income gaps to widen forever. The third of these options, which would target the fact that inequality in the US is extraordinarily high by OECD standards, seems most desirable to this observer, yet must remain only a longer-term goal. Thus, we will use the second standard, ensuring that the policies we choose will not decrease the share of real disposable income of the poorest members of society.

*Don't raise the deficit share, except in a slump:* Any proposal must be revenue-neutral or deficit-reducing when the economy is not in recession, leaving the deficit no greater as a share of GDP than it is now.

At face value, this goal might seem to reflect some consensus that our current deficits and government debt are already too high in relation to annual GDP. No such consensus exists in the economics profession, however, especially not during slumps. No economist can quantify the optimal ratio of a deficit or debt to GDP. There is no solid basis for trying to legislate a balanced budget. Furthermore, the wolf is not yet at America's door: our country enjoys more slack in its external credit than do the Mediterranean

**Figure 1. Inequality and Redistribution in OECD Countries, c 2004**



countries or Japan. Nonetheless, the goal of not adding deficits acknowledges a very long-run constraint: deficits cannot rise faster than GDP forever. Eventually, once the economy has recovered and is on an upward growth path, the United States should start swimming upstream toward surplus to avoid being swept into larger deficits by the increased flow of debt service that higher interest rates will eventually bring.

#### Four Strategies

These basic goals are well served by four strategies on which economists and a fair reading of modern economic history tend to agree.

*Broad is good:* Broad-based taxes and broad universalist social expenditures have good incentive effects and promote a sense of even-handedness.

*Address externalities:* A real-world economy is rife with cases of externalities, in which the costs or benefits of any exchange accrue to third parties, not just to the two parties deciding on the exchange. Economists prescribe tax incentives to offset negative externalities and subsidies or tax forgiveness to encourage positive ones. Again, the prescription is to address the externalities on a broad front, with incentives geared to all sources of the externalities. Let private parties decide how to reduce external-damage activities, like pollution, and how to expand external-benefit activities. Do not presume, for example, that the government knows which specific pollution-control technology needs to be required or subsidized. Similarly, do not presume that it knows what kind of education each individual should have.

*Grandfathering is good:* People become accustomed to any economic policy regime, and typically make plans and contracts based on the assumption that the regime will continue. Any major change will impose costs on their decisions, even if the change is correcting a bad policy regime. Time and again nations have realized that grandfathering is good, meaning that existing contracts must be honored. Pre-announce the changes that will take place only for new contracts, and often only gradually over several years.

*Competition is good:* While economists carefully draw boundaries around the realm where competition and free markets should reign, economic freedom is our default set-

ting. It is, after all, the economic counterpart of democracy. In specific settings, however, having the government as a competitor also improves efficiency, as will be noted below.

## How ‘Broad is Good’ Works in Theory and History

Most economists prefer broad taxes, with lower rates and few loopholes. A majority of economists also seem to favor broad universalist expenditure programs. Their preference for breadth is not supported by any tight theorem derived from axiomatic principles. Rather it is their experience that tells them “broad is good.” The hunch is that we will minimize “deadweight costs” and GDP loss if we avoid narrow taxes or targeted subsidies that address one specific behavior, only to find that people overdo, or fail to do, something else. By going for broad and even incentives, we also avoid assuming that the government has enough information to micro-manage specific solutions. An environmental example is the case for broad effluent taxes as a way to reduce pollution. Similarly, economists’ call for a carbon tax is a call for a solution as broad as the problem. And cap-and-trade markets avoid presuming that the government knows just who should do the pollution cutting.

#### Low Administrative Costs

While the argument that broad means better incentives remains just a good unproven hunch, one other advantage of broad universal taxes and social programs stands out clearly in the historical data. This is their lower administrative costs, both when collecting the taxes and when spending them.

Since the 19th century, prosperity and democracy have allowed countries to economize on administrative costs by shifting from narrow taxes and transfers toward broad taxes and broad entitlements. On the tax side, history shows steep declines in the administrative cost shares of indirect tax collection across the 19th century and the early 20th, both in Britain and in the United States, as shown in **Figure 2**. In both countries, the cost of collections dropped, from over 4.5 percent of the amounts collected in the mid-19th century or earlier, to two percent or less since the middle of the 20th century. Economies of scale have cut

the costs of bureaucracy, so that administering the U.S. Internal Revenue Service, for example, costs only 0.5 percent of the amounts collected.

On the public social expenditure side, contemporaneous comparisons suggest that shifting from narrow and heavily policed social assistance to broad public entitlements programs has cut costs through economies of scale and the reduction in monitoring. Before 1880 European societies, intent on forcing all the able-bodied to work, tried to emphasize “indoor relief,” in which a person was kept in a poorhouse or workhouse. Its administrative costs were a high share, often 25 percent, of the total amount spent. Stricter regimes are more bureaucratic and more costly than universal entitlements.

By the postwar era, program-operating costs have fallen to almost-negligible levels in the high-income OECD countries. This applies not only to programs for the poor, but also the data on public pensions. International data on pension support programs show that administrative costs are less than 3 percent of the pension-program budget in all high-income countries, and often below 1 percent.

In the health insurance sector as well, universalism lowers bureaucratic administrative cost shares. The best-documented contrast is the somewhat-more-private health care system of the United States, which has administrative and overhead (i.e. bureaucratic) costs far above those in the universal insurance countries of Canada and Germany on a per capita basis. One of the reasons is insufficient breadth of health insurance coverage.

### Welfare States’ Historic Performance

Accepting economists’ preference for broad taxes and benefits, and seeing the administrative cost saving of universalism, will prepare one for a historic result that still surprises some Americans. The welfare states of Northern Europe, with their social spending as high as 30 percent of GDP in some cases, have not suffered any clear net loss of GDP from it. So say decades of data on GDP and economic growth, with or without the use of econometric regression analysis. This is what I have called the “free lunch puzzle”: Large democratic welfare states, with universal entitlements, have not paid any net price in terms of economic growth or competitiveness, while following policies that delivered more equal incomes, less poverty, slightly higher

life expectancy, and cleaner government relative to the United States or the average small-government economy.

While some may try to cite the problems facing Europe, the fiscal troubles of Mediterranean Europe and Ireland are unrelated to the welfare state. Rather, the Mediterranean countries deliver relatively little aid to schools or the poor, while over-protecting senior workers in older industries. Meanwhile, both Spain and Ireland have suffered mainly from the bursting of huge market bubbles in real estate.

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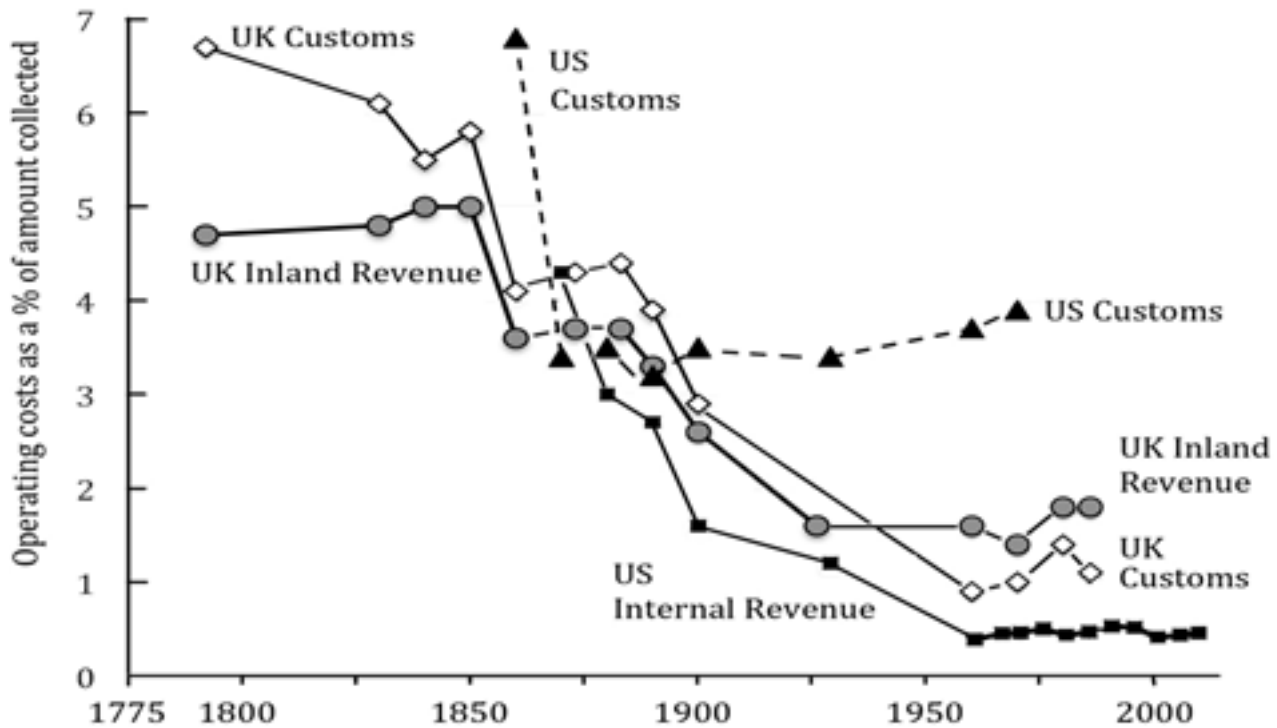
**Large democratic welfare states, with universal entitlements, have not paid any net price in terms of economic growth or competitiveness.**

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The lack of any net GDP penalty from the whole welfare state package is not just a statistical finding. There are clear economic reasons for this outcome. The large-social-budget package has delivered enough economic growth advantages to offset any negative effect on GDP of work disincentives caused by generous unemployment compensation or higher taxation. Among those advantages are better health under universal insurance, better support for the development of mothers’ careers, and a more pro-growth tax structure, with consumption taxes like a VAT. There is also an important political side-benefit of welfare states’ having a flatter tax rate that pays for more universal benefits: the parts of the income spectrum that want social insurance and human investments are paying for a large share of it. Beneficial human investment programs, and beneficial social insurance programs, are not dependent on victories in class warfare.

Translating such broad approaches into better ideas for financing social programs is easier for some categories than for others. Let us review the historical and economic wisdom of different kinds of social programs, and the taxation that supports them. Our review begins with policies for developing the young, and moves up the age ladder to policies toward the elderly.

**Figure 2. Tax Collection Costs as a Percentage of The Amounts Collected by Central Government, US and UK, 1787/96 - 2011**



## Investing in the Young

### Stop the Mission Drift Away from the Young and the Poor

Our country and others have failed to do as much for the young as we have for the elderly. Ever since the late 1960s, when we installed the Social Security cost-of-living adjustment and shifted to a less pre-funded pay-as-you-go system, poverty among elderly Americans has plummeted, as shown in **Figure 3**. By contrast, poverty among children and those of working age marches on.

The decline in the share of elderly in poverty did not result from any changes in the private market economy. Rather, millions of elderly were removed from poverty by the rise of political “gray power.” That the decline was policy-driven is clear from **Figure 4**. On its vertical axis **Figure 4** shows the relative support for the elderly versus others, a double ratio equaling: (social spending on the elderly, per elderly person) / (social spending on the non-elderly, per non-elderly person). This elderly bias is not positively linked to large welfare states, like Denmark, France, and Sweden, as

one can see along the horizontal axis. Rather, the elderly bias ratio looms large for four countries – Japan, United States, Italy, and Greece – each of which offers little to the poor by OECD standards. What makes these four countries stand out from the others is not generous pension support for the elderly, but rather the low levels of public support for children and working-age adults.

### The Earlier the Human Investment, the Better

Our bias toward subsidizing the elderly runs against economists’ insights and against any reading of the history of modern economic growth. Economists keep measuring the social rate of return on educating the young, and keep finding the rewards very high.

Historically, the countries that were the earliest to achieve modern economic growth were those whose leaders appreciated the case for raising taxes to pay for school. Even such free-market advocates as Adam Smith, Thomas Jefferson, and Milton Friedman appreciated the case for tax-based

support for schooling. The northern states of the United States were world leaders in tax-financed public school enrollments in the nineteenth century, and led again in the high school wave of the twentieth century. The core economic reasons for turning to the taxpayers for school money are capital market imperfections (parents can't borrow privately against the prospective future earnings of their children) and the positive externalities from the extra knowledge and the civic engagement that schooling brings.

One pattern stands out clearly in the social returns to education: the younger the students, the higher the rate of social return to public funds spent. This result persists, both in the global literature summarizing the average apparent returns to schooling and in the deeper econometric literature based on American data. Indeed, there is an easy way to rank the social rates of return on investments in different levels of schooling, either in this country or globally: pre-school > primary > secondary > higher education, with even the rates of return on higher education being as high as those on such alternative assets as long-term bonds.

At the top of the education pyramid, the urgency of raising public investment is the least, partly because we have a clear American success story. We have been world leaders in partially subsidizing higher education, going back to the Land Grant Colleges launched in 1862 and even to the colonial government subsidies to Harvard, Yale, and others. Yet the United States has always shown some finesse in higher education finance, giving only partial and egalitarian

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**The younger the students, the higher the rate of social return to public funds spent.**

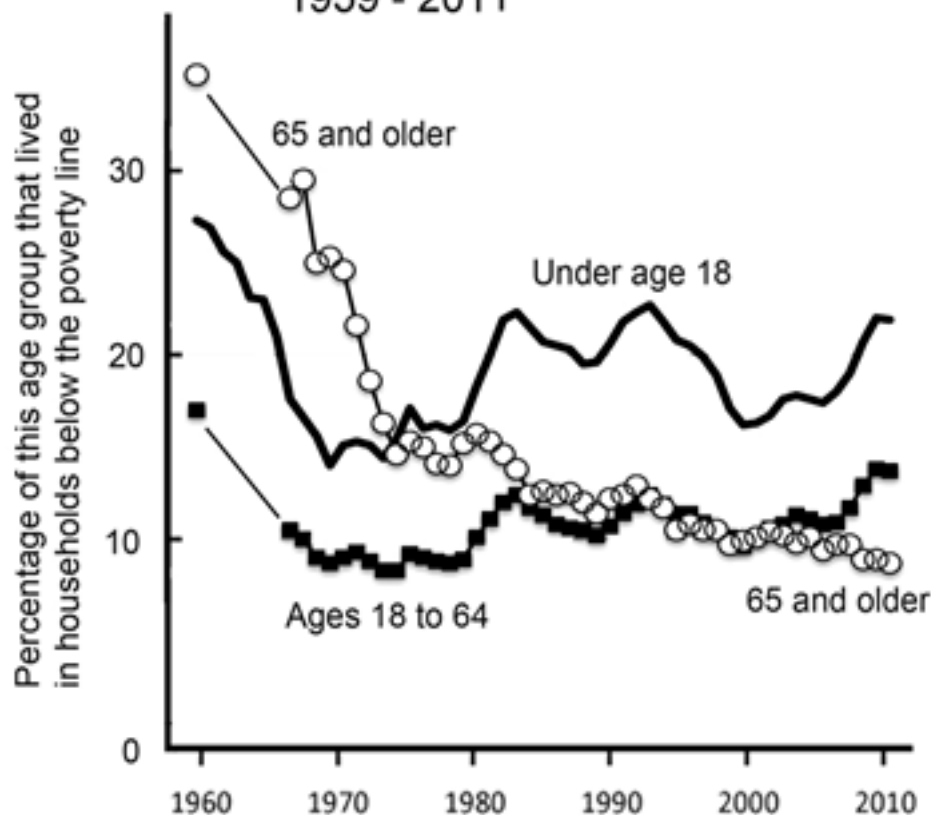
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support and forcing its institutions to compete against each other. The support is partial and egalitarian to the extent that it features means-tested grants and loans. The goals of economic growth and equality are well served by means-tested Pell grants and loans, which can be thought

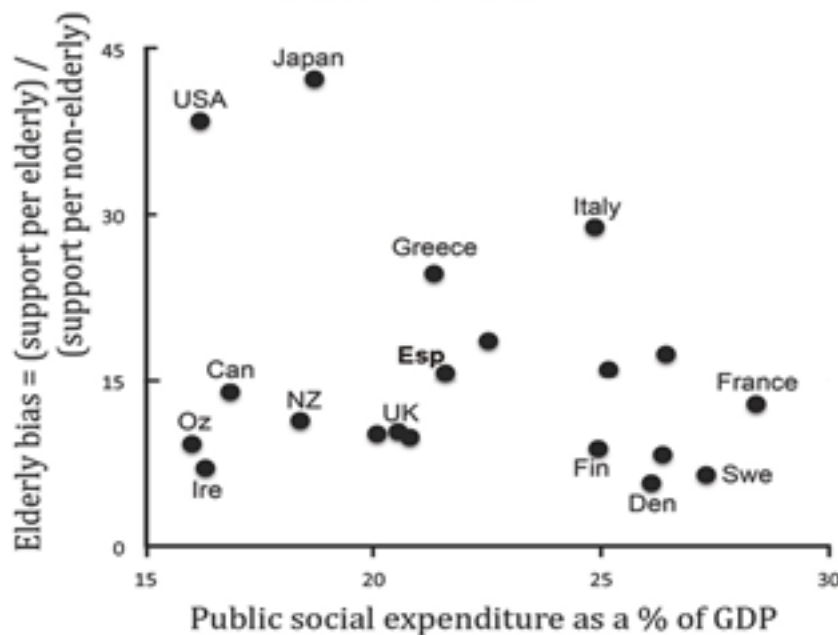
of as higher-education vouchers for lower-income families. This country wisely avoids the next step taken by some countries in subsidizing higher education: we avoid guaranteeing free rides for well-off students whose private schooling makes them excel on national exams.

The competition is also crucial: higher education is a sector with sovereign consumers quite capable of shopping intelligently. The rising cost of college, led by persistently high returns to higher education, should not be seen as evidence of any lack of competition at the top. Berkeley, for example, faces tough competition – for good students, for good faculty, and for research grants – from its public-sector sister UCLA as well as from private competitors like Stanford. The competition is one reason that the United States

**Figure 3. U.S. Poverty Rates by Age Group, 1959 - 2011**



**Figure 4. Bias toward the Elderly in Public Social Spending, 1985 - 2000**



completely dominates the world rankings, and is a heavy net exporter, in higher education.

At the bottom of the education pyramid, which we tend to focus less on, investing tax money in pre-school education remains more urgent on both efficiency grounds and equity grounds. Here is an opportunity for major productive expansion based on free choice among accredited institutions not controlled by large school districts, large unions, or any officially sanctioned religion. Note that the compelling case for tax financing of education is not a case for public provision of education. Economists have never seen a compelling reason for having the public sector dominate the supply of education services themselves, common as that practice may be.

As for primary and secondary education, the middle steps in the pyramid, our country continues to be among the leaders in quantity, though not in quality. We have always been a world leader in the number of years that an average youngster spends in school, despite a postwar rise in high school dropout rates. Yet we consistently fail to rank in the top 15 countries in terms of actual student curriculum learning, as measured in international tests such as PISA.

Would injecting more competition, more school choice, improve the quality of primary and secondary education? The fierce fight over vouchers cannot be resolved here. On the one hand, history speaks in favor of them where the status quo was abysmal, as it was when Cleveland and Milwaukee launched their limited voucher programs. Yet Chilean experience with vouchers has not been so positive, and the issue of what to do with the lowest quality schools has no simple resolution and is deeply intertwined with other welfare issues like poverty.

Whether the nation goes with vouchers or just with freer choice within the public school system, two side-points need emphasis here. First, greater parental choice of schools brings gains even if it does not improve aggregate school performance.

Economists recognize a gain in wellbeing just from allowing dissatisfied parents to change their children's schools. Second, conservatives in favor of vouchers would need to accept the political reality that tax money would not go to private schools without heavy government regulation of a generally secular curriculum, as is practiced in the Netherlands and other European countries allowing the subsidies to extend to schools run by organized religions.

## Welfare as We Have Come to Know It

A straightforward broad strategy for fighting poverty has remained popular among American economists since the 1960s. In 2009, fully 79 percent of economic experts agreed that "[t]he government should restructure the welfare system along the lines of a 'negative income tax' such as the one advocated by Milton Friedman, Robert Lampman, James Tobin, and many others. With a negative income tax, we tax everybody's income at a flat percentage and give the revenues back to everybody in equal dollar amounts based on family size (a tax rebate or "demogrant") and whether they are rich or poor, so that the poor pay a

negative income tax. Aside from a broad low work disincentive, the negative income tax does not mess with the marketplace. It avoids subsidizing family farms, building public housing, or legislating minimum wage rates, all of which are costlier distortions. Given its bipartisan appeal among economists, we might easily settle on the negative income tax as a prescription for a larger social contract; however, the idea of a negative tax remains viscerally unpopular with many Americans.

Since 1993 an alternative approach has mustered bipartisan political support, and some theoretical support among economists. That year's expansion of the Earned Income Tax Credit (EITC) subsidizing work among lower-wage earners, and the 1996 Personal Responsibility and Work Opportunity Act (PRWORA) setting strict limits on welfare for those out of work, "ended welfare as we know it," in the words of President Clinton. Support for those out of work became much less generous, while work became subsidized up to a certain "phase-out" range of earnings, beyond which one rejoined the usual taxpaying ranks. The new combination of work subsidies and workfare toughness continues to draw bipartisan political support, aside from a brief Tea Party attack on the EITC in 2011. The negative income tax idea is history, it would seem.

What are the respective merits of the alternative approaches? Some economists have theorized that the EITC may have raised employment, reasoning that by drawing people initially into low-paid employment, it gets them on a career path they will not leave later when their earnings rise to enter the high-tax phase-out range. Others question whether there has been enough net employment gain to justify the regressivity of the EITC-PRWORA package relative to a negative income tax.

A major test came in the Great Recession of 2008-2009, when a large share of the poverty population was no longer entitled to cash welfare. Studying this recent harsh test case, Marianne Bitler and Hilary Hoynes have found that the remaining combination of safety nets seemed to take up much of the slack left by the expiration of cash assistance to poor families. Food stamp benefits proved more quickly responsive to the new hardship than in earlier slumps, and the Great Recession did not show any extra damage in terms of such outcomes as health or household crowding. On the other hand, a given unemployment rise did mean a significantly greater rise in overall poverty after

the PRWORA reform than under the older regime. Thus the tidier negative-income tax approach preferred by most economists still looks like the more effective short-run anti-poverty safety net, despite some offsetting responses from food stamps and medical aid. To reduce poverty rates over the longer run, so that we at least approach the lower OECD average poverty share, we need greater investments in human capital, on the education and health fronts.

## Paying for Health Insurance

The health sector in the United States will be perennially problematic because of its peculiar economics. Thus it has been for the last century, thus it is now, and thus it shall be. The main reason why these problems absorbed less attention before the early twentieth century was that medical care was so ineffective. Only in the last hundred years have we seen an explosion of successful, and very costly, health technologies. The demand for health care has soared with good reason, especially when the patients and providers could get someone else to pay for it. The rise in demand will surely continue, as technology keeps improving and the population gets richer and older.

The battle to contain costs while assuring quality will never end, given the overwhelming informational complexity of health care and the fact that within the current system this sector is riddled with market power on the part of providers and insurers. International opinion surveys have never turned up a country where people are enthusiastic about their health care sector, and Americans tend to have more complaints than the international average.

There never will be a formula that allows the public to relax and ignore the health care sector. Nor, in the face of aging, is there a pension-style formula that puts just the right ceiling on care for the elderly. All that can be offered here are two guidelines for re-shaping cost control in health insurance.

## Broad is Good in Health Insurance

Health insurance is less costly if coverage is mandatory and supplied by either a single payer or a single regulator setting rules for competing insurers. Such a broad

approach is superior in health insurance because of the informational structure of health care. Having a central insurer, usually the government, cuts administrative costs, as we have already noted.

Doing so also addresses the “asymmetric information” problem with voluntary private insurance. Insurers know less about a customer’s health prospects than does the customer. Thus when insurance is voluntary, those who suspect they are in poor health are more likely to enroll. This sets up the famous “voluntary insurance death spiral”: the self-selection by high-risk customers forces the insurer to raise premia, which induces healthier customers to flee, leaving an even higher-risk residue of customers, which leads to further premium hikes, and so on until the insurance plan disappears.

To avoid this spiral, private insurers seize upon whatever information they can get that justifies denying coverage to those with previous conditions. The problem of asymmetric information is more severe in health insurance than in other insurance sectors. Auto insurance, for example, takes advantage of the fact that key predictive information about the customer, such as age or driving record, is in the public realm. Insurers have also tried to raise profit margins by exploiting complexity to delay or deny a certain share of claims. The Patient Protection and Affordable Care Act of 2010 (Obamacare) took steps to limit such practices, with partial success.

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### The cheapest way to pool insurance customers at a low informational cost would be to pool the entire population,

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America has yet to accept the insurance solution that has worked relatively well in other countries: let the government serve as a dominant payer, with mandatory universal coverage and mandated pure community rating. (Note that international experience recommends single-payer *insurance*, but is indifferent to government *provision* of health care.) Instead, American state and federal insurance systems embody an unavoidably messy political compromise, one in which the public is forced to buy coverage choosing from a menu of private insurers. As it stands, the govern-

ment will act as single regulator, not as single payer. This has the political advantage of keeping government budgets from raising taxes to cover insurance, but the disadvantage of perpetuating, and still subsidizing, a costly private insurance industry.

### Liberate Health Insurance from Jobs, and From Elderly Bias

American health insurance is dominated by plans negotiated by employers. There is no economic logic to this. Why should health insurance have anything to do with one’s current job? The cheapest way to pool insurance customers at a low informational cost would be to pool the entire population, using national health statistics to define the probabilities of claims. Using employer-based pools has three defects in the American case: employer-specific coverage is not portable for those who change (or lose) their jobs; taxpayers have to subsidize the coverage; and to the extent that its extra costs exceed the tax subsidy, employer-based coverage makes American businesses more costly and less competitive.

Why are employer-based plans so dominant in this country? At the center of the problem is a series of historical wrong turns. Employer-based plans gained popularity in World War II, when wage controls prevented employers competing for scarce workers by offering higher straight pay, but allowed them to offer attractive fringes. Then came a tax policy, enacted in 1943 and solidified in a 1954 Supreme Court ruling, which exempts employer contributions to employee health plans from taxation, either as corporate income or as employee income. Thus one major reform left undone by the Congressional fight of 2010 is the removal of special subsidies on employer-based health coverage to push the industry toward offering plans that are more portable from job to job.

Another needed reform is to liberate public (alias “socialized”) health insurance from its costly confinement to those over 65 (plus the military). This restriction was forged in another costly wrong turn. The passage of Medicare in 1965 was targeted at the elderly because they rightly feared facing costlier health care with no job to offer them coverage. Some have tried to reduce this elderly bias by extending Medicare to all age groups. In 2010, Obamacare succeeded in extending insurance toward the young, with extensions

of Medicaid and the State Children’s Health Insurance Program. It thus made partial steps toward making coverage more universal, while proceeding slowly enough to honor (to “grandfather”) existing insurance arrangements. Yet one’s 65th birthday still brings a jump in coverage, and this country’s deficit in life expectancy among OECD countries is still worse before the age of 65 than after that birthday.

## Sustainable Pensions

We turn next to the kind of social program that lends itself most easily to the use of broad formulae to solve an undeniably big problem.

### Something Has to Give

Today for every 100 Americans of working age (18-64 years) there are 35 elderly Americans (65 and up), most of them retired. By the year 2050 there will be 49 elderly for each 100 Americans of working age, assuming today’s rates of birth, migration, and survival. The balance between people paying into retirement and people drawing on it is shifting. So we are warned in the media every week. Social Security currently costs 5.0% of GDP, but spending will have to rise to 6.2% of GDP by 2037. Actually, the ratio is likely to shift even faster than that, because of a newly documented “longevity transition”: The life expectancy of seniors is shooting up rapidly, presenting all pension calculations with a possible curse of unexpectedly long life.

This demographic fact of life has a clear implication for setting pensions:

*As the share of elderly rises, their annual benefits past the age of 65 absolutely cannot rise as fast as the average incomes of those of working age.*

This clear warning is both softer and louder than it may sound at first. Softer, in the sense that it does not mean your pensions have to drop in real purchasing power. Pensions should still keep up ahead of the cost of living – it’s just that they cannot grow as fast as earned incomes per person of working age, which historically grow at about 1.8 percent a year, adjusting for inflation.

Yet the warning should sound louder when one realizes that it applies to the future of any kind of provision for old age, no matter how private or public. The curse of longer life is not specific to Social Security or other public pensions. It is the same even if you relied only on your own savings for old age. To plan ahead, if you live to age 65, you are likely to live to 85 even at today’s survival rates. Your grandfather only had to plan on living about 14 years more, if he were to reach age 65. Even in such an individualist calculation, your annual consumption in retirement has to be a lower share of annual earnings than in the past, because you’ll live more years. So it’s not a problem of government pensions, but a problem facing *any* pension plans, be they individual savings, private job-based pensions, or Social Security.

### Formulas that Work for Social Security

Fortunately, there are broad formulas that can adjust our pensions to longer life spans. Here are three formulas that would make Social Security sustainable indefinitely, formulas that private savings plans should also try to emulate.

The first formula is one on which the United States has already done its homework quite well, and just needs to follow through. The formula is this:

*Keep the share of adult life spent on Social Security from rising, by extending the working age for each benefit in proportion to the average adult life expectancy of people with similar career histories.*

The United States has already taken steps down this path, thanks to the 1983 Greenspan Commission on Social Security Reform. We have advanced the age of “full” retirement benefits from 65 to 67 for those born after 1960. The gradual formula adopted in 1983 follows the strategy of “grandfathering is good” by not hitting those of middle age with a shock to their life plans.

Yet the news about accelerating senior longevity means we must continue. Seniors are increasingly healthy, and the share of them in poverty has declined, so it is not unreasonable for them to receive full Social Security benefits only if they work the same share of their adult lives as did their parents. Fixing the share of adult life at work would mean

something like this: to receive the year 2007's retirement benefit as a percentage of average earnings at any given age, one must work 51.6 percent of one's life expectancy for males, and 41.5 percent for females, as we did in 2007. America's progress along this path needs to continue, with more age adjustments.

The second formula builds in an automatic adjustment of the work-retirement balance to the longevity trend. Borrowing from the "notional defined contribution" pension reform that Sweden set up in the 1990s, the formula is this:

*Index the retirement benefits for each cohort to life expectancy at age 60 for persons of given earnings histories.*

That is, while every individual's annual pension benefits are still tied to his or her lifetime earnings history, they are indexed to the senior survival odds of people in his or her birth cohort. Thus if you were born in 1980, and you worked from 2000 to 2045, your Social Security benefits would be tied to your earnings over those years divided by an index that is tied to the age-60 life expectancy calculated from survival outcomes around the year 2040. The longer your cohort of people is expected to live, the less your benefits each year, though of course your benefits are likely to continue for more years. This helps maintain aggregate balance in the pension budget. An extra twist for the United States is one that Sweden didn't need. Since American senior life expectancy is shorter for persons with lower lifetime earnings, avoiding regressivity in the pension formula requires tracking the senior life expectancy of persons in different career earnings ranks. Making that adjustment is not difficult, given the Census Bureau's mortality data and Social Security's career earnings data.

The third formula is also patterned after Swedish practice since the 1990s:

*Index annual pension payouts to recent GDP per working-age person.*

Pensioners' benefits from Social Security should share in the fortunes of the economy. When there is a boom, pensioners share in it, by automatic formula. By the same formula, pensions share the pain of a recession as much as others. In an unlikely Great Depression extreme, their ulti-

mate safety net would be the same as for the young: public support for the poor plus medical care.

Pre-commitment to such pre-determined formulae could remove the pension parameters from the political arena. Of course, social contracts can only make political pre-commitment easier. They cannot guarantee it. Even Sweden softened its pre-set formula very slightly in response to the 2008-2009 slump. Under the original formula, the government was obligated to cut benefits for the two years 2010-2011. Afraid to follow through on the cuts in 2010, an election year for Parliament, officials changed the formula to stretch the reductions out over more years. Yet the system remains intact, and it still works.

## Which Taxes Pick Up the Rest of the Tab?

The changes in social programs just sketched imply greater expansions of government expenditures than revenue contributions internal to these same reforms of pensions, education, health insurance, and welfare programs. The net extra expenditures must be covered by more general taxes. Specifically, the tab includes these expansions, in order of expenditure urgency: improving and expanding public education, with an emphasis on the earlier years; deficit reduction, once recovery from the 2008-2009 recession is fully under way; and universal government provision of health insurance for citizens under 65.

What taxes should pick up the tab here? First, here are two types of tax changes that are not needed: We may not need any new taxes or contribution increases for Social Security. There seems to be sufficient time to install the formulas for pension sustainability. There is also no strong case for changing direct taxes from what they were in the Clinton boom of the late 1990s, an era that produced budget surplus. For all the talk of the complexity of the income tax structure, its administrative costs are low. Let the Bush tax cuts expire for high incomes, for capital gains, and for inheritances, slightly reducing the deficit.

## Addition Taxes

As for new or expanded taxes, the two best candidates are

addiction taxes (“sin taxes”) and the value added tax (VAT), two types successfully applied in virtually all industrialized democracies outside the United States.

The United States is a laggard in taxing three addictive goods that cause serious negative externalities: alcohol, tobacco, and gasoline. The first two are private addictions with obvious health externalities. The third is a collective addiction leading to pollution and climate change as well as to dependence on oil imports from hostile suppliers. As **Figure 5** shows, the United States charges so little tax on gasoline at all levels of government that our overall gasoline prices, per liter or per gallon, are only half those of the average industrialized country. We even tax it less than Canada and Australia, two other countries with long travel distances. The resulting high rate of gasoline consumption per capita helps make the United States, along with China, the world’s worst contributor to greenhouse gases and other airborne pollutants. There is a strong case for raising federal gasoline taxes over the next decade. To be sure, the amount of increase that would cut our emissions to the average OECD level will not necessarily equal the amount needed for the right budget balance, but the direction in which gasoline taxes should move is clear. The other two sin taxes, on alcohol and tobacco, could also be raised toward the OECD average.

## The VAT

A European-style credit invoice VAT is the other most appropriate broad tax for filling revenue needs, as long as it is funding worthwhile expenditures that are more progressive than the VAT itself.

What needs emphasis here is that the whole American debate has been discussing the wrong context for a new VAT. Postwar U.S. discussions have presumed that the VAT must be a substitute for income taxes and other current taxes, in order to lower administrative costs as a share of the amounts collected. This presumption has a factual error, and has a redistributive character that should continue to doom the tax-replacing approach to the VAT.

The common assumption that the appeal of the VAT depends on its having lower administrative costs than the direct taxes it would replace is wrong. Direct federal taxes already have a low administrative cost as a share of the

amount collected, as we saw in connection with **Figure 2**. A VAT should supplement the existing direct tax structure (at its Clinton-era tax rates), rather than replace it, and can do so without any jump in administrative costs.

The fixation on using a VAT to replace other taxes has always been so blatantly regressive as to doom the VAT each time it was introduced into Congressional committee. Democrats saw the regressivity, and Republicans saw a new tax. What made the European pioneers so successful in introducing and expanding the VAT was using the revenues to fund such progressive programs as universal health insurance and education.

## They Are Not Regressive

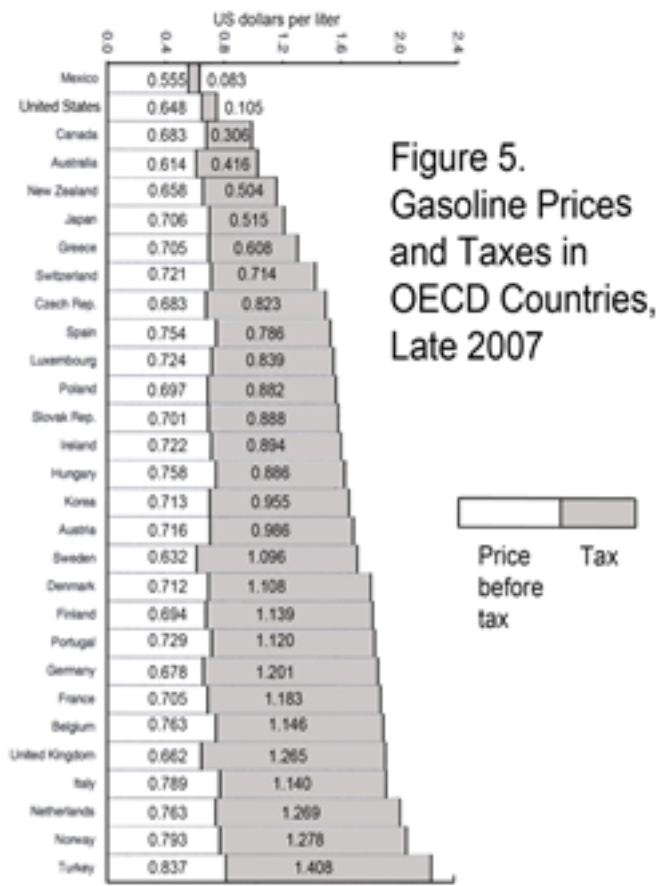
Another error commonly made about the VAT is the regressivity argument: “Wait, it’s regressive – it takes a bigger share of income from ordinary working folks than from rich people.” People base this claim on the fact that the taxed consumption would represent a bigger share of the current household incomes for the poor than of the incomes of those who are better off and able to save more to avoid the consumption tax. This is the prevailing American wisdom, something that “we all know,” and it is wrong.

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## One way to make a consumption tax progressive is to spend it progressively, with the share of benefits declining with income.

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One cannot say whether or not the consumption tax is regressive until one says what is done with the extra tax revenue. The consumption tax could easily be *progressive*, and actually tends to be progressive in some of the countries that rely heavily on it today. One way to make it progressive is to spend it progressively, with the share of benefits declining with income. For a simple and extreme example, suppose that we had a flat 15 percent consumption tax (VAT), and used the revenues to give a \$5,500 entitlement to every person, or \$22,000 per family of four, approximately the poverty threshold for a family of four. If your four-person family consumption were below \$146,667 (which =  $\$22,000 / 0.15$ ), you would receive more than you pay in consumption tax. The more your consumption



**Figure 5.**  
Gasoline Prices  
and Taxes in  
OECD Countries,  
Late 2007

exceeded the \$146,667, the more your consumption tax would exceed your flat benefit, and the more you would pay to others. The result is clear “progressivity,” defined as a rise in net taxation as a share of income as income rises. Something like this happened when Sweden introduced the consumption tax in the 1950s with the explicit main purpose of funding universal public health insurance.

Even if the unspoken assumption is that we are comparing a consumption tax (VAT) with a fixed percentage tax on all incomes, instead of a flat entitlement, the consumption tax is not necessarily regressive. People usually think it is, reasoning that a consumption tax is proportional to consumption, which declines as a share of income as income rises. Ergo it takes a higher percentage from low incomes than from high incomes.

The fallacy here is to assume that the part of income that is saved avoids the consumption tax. On the contrary, the saver and his or her heirs will actually pay the consumption tax in the future, since the consumption tax is probably permanent. As long as the rate of discount applied to

future consumption is the same as the rate of return on savings, the net present value of the taxes paid will be the same, whether you consume now or you consume later. Again, one must take a clear look at the alternative before announcing the effect of a particular tax.

## The Contract and the Challenges

The daunting challenges facing any such social contract are all too familiar. For all the desirability of welding the tax and expenditure sides of a contract together, the political process can be unkind to solemn attempts to pre-commit competing sides to a long-term agreement. Some pre-commitments have indeed been carried off, when implemented gradually. Two good examples were the Greenspan Commission’s 1983 fixing of the advance of full-benefit retirement ages, and the pension index mechanisms still built into Sweden’s notional defined contribution system. But binding pre-commitments have failed in the past. Remember Gramm-Rudman, the balanced budget amendments, and other rules aimed at constraining the whole budget? Without bipartisan appeal, Presidential commitment, and Supreme Court approval, social contracts will fail.

Another challenge is historical “path dependence,” a historian’s way of saying that where you can go is constrained by where you are now. Our history has driven us into some sand traps, such as the double exemption of premiums paid on employer-based health insurance plans, the deductibility of mortgage interest, and California’s infamous Proposition 13. To follow through on the golf metaphor, history does not allow mulligans. The wisdom of hindsight about past mistakes helps only a little, and reforms must be incremental.

One implementation tactic that can help a little is to time the bundles of reforms so that accounts balance along the way. Thus one can envision a Wave 1, over a decade or less, in which the social contract targets the most urgent expenditures – the expansion of public funding for education, with reforms promoting competition and choice, plus some post-slump deficit reduction. Wave 1’s revenue increases can easily include sin taxes and the introduction of VAT at a low rate. A later Wave 2 can expand the generosity of anti-poverty aid, lowering our poverty rate to

the OECD-30 average, and phase in government-financed health insurance to lift the burden on employers. These second-wave expenditure targets must again be progressive enough to keep the whole package progressive as the VAT expands, as it has slowly done in other countries.

Such a sequence would not be achieved easily, but it is

consistent with the goals and strategies of social contract reform: promoting growth, doing no net harm to the poverty population, and reducing deficit shares, and doing so through breadth, addressing externalities, gradualism, and competition.

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## Notes

1. Aggregate material wellbeing here means the well-known Measure of Economic Welfare (MEW) proposed by William Nordhaus and James Tobin in 1972 (Nordhaus and Tobin, *Is Growth Obsolete?* New York: Columbia University Press). It adjusts gross domestic product by putting values on free time, length of life, environmental quality, and other aspects of wellbeing not captured by annual GDP. Still, one can often refer to GDP as though policies raising it also raised the MEW. Note that the Nordhaus-Tobin MEW does not put a value on income or wealth equality. Reducing inequality is a goal that must be weighed separately.

2. Defining the poverty threshold as one-half the median household income, the United States had 17.1 percent of its population in poverty as of the mid-2000s, versus an average poverty rate of 10.6 percent for 30 OECD nations. Of the 30 countries, only Turkey and Mexico had higher poverty shares than the U.S. (OECD 2008, Ch. 5, esp. p. 127).

3. Figure 1's estimates are from Wang et al. (2012). For similar results, and for international comparisons of relative poverty, see the OECD *Growing Unequal* study (2008). International comparisons of absolute poverty are found in studies by the Luxembourg Income Study: See Smeeding et al. (2000), and Scruggs and Allan (2005). For a readable and balanced summary of the issue of "vertical equity" and the case for progressivity in redistribution, see Slemrod and Bakija (2004), especially Chapter 3.

4. Among the Chicago Business School's IGM group of economic experts, 90% agree that fiscal policy (e.g., tax cut and/or government expenditure increase) has a significant stimulative impact on a less than fully employed economy. Further, 85% agree that if the federal budget is to be balanced, it should be done over the business cycle rather than yearly. And 83% agree that a large federal budget deficit has an adverse effect on the economy, but without any definitions of "large" or "adverse" or the relevant time frame.

5. Some issues must be set aside here, either because economists recognize that truth is nuanced or because they agree only that moderation is optimal, without being able to quantify the optimal moderate level. Here are three issues on which Harry Truman's famous search for a one-

handed economist should be abandoned:

*The choice between centralized and decentralized government.* This is a sub-branch of economics full of nuanced results, whether the subject is the level of government that raises revenue, or the level that does the spending, or the level having control of allocation. On the one hand, centralization can bring economies of scale and can smooth away incentives for inefficient flight from taxes and control. On the other hand, local control offers better monitoring in response to local needs and local political tastes, offering the advantages of free competitive shopping among local governments.

Also omitted, because history does not support a simple rule, is any clear stand on *bailouts and bankruptcy for business sectors*. The tension between the insurance principle and moral hazard concerns has no simple formula solution. History finds too many cases on both sides.

Let us also set aside the economics of *staple public purchases* such as national defense, infrastructure, and other budget categories for which the case for collective action and for sharing finite "moderate" budgets is more obvious and less controversial.

6. On the environmental front, for example, 78% of the economic experts surveyed by the Chicago Business School agreed that "Effluent taxes and marketable pollution permits represent a better approach to pollution control than imposition of pollution ceilings."

7. The sources for Figure 2 are the IRS *Yearbook* and the sources cited in Lindert (2004, vol. 1, p. 304). The low cost share for the IRS omits the cost to taxpayers of preparing their income tax forms each year.

8. The administrative costs for the US Social Security Administration were 1.6 percent of benefit payments in fiscal year 2012, and are projected as 1.4 percent for fiscal 2013. See [www.ssa.gov/budget/2012KeyTables.pdf](http://www.ssa.gov/budget/2012KeyTables.pdf), Table 9, and similar for 2013. For the late twentieth century, see Estrin, Alexander, 1988. "Administrative Costs for Social Security Programs in Selected Countries," *Social Security Bulletin* 51, 88: 29-31. For the usually higher cost shares

of less universal assistance programs in the early twentieth century, see Gordon, Joel. 1940. "Comparative Costs of Administering Public Assistance: An Analysis of the Administrative Expenses of 28 Public Assistance Agencies during 1938-39". *Social Security Bulletin* 3, 2 (February): 11-20.

9. Woolhandler et al. (2003, especially p. 771), Reinhardt (2000), Cutler and Ly (2011).

10. This section draws on Lindert (2004, especially Chapters 1, 10-12, and 18) and Allard and Lindert (2007). The reference to competitiveness is to World Economic Forum (2012). The reference to cleaner government is based on Transparency International's business-based "corruption perceptions index", which consistently ranks Nordic countries and Switzerland at the top.

11. Source for Figure 3: United States Census Bureau, "[Historical Poverty Tables](#)," accessed 29 September 2012. Source for Figure 4: Lynch (2006). For similar figures covering 1980, 1985, and 1993, see Lynch (2001). Lynch's numbers include public education spending, unlike the OECD data on social expenditures.

12. The global average return studies are summarized by Psacharopoulos (1994, 1996). The econometrics of returns to early education is presented by Heckman (2000), Carneiro and Heckman (2003), and Carneiro and Ginja (2012).

13. For a quick introduction to the history of the negative income tax idea, see Moffitt (2004). For Friedman's classic statement, see *Capitalism and Freedom* (1962, pp. 190-195). We should note that while Friedman popularized the idea, his version of it was not so generous. His offering a hypothetical \$300 per person was far below the 1962 U.S. poverty line of \$1,245 for an unrelated individual.

14. Diamond and Saez (2011, p. 176).

15. Moffitt (2004).

16. See Bitler and Hoynes (2010), and the broader survey of welfare program results in Ben Shalom et al. (forthcoming).

17. In health care as in education, there is no case for gov-

ernment *provision*. Government-supplied health care works well enough in England and Wales, but no better than in other countries where government centrally finances the insurance, and not the provision, as in Germany or Canada.

18. Thomasson (2002, 2003).

19. Egelston and Fuchs (2012).

20. "The 2012 Long-Term Budget Outlook," Congressional Budget Office, 2012, Table 4-1.

21. On the recent acceleration of senior survival rates, see Egelston and Fuchs (2012).

22. This result is derived from a budget balancing equation in Lindert (2004, vol. 1, pp. 195-196).

23. I have oversimplified Sweden's system, which is well described in Knuse (2010). Instead of an index tied to GDP per working-age adult, Sweden uses two other index factors that yield a similar result. The economic aggregate is wages and salaries per employed person, not GDP per person 18-64. And Sweden backs up its pension stability with an additional trigger that goes off whenever the pension fund's "Balance ratio"  $BR = \text{capitalized assets} / \text{capitalized obligations}$  drops below 1.

24. For an international comparison of the rates of all three kinds of sin taxes in the mid-1990s, see Lindert (2004, vol. 1, pp. 242-244). Figure 5 updates the gasoline tax rates, drawing on International Energy Agency (OECD), *Energy Prices & Taxes*, 4th Quarter 2007, Figure 8.

25. And symmetrically when the usual analysis mistakenly associates a particular public *expenditure* with the poor or the rich. Subsidizing public elementary and secondary school might seem progressive, since the beneficiaries are not the elite. Yet if the schools were paid for by a poll tax or a tax on staple foods, they could deliver a net cost to the poor and a net benefit to the rich.

# **APPENDIX ONE**

## **Public Attitudes Toward the Next Social Contract**

**Bruce Stokes**

# Public Attitudes Toward the Next Social Contract

*Bruce Stokes, Director, Global Economic Attitudes, Pew Research Center*

The recent deliberations in Washington about the fiscal cliff have triggered a national debate in the United States about the nature, extent and future sustainability of key elements of the U.S. social safety net: Social Security, Medicare, Medicaid, support for education, the unemployed and the poor. In the effort to tame the federal debt, cuts in spending on these social services have been a major part of the discussion – calling into question the social contract established with the American people during the Great Depression through the creation of public pensions and in the 1960s with the launching of limited government-provided health insurance.

America was a latecomer to the provision of many such social services. Germany put in place health and old age insurance in the 1880s. The United Kingdom instituted national health insurance after World War II. The benefits provided by the U.S. government cover a far smaller portion of the American population and are far less generous than those afforded to the citizens of other high-income nations.

In 2012 the United States spent an estimated 19.4% of GDP on such social expenditures, according to the Organization for Economic Cooperation and Development, the Paris-based industrial country think tank. Denmark spent 30.5%, Sweden 28.2% and Germany 26.3%. All of these nations have a lower central government debt to GDP ratio than that of the United States.

Why the United States invests relatively less in its social safety net than many other countries and why those expenditures are even at risk in the current debate over debt reduction reflect Americans' conflicted, partisan and often contradictory views on fairness, inequality, the role and responsibility of government and individuals in society and the efficacy of government action.

Rooted in value differences, not just policy differences, the

debate over the U.S. social contract is likely to go on long after the fiscal cliff issue has been resolved.

## A Question of Fairness

Recent years have not been good economically for most Americans. Thanks to the Great Recession, roughly 8.7 million lost their jobs. For those who lost employment, the average earnings loss two years later was 48%, according to a recent study by the Brookings Institution. And, even those who found new employment quickly earned 17% less, on average, in their new jobs than in their former employment.

But such signs of trouble did not begin with the economy's downturn in 2008. The median earnings of all working-age men in the United States have declined by 19 percent since 1970. This means that the median man in 2010 earned as much as the median man did in 1964 – nearly half a century earlier.

Declining earnings have contributed to rising income and wealth inequality. Between 1983 and 2010, the richest 1% of households accounted for 38.3% of all growth in house-

## Most See Wider Gap in Living Standards, Not Values

	Aug 1986	Apr 2012
<i>Compared to 10 years ago, gap in living standards between middle class and poor has become...</i>		
	%	%
Wider	40	61
Narrower	39	28
No Change (Vol.)	10	5
Don't Know	<u>11</u>	<u>6</u>
	100	100
 <i>In last 10 years, values held by middle class and poor people have gotten...</i>		
	44	47
	33	41
	10	3
	<u>12</u>	<u>8</u>
	100	100

Source: Pew Research Center 2011 Pew Global Attitudes Survey

hold wealth, according to the Economic Policy Institute. For the bottom 60% of households, their wealth actually *declined* during this time period.

It is little wonder then that most Americans think that the economy is stacked against them. Voters in the 2012 election told exit pollsters – by a margin of 55% to 39% – that the U.S. economic system generally favors the wealthy. Such sentiment was particularly prevalent among those who voted for president Barack Obama (79%) and voters age 29 and younger (61%). Only among those who voted for Republican presidential candidate Mitt Romney (63%) did people think that the system was fair to most Americans.

And Americans strongly believe (76%) that the rich are getting richer and the poor are getting poorer. There is general agreement across socioeconomic lines in this regard.

Notably, such concerns are worsening. In 1986, 40% of Americans thought that the gap between living standards of the poor and the middle class had widened in the previous decade. By 2012 61% of Americans said such inequality had risen in the previous ten years.

Yet the public is ambivalent about whether this unfairness affects them directly. In January 2012, 62% of Americans told Gallup that the economic system was fair to them personally.

This distinction between personal experience and a broader judgment of the economy is not unique to fairness issues. People make the same distinctions between their personal finances and the health of the economy, generally judging their personal situation better than that of the nation. This dichotomy may help explain why the public often expresses disdain for the government in general while supporting particular government programs. And it may also help explain why inequality has not yet become a defining political issue in the United States despite demonstrable evidence of its rise.

Americans are actually less likely to say that income inequality is a problem than citizens of many other developed nations. This is, in part, because inequality is rising throughout most of the industrial world. Inequality is higher in the United States, but it is also rising in most of Europe and Japan. Overwhelming percentages of Europeans think the rich are getting richer and the poor poorer, including 91% of Italians, 89% of French and 87% of Germans, according to a Pew Global Attitudes survey. Moreover, 88% of European Union citizens think income differences in their country are far too large, according to a 2010 Eurobarometer poll. This includes 92% of Germans and Spanish, 90% of the French, 85% of the Italians and 82% of the British. Fewer Swedes (75%) and Danes (65%) share this concern, possibly reflecting the lower levels of inequality there and the stronger social safety net in their societies. But it is significant that even in these latter two nations strong concern for inequality remains.

## Particularly Strong Support for Universal Entitlements

## Economic Sentiment

Public views about the social contract, government's role in creating a social safety net and what can and should be done to ensure preservation of major social welfare programs grow out of a broader public consciousness about the state of the domestic and international economy.

In September 2012, Americans were particularly gloomy about the economy. Just 13% rated national economic conditions as excellent or good. Only 25% said the economy was recovering, while a 43% plurality thought it would be a long time before it recovers.

In spring 2012, responding to a slightly different question by the Pew Global Attitudes project, less than a third of Americans (31%) said the U.S. economy was doing well – down 19 points from 2007, the year before the financial crunch began. While such confidence is low, public sentiment about the economy since 2011 improved more in the United States than in most other nations.

By comparison, a median of just 16% of Europeans surveyed thought their economy was performing up to par. That included just 2% of the Greeks and 6% of the Spanish and Italians. Among Europeans, only the Germans (73%) gave their economy a thumbs up. And just 7% of Japanese believed their economy was doing well. Confidence in the economy was down 59 percentage points in Spain and 54 points in Britain in the last five years.

People are, however, generally far more positive about their personal economic condition than they are about their nation's economic situation. A median of 52% in the 21 nations surveyed felt satisfied with their own circumstances. Americans were more than twice as likely to say their family finances were in good shape (68%) as they were to say that the national economic situation was good (31%).

In fall 2012, moreover, there was evidence that U.S. public sentiment about the economy was improving. In October, 45% said they thought the economy would improve over the next twelve months, up from just 21% who held such sentiments in October 2011, according to an NBC/Wall Street Journal survey. And on election day, November 6, 68% of voters told exit pollsters that they thought the economy was staying about the same or getting better.

Nevertheless, there is great unease about the state of the economy. Fully 72% of the public told Gallup in October 2012 that economic issues were the most important problems facing the country. This includes 37% who cited the economy in general, 26% who mentioned unemployment and 12% who expressed concern about the federal budget deficit.

Such concerns are widely shared. In a Spring 2012 Pew Global Attitudes poll, 82% of Americans said a lack of jobs posed a major threat to the economic wellbeing of the country. In addition, 71% believed that the national debt was a danger. By comparison, 97% of the Spanish, 95% of the Italians, 89% of the French, 87% of the British and 70% of the Germans said unemployment imperiled their economy. And 83% of the Spanish, 81% of the Italians, 80% of the French, 77% of the Germans and 72% of the British thought debt was a threat.

But the national debt is far more of a partisan issue in the United States, where 59% of liberals rank debt as a major threat to the economy compared with 79% of conservatives. In Europe the left-right divide is just five percentage points in Germany, four in France, and three in Britain.

Americans are quite supportive of some of the major building blocks of the public social support network, such as the Medicare system. In an October 2012 Kaiser poll, 60% favored keeping Medicare as it is today, with the government guaranteeing all seniors the same set of health insurance benefits. When asked in a Pew Research Center survey in August 2012 if they favored or opposed a proposal to change Medicare into a program that would give future participants a credit toward purchasing private health insurance coverage, a move that would limit the value of such benefits over time, 44% opposed and 32% favored it. At the same time, a Washington Post/ABC News poll found that 64% opposed giving people vouchers to pay for their Medicare.

There is similar backing for Medicaid. Fully 78% of the public said they like knowing that the Medicaid program exists as a safety net to protect low-income people who can't afford needed care in a July 2012 Kaiser survey.

Unemployment insurance has long been a pillar of the social contract. And the public has favored its recent extension. In January 2012 about half (52%) of the public thought it was a good idea to continue to provide unem-

ployment benefits for up to 99 weeks, according to a NBC News/Wall Street Journal survey. Only 33% thought that it was a bad idea.

The recently-enacted Obamacare, by contrast, does not fare so well. A November 2012 CNN poll found that by a margin of 51% to 42% the public opposed this expansion of health care insurance. Once the law is fully in place these numbers might change, but for the time being this is a strand in the social safety net that lacks robust public support.

## Greater Divisions in Support for Programs for the Poor

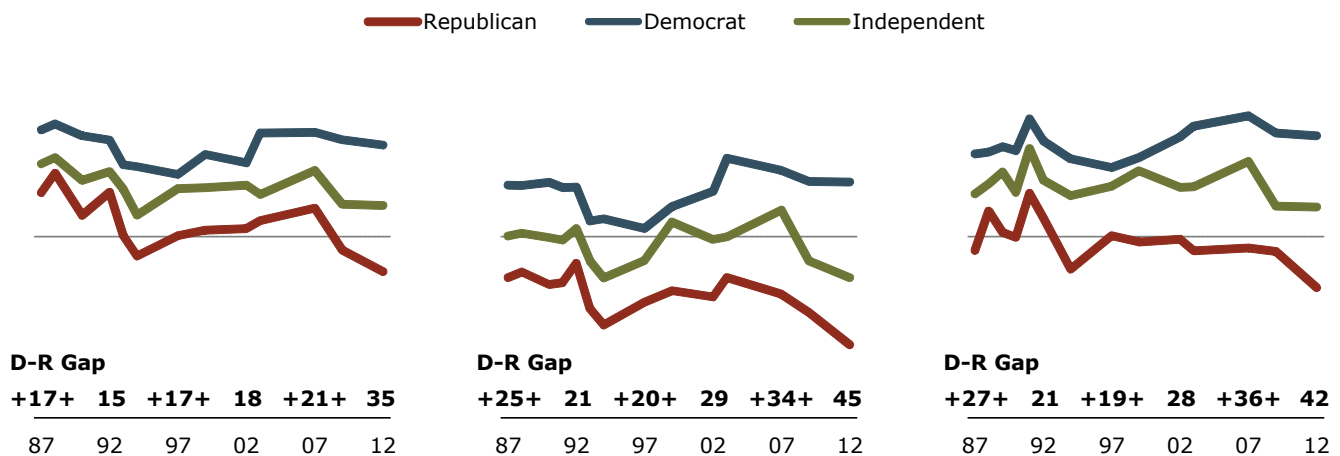
The Great Recession, the economy's slow recovery from it and the knock-on effect on incomes and income distribution have increased demand for a range of social services needed by society's most vulnerable. And that portion of the U.S. population that may need such services is growing. The percentage of Americans who say they are now in the lower middle or lower class has risen from a quarter of the adult population to about a third, according to a study

## Partisan Rift Over Safety Net Grows

*It's the government's responsibility to take care of people who can't take care of themselves*

*The government should help more needy people even if it means going deeper in debt*

*The government should guarantee every citizen enough to eat and a place to sleep*



Source: Pew Research Center 2012 Values Survey

by the Pew Research Center.

Not only has the lower class grown, but its demographic profile also has shifted. People younger than 30 are disproportionately swelling the ranks of the self-defined lower classes. And the shares of Hispanics and whites who place themselves in the lower class are also growing.

A majority of Americans has consistently agreed that it is the responsibility of government to help take care of such people.

Overall, however, the public majority in favor of the social safety net has slipped from 69% in 2007 to 63% in 2009 to 59% in 2012, according to the Pew Research Center. And Republicans and Democrats are far apart in their opinions about various aspects of the social safety net. There are partisan differences of 35 percentage points or more in opinions about the government's responsibility to care for the poor, about whether the government should help more needy people if it means adding to the debt and if the government should guarantee all citizens enough to eat and a place to sleep.

The percentage of Republicans asserting a government responsibility to aid the poor has fallen sharply in recent years. Just 40% of Republicans say that "It is the responsibility of the government to take care of people who can't take care of themselves," down 18 points since 2007. By comparison, in three surveys during the George W. Bush administration, no fewer than half of Republicans said the government had a responsibility to care for those unable to care for themselves. And, in 1987, during the Ronald Reagan's second term, 62% expressed this view.

Majorities of Republicans now say they disagree that the government should guarantee every citizen enough to eat and a place to sleep (36% agree, 63% disagree) and take care of people who can't take care of themselves (40% agree, 54% disagree). As recently as 2009, Republican opinions on these questions were more evenly divided.

Republicans also have consistently disputed the statement: "The government should help more needy people even if it means going deeper in debt." 76% now say they disagree, an increase of 15 points since 2007.

Democrats, however, continue to support government assistance to the poor and needy at the same level as they

have over the last generation. Three-fourths (75%) of Democrats believe that the government should take care of those who can't take care of themselves. Similarly, 78% say basic food and shelter should be government guarantees and 65% think more support for the needy should be provided, even in the face of increased debt.

In addition to the partisan divide, there are gaps between demographic groups on views of the social safety net. But

## The Social Safety Net: A Closer Look At Demographics

*The government should guarantee every citizen enough to eat and a place to sleep*



Source: Pew Research Center 2012 Values Survey. Whites and Blacks include only those who are not Hispanic.

these gaps have been largely stable over the past 25 years and are now much smaller than the partisan gap. African Americans have consistently been more supportive of a government safety net than whites. More than three-quarters (78%) of blacks support government guarantees of food and shelter, compared with 52% of whites. Support also is high among Hispanics: 78% now agree that the government should guarantee people food and shelter.

As might be expected, people with lower incomes are far more supportive of the social safety net than those with higher incomes. Women also have consistently been bigger backers of the social safety net than men: 64% of women and 54% of men support the government guaranteeing all citizens food and shelter. There are modest age and education differences, but these have changed little over the last quarter century.

In contrast, as might be expected of societies with a strong social contract, Europeans take a decidedly different view of the government's responsibility and role in providing a social safety net. Asked in 2007 by the Pew Global Attitudes survey whether it is the responsibility of the state to take care of very poor people who can't take care of themselves, 56% of the Swedes completely agreed, 53% of the British and Spanish similarly strongly assented and 52% of the Germans completely agreed, but only 28% of Americans held such firm views. And by 2012 that sentiment in the United States had fallen to 22% in a separate Pew Research Center survey.

The European social safety net is often held up as an example of a more generous and successful system of supplying health and welfare services. And many Europeans, especially northern Europeans, are particularly proud of their safety net: 81% of the French, 79% of the Danes, 75% of the Dutch, 69% of the Swedes and 62% of the Germans believe that their social welfare system could serve as a model for other countries, according to Eurobarometer.

But Europeans also harbor doubts about their welfare systems, feel somewhat less well protected than in the past and are dissatisfied with the cost.

In 2009, when asked by Eurobarometer to rate the statement that their own country's social welfare system "provides wide enough coverage" 48% of Europeans thought "it applies fairly well." That was down from 51% in 2006. And slightly fewer (42%) believed it "applies fairly badly,"

up from 38%. More Europeans (54%) considered their national social welfare system "too expensive" than not (29%).

Eastern Europeans are particularly dissatisfied with their social welfare systems, especially the Latvians (88%), Lithuanians (68%), Bulgarians (67%), Estonians (67%), Romanians (63%), and Slovaks (62%). Men (51%) are more likely to think their social welfare system provides wide enough coverage, while women (46%) and the unemployed (42%) are less likely to agree.

The Nordic countries are less concerned that the social welfare system is too expensive; only relatively small proportions of respondents in Finland (34%), Denmark and Sweden (both 36%), and also in Luxembourg (26%) tend to complain about the cost of their system. Eastern European nations are more worried about cost: Slovenia (64%), Estonia (58%), Bulgaria (49%) and Romania (42%).

## Government's Role in Providing a Social Safety Net

One possible explanation for the lack of support for a robust social safety net in the United States is that four in five Americans believe that the government does an ineffective job of helping poor and middle class Americans, according to a 2011 study by the Pew Economic Mobility Project. Americans also say that when government intervenes it is most likely to help the wrong people. And more than half (54%) believe government helps the rich a "great deal." Far fewer say it helps the poor (16%), the middle class (7%) and people like me (6%). This suggests that some Americans' antipathy toward the social safety net may stem from lack of faith in government efficacy and fairness rather than opposition to helping those in need.

But this wariness of government's side in the social contract may also have its roots in Americans' broader and conflicting views about the proper role for government in society.

In March 2011, 58% of Americans said it was more important in the United States that everyone be free to pursue their life's goals without interference from the state. Just 35% thought that it was more important for the state to

play an active role in society to guarantee that nobody was in need.

Yet, Americans are conflicted about government's role. In April 2012, 59% of the public believed it is the responsibility of the government to take care of people who cannot take care of themselves (albeit down 10 points from 2007). And, more specifically, 59% said the government should guarantee every citizen enough to eat and a place to sleep.

In general, however, Americans favor a smaller government with fewer services (56%) than a bigger government that offers more services (38%), according to a Washington Post/ABC News survey in August 2012. And about half (51%) of voters in the 2012 presidential election told exit pollsters that they thought government was doing too many things better left to businesses and individuals. This may be, in part, because just 41% of the public believe that the government is really run for the benefit of all the people, according to the Pew Research Center.

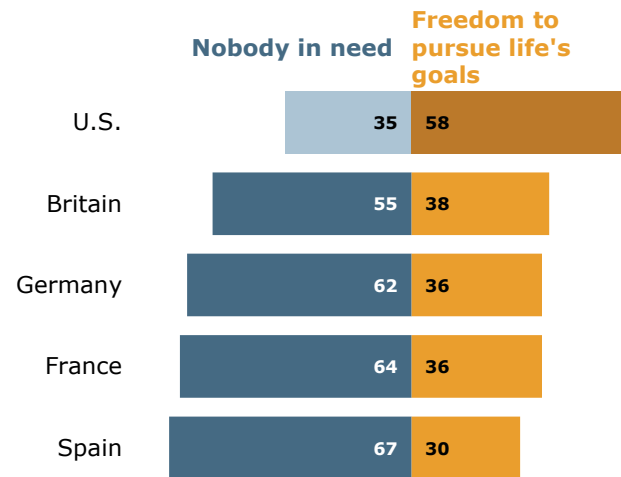
There is a strong partisan divide on the role of government. More than three-quarters (77%) of Republicans say that when something is run by the government it is usually inefficient and wasteful. Just 41% of Democrats agree. And on election day 2012 it was overwhelmingly Romney voters (82%) who thought government was doing too much. Obama voters (69%) thought government should do more to solve problems.

The relatively stronger European social safety net may, in part, reflect Europeans' belief that this is a governmental responsibility. Fully 67% of the Spanish, 64% of the French, 62% of the Germans and 55% of the British believe that the state needs to play an active role in society to guarantee that nobody is in need.

## Attitudes a Reflection of Values

The interplay between economic conditions and fundamental values – such as faith in hard work – provides some insight into public attitudes toward the social safety net. It also helps to explain what would appear to be contradictory American sentiments about the role of the state and the responsibility of the individual in responding to economic challenges.

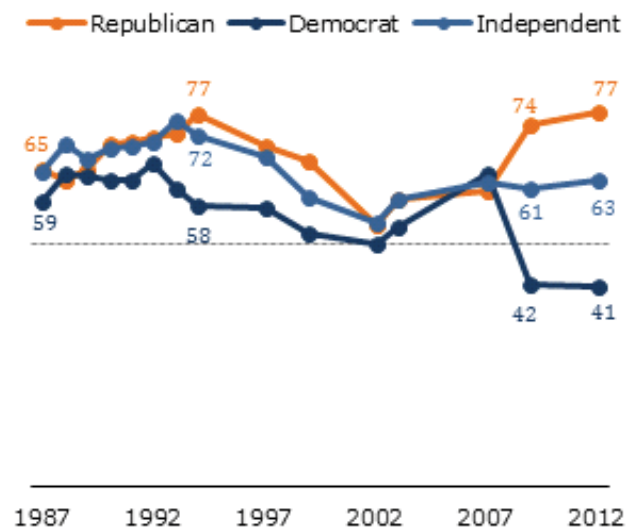
## Which is More Important?



Source: Pew Research Center 2011 Pew Global Attitudes Survey

## A Partisan Reaction to Government

*When something is run by the government, it is usually inefficient and wasteful*



Source: Pew Research Center 2012 Values Survey

Rugged individualism is a much prized and storied American value, at least in theory. Americans are among the most individualistic people in the world. In a view consonant with laissez-faire economic attitudes, roughly six in ten reject the notion that outside forces determine success in life. And Americans overwhelmingly agree that individuals, not society, are to blame for personal failures.

But this broad individualistic self-image belies deep divisions among Americans. Half of lower-income Americans believe they are victims of fate, but only 22% of upper income Americans see their lives determined in that way. Democrats (41%) and Blacks (50%) are more likely than Republicans (29%) and Whites (31%) to believe that their destiny is beyond their control.

Americans largely stand alone in such an individualistic view of their personal fate. Unlike Americans, about seven in ten (72%) Germans, more than half (57%) of the French and nearly four in ten (41%) of the British see success determined by forces outside their influence.

Moreover, Americans largely believe that personal effort is the key to success. Only 35% agree with the idea that “hard work offers little guarantee of success.” More than six in ten (63%) disagree. But such sentiment is clearly a class issue. Those with less education and lower incomes are more likely than those with more education and higher incomes to say that hard work does not ensure success.

Nevertheless, this broad American embrace of individualism as a matter of faith breaks down when people are asked to account for individual economic failures. When queried why unemployed people in the country are without jobs, Americans hesitate to place the blame on the jobless themselves. Less than one-in-five (18%) say those without work are responsible, according to a Pew Global Attitudes

survey. Such sentiment is similar to that in Germany (25%) and Britain (22%), and far lower than that in Indonesia (46%) and India (45%).

This seeming dichotomy between Americans’ philosophical commitment to individual responsibility and yet an acknowledgment that individuals can be the victims of forces beyond their control plays itself out in attitudes toward the nature of the U.S. social contract and how to pay for it.

## Paying the Price

Given declining incomes over time, the rise in inequality, the need for social services and yet Americans’ wariness of government and traditional individualism, what are Americans willing to do to provide themselves with a social safety net, especially given current U.S. government indebtedness?

When a price tag is attached to the provision of the social safety net, American backing for such aid declines. Since 1987, about half or less of the public has agreed with the statement that “government should help more needy people even if it means going deeper in debt” and in 2012 it was near the low point last seen in 1994. Just 43% agree that the government should help more needy people regardless of whether it means more debt, down from 48% in 2009 and 54% in 2007.

Partisan and other divides are particularly evident when cost is an issue. In 2012, only 20% of Republicans believed that government should help more needy people even if it means going deeper in debt, compared with 65% of Democrats. In 1992, 43% of Republicans were willing to pay such a price for a social safety net. In 2012, just 36% of whites were willing to see further public indebtedness to provide such government services; in 1992 50% were willing to bear that burden.

Paying for the social safety net is intimately bound up with attitudes about the current U.S. budget deficit and what to do about it. This has been particularly true in the debate between Congress and the White House over a long-term deficit reduction deal. In any such agreement, the social safety net may be a major victim.

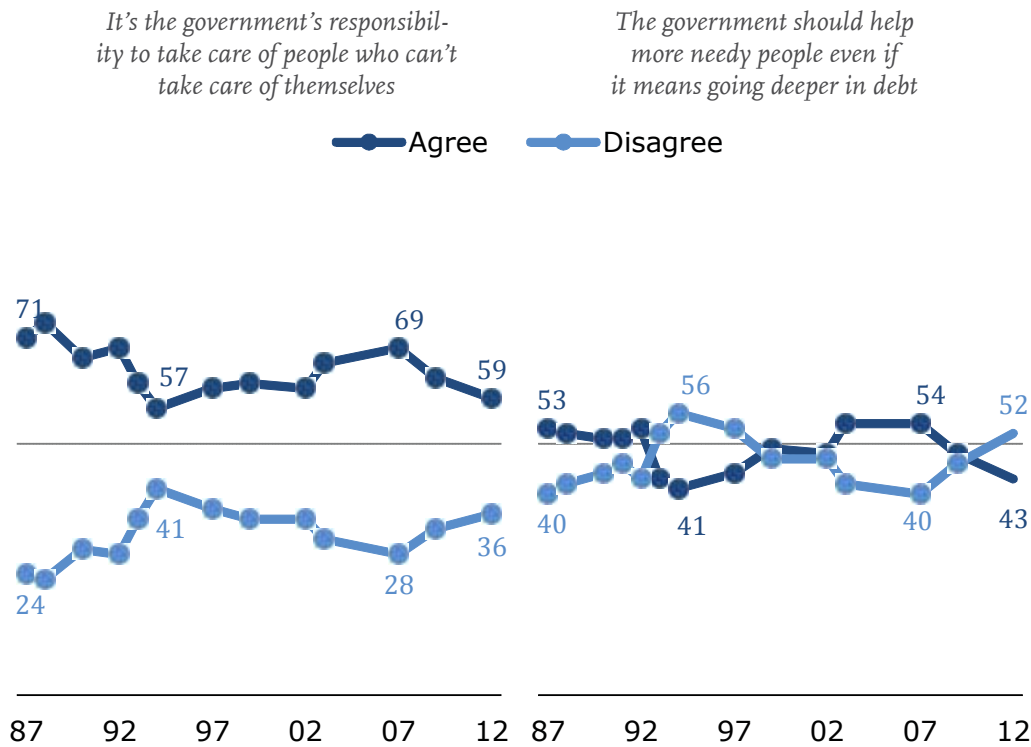
## Differing Views of Individualism

*Success in life is determined by forces outside our control*

	Agree	Disagree	DK
	%	%	%
<b>U.S.</b>	<b>36</b>	<b>62</b>	<b>3</b>
Britain	41	55	4
Spain	50	47	3
France	57	43	0
Germany	72	27	1

Source: Pew Research Center 2012 Values Survey

## Americans' Low Support for Social Safety Net



Source: Pew Research Center 2012 Values Survey

The public does not want to have to choose between deficit reduction and eroding the social safety net. If forced to choose, they prefer keeping programs rather than making cuts. In a Pew Research Center survey in August 2012, 51% of the public said that keeping Social Security and Medicare benefits as they are was more important than taking steps to reduce the budget deficit (33%).

In general, Americans have long felt that deficit reduction should be achieved with a combination of spending cuts and tax increases. In early December 2012, nearly three-quarters (74%) of Americans said the best way to reduce the deficit is by both cutting major public programs and increasing taxes, up from 69% in September and just 60% in July 2011. Just 11% said the focus should mostly be on cuts in government programs and 7% said the focus should be mostly on tax increases.

However, while the public endorses a balanced approach to deficit reduction, majorities continue to oppose making cuts in federal funding for many social welfare programs,

including education (77% disapprove) and aid to low-income Americans (58%). And majorities also disapprove of gradually raising the retirement age for Medicare and Social Security (56% each). Moreover, the public is divided over whether Social Security and Medicare benefits should be reduced for seniors with higher incomes (51% approve while 46% disapprove for each).

There are substantial partisan differences over deficit-cutting efforts to undermine the social safety net. Republicans are about twice as likely as Democrats to support cuts in federal funding for programs that help low-income people (53% vs. 24%). And while Republicans are divided over whether to gradually raise the age for Social Security benefits, fully 67% of Democrats disapprove. The pattern is similar for increasing the eligibility age for Medicare. Republicans also are more likely to support cuts in federal funding for education, although majorities across partisan lines disapprove of this.

There are no significant partisan differences on reducing Social Security and Medicare benefits for seniors with

higher incomes.

At the same time, people are willing to pay for major components of the social safety net. More than half (53%) favored raising Social Security taxes so that the benefits can be kept the same for everyone, according to a survey by the Associated Press in August 2012. Just 36% backed keeping Social Security taxes at the same rate they are at now, but reducing the benefits for future generations.

In Europe, there is even greater support for paying for the social safety net. Despite their recent economic troubles, 61% of Europeans say that a higher level of health care, education and social spending must be guaranteed, even if it means that taxes may increase, according to a 2010 Eurobarometer survey. Such support is particularly strong in northern European countries with strong social safety nets: Sweden (84%), Finland (83%) and Denmark (80%).

Nevertheless, there is some support in Europe for reducing the government's deficit through cutting spending rather than raising taxes. But there is also sympathy for the view that the rich should bear more of the tax burden.

A late June 2012 survey by TNS Sofres found that about two-thirds of the French (68%) wanted budget rebalancing to come from cutting government spending and reducing public services. Only 2% backed increasing taxes, while just 20% wanted a mix of the two. At the same time, nearly three in four people in France (73%) supported a 75% marginal tax rate for people making more than one million euros per year, according to an early July BVA survey.

Similarly, a late January 2012 YouGov poll in the United Kingdom showed that only 11% were in favor of increasing taxes to help reduce the deficit. At the same time, 62% of the British thought that taxes should be raised on the wealthiest people in the UK.

## Conclusion

The American social safety net is more porous than that afforded to citizens in many other high-income economies and the social contract is weaker. And in the effort to curtail the U.S. government debt, the support provided to average Americans who are unemployed, poor, or in need of

## Deficit Reduction Options: Tax Higher Incomes, Spare Programs

*In order to reduce the deficit and national debt...*

	Agree	Disagree	DK
	%	%	%
Raise income tax on income over \$250,000	69	62	3=100
Limit deductions a taxpayer can claim	54	55	6=100
Raise tax rate on investment income	52	47	5=100
Reduce Medicare benefits for higher income seniors	51	43	3=100
Reduce SS benefits for higher income seniors	51	27	3=100
Reduce military defense spending	43	55	2=100
Gradually raise Social Security retirement age	42	56	2=100
Gradually raise Medicare retirement age	41	56	2=100
Limit home mortgage interest deduction	41	52	6=100
<i>Reduce federal funding...</i>			
To help lower-income Americans	38	58	4=100
For roads and transportation	30	67	4=100
For education	21	77	2=100

Source: Pew Research Center Dec. 5-9, 2012  
 Figures may not add up to 100% because of rounding.

## Huge Gaps Between Republicans and Democrats over Taxes, Cuts in Defense, Aid to the Poor

*In order to reduce the deficit and national debt...*

		Rep	Dem	Ind	
<i>Wide Partisan Differences</i>		%	%	%	<b>R-D Diff</b>
Reduce military defense spending	Approve	22	57	46	D+35
	Disapprove	76	41	52	
Raise income tax on income over \$250,000	Approve	52	86	68	D+34
	Disapprove	44	12	30	
Reduce funding to help low income Americans	Approve	53	24	39	R+29
	Disapprove	43	73	57	
Raise tax rate on investment income	Approve	34	62	57	D+28
	Disapprove	60	32	40	
Reduce federal funding for education	Approve	32	10	26	R+22
	Disapprove	65	89	72	
Gradually raise Social Security retirement age	Approve	48	32	50	R+16
	Disapprove	49	67	48	
Gradually raise eligibility age for Medicare	Approve	51	38	38	R+13
	Disapprove	47	59	59	
<i>Narrow Partisan Differences</i>					
Limit tax deductions for mortgage interest	Approve	35	45	42	D+10
	Disapprove	57	51	51	
Limit tax deductions	Approve	61	52	54	R+9
	Disapprove	34	42	41	
Reduce Medicare benefits for high income seniors	Approve	54	48	52	R+6
	Disapprove	43	47	45	
Reduce Social Security benefits for high income	Approve	51	47	57	R+4
	Disapprove	44	50	42	
Reduce funding for roads and transportation	Approve	29	25	32	R+4
	Disapprove	64	73	65	

Source: Pew Research Center Dec. 5-9, 2012 People-Press survey.

## Views of Trade and Globalization

The economic mood of the country is primarily a function of the state of the domestic economy. But this cannot be divorced from America's growing integration with the rest of the world economy. And that process of globalization looms large in public attitudes.

Americans' views of trade, foreign investment and globalization are complex, at times contradictory and cannot be explained as a simple preference for free trade or protectionism. Two-thirds of Americans think trade is good for the economy. But they don't buy economists' argument that trade is necessarily good for them. Rather, they think it kills jobs and undermines wages. A strong majority favors protecting domestic businesses.

In comparison, Europeans are more likely to say growing trade and business between countries are good for their country, although they too have some worries about its impact on them personally. In particular, Europeans share with Americans a concern about trade hurting jobs. And half would erect trade barriers to protect domestic industry.

Despite the recent economic crisis, Americans (67%) maintain majority support for trade and business ties with the rest of the world. This support has improved 14 percentage points since 2008. But it is still among the weakest enthusiasm for globalization among major economies. Majorities in Spain (96%), Germany (95%), Britain (87%) and France (83%) say such globalization is good for their country, according to the 2011 Pew Global Attitudes survey.

health insurance and pensions may be further reduced. Americans oppose such cuts in social services. But they also oppose most other efforts to reduce the debt, while supporting debt reduction in principle. And they remain uncertain about the role government should play in the provision of health care, old age insurance and the like.

Public ambivalence about the social safety net suggests the United States will never provide its citizens with support comparable to that provided to citizens of Germany or

Scandinavia. At the same time, Americans value the social safety net that exists and do not want it changed.

Americans do have a social contract with each other and with their government. But this bond is currently under great strain. Americans' conflicting values and goals and deep partisan divisions over the specifics of the social safety net, along with worries about how to pay for it, suggest that the tensions surrounding the social contract will continue for some time.

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*Bruce Stokes is director of global economic attitudes at the Pew Research Center, a nonpartisan source of data and analysis that takes no advocacy positions on public policy issues. This analysis was written to provide relevant public opinion information on topics addressed by the Next Social Contract Initiative. It is not intended to indicate support for or opposition to any of the policy proposals put forward as part of the initiative.*

# APPENDIX TWO

## Further Resources on the Next Social Contract

# Further Resources on the Next Social Contract

## Visions for a New Social Contract

### **The Conservative Welfare State**

Michael Lind, July 17, 2012, *Salon*

### **Rethinking the American Social Contract**

Lauren Damme, July 7, 2011

### **The American Middle Class Under Stress**

Sherle R. Schwenninger and Samuel Sherraden, April 27, 2011

### **The Great Recession Strains the American Social Contract**

Lauren Damme, November 23, 2010

### **The American Social Contract**

Sherle R. Schwenninger, September 28, 2010

### **The American Social Contract: A Promise to Fulfill**

Michael Lind and David McNamee, 2008

### **A Citizen-Based Social Contract**

Michael Lind, July 2007

## Economic Recovery and Job Creation

### **The Missing Economic Debate**

Sherle R. Schwenninger, October 29, 2012, *The Nation*

### **America's Emerging Growth Story**

Sherle R. Schwenninger and Samuel Sherraden, July 19, 2012

### **Democracy: Jobs and Economy Roundtable**

featuring Sherle R. Schwenninger, Winter 2011

### **Unequal and Unstable**

Anant Thaker and Elizabeth Williamson, January 11, 2012

### **The Way Forward**

Daniel Alpert, Robert Hockett, and Nouriel Roubini, October 10, 2011

### **Yes We Can Create Decent Jobs**

Heather Boushey, July 28, 2011

### **A Vision for Economic Renewal**

Task Force on Job Creation, July 26, 2011

### **The Jobs Question**

James K. Galbraith, July 19, 2011

### **Import Money – Export Goods**

Robert Atkinson, July 5, 2011

### **Winning the Prosperity**

Sherle R. Schwenninger, March 15, 2011

### **The Pillars of Economic Transformation**

James K. Galbraith, February 1, 2011

### **A Recovery at Risk**

Sherle R. Schwenninger and Samuel Sherraden, October 11, 2010

Plan B Series:

### **Plan B for Obama**

Thomas Palley, September 6, 2010

### **Readying a Plan B for Economic Recovery**

Marshall Auerback, September 6, 2010

### **Promoting Recovery Through Cheap Credit for Small Businesses**

Robert Pollin, September 6, 2010

### **The Case for a Multi-Year Infrastructure Investment Plan**

Laura Tyson, September 6, 2010

### **Thoughts on a Plan B**

James K. Galbraith, September 6, 2010

### **Monetary Policy's Role in America's Economic Recovery**

Joseph Gagnon, September 6, 2010

### **Focusing on Innovation**

Michael Mandel, September 6, 2010

### **The Danger of Long-Term Structural Unemployment**

Sherle R. Schwenninger, July 12, 2010

### **U.S. and Europe: Shaping a New Model of Economic Development**

Sherle R. Schwenninger, June 1, 2010

### **What's Wrong (and Right) With this Recovery**

Sherle R. Schwenninger and Samuel Sherraden, May 24, 2010

### **Long-Term Consequences of Economic Fluctuations**

Jeff Madrick and William Dickens, May 20, 2010

### **The Worrying Return of Inequality**

Sherle R. Schwenninger and Lauren Damme, April 13, 2010

### **The Jobs Deficit**

Sherle R. Schwenninger, Samuel Sherraden, and Benjamin Kolansky, April 12, 2010

### **Getting Serious about Doubling U.S. Exports**

Sherle R. Schwenninger and Samuel Sherraden, March 17, 2010

### **The Case for an Infrastructure-Led Jobs and Growth Strategy**

February 23, 2010

### **Jobs and the New Growth Agenda**

Michael Lind, December 2, 2009

### **America's Debt Overhang**

Sherle R. Schwenninger and Samuel Sherraden, October 19, 2009

### **Overcoming America's Debt Overhang: The Case for Inflation**

Christopher Hayes, September 9, 2009

### **America's Exhausted Paradigm**

Thomas Palley, July 22, 2009

### **Not Out of the Woods**

Niko Karvounis, June 30, 2009

## **Good Jobs, Adequate Compensation, and Full Employment**

### **Losing Middle America?**

Lauren Damme, September 15, 2011

### **A Global Minimum Wage System**

Thomas Palley, July 19, 2011

### **A Most Undemocratic Recovery**

Joel Kotkin, July 15, 2011

### **Low-Wage Jobs and No Wage Growth**

Lane Kenworthy, June 27, 2011

### **Making Work Better for Everyone**

Paul Osterman, June 27, 2011

### **Work Sharing**

Shayne Henry, June 23, 2011

### **Needed: A New Social Contract at Work**

Thomas Kochan, June 21, 2011

### **It Takes a Policy Agenda**

L. Josh Bivens and Heidi Shierholz, June 21, 2011

### **The Vulnerable American Worker**

Lauren Damme, August 27, 2010

### **Workers of the World**

Harold Meyerson, June 15, 2009,

## **Benefits, Social Insurance, and Economic Security**

### **U.S. Leaves Working Families in the Lurch**

Joshua Freedman, September 27, 2012, *CNN*

### **Education Reform's Central Myths**

Michael Lind, August 1, 2012, *Salon*

### **Gambling with Economic Security**

Michael Lind, April 10, 2012, *Salon*

### **Economic Security Through Employment Assurance**

Steven Attewell, January 27, 2012

### **The Public Option**

Timothy Canova, June 30, 2011

### **The Old Do Not Eat the Young**

Teresa Ghilarducci, June 17, 2011

### **The Politics of Social Security**

Eric Laursen, October 28, 2010

### **Secure Retirement for All Americans**

Steven Hill, August 16, 2010

### **Public Affluence, Private Squalor**

Mark Paul and Micah Weinberg, July 20, 2010

### **The Dignity Voucher Program**

Michael Lind and Lauren Damme, July 15, 2010

### **The American Retirement Security Crisis: An Introduction**

Lauren Damme, May 27, 2010,

### **Facing an American Retirement Security Crisis**

Lauren Damme, May 17, 2010

### **Holes in the Safety Net**

Lauren Damme, March 24, 2010,

### **A Next Social Contract for the Primary Years of Education**

Lisa Guernsey and Sara Mead, March 31, 2010,

### **Freedom from Fear**

Steven Attewell, January 11, 2010

### **American Healthcare: How Do We Measure Up?**

Lauren Damme, December 15, 2009

## **Paying for the Social Contract**

### **The Tax-Break Myth: They're Not Really for The Middle Class**

Joshua Freedman, November 1, 2012, *The Atlantic*

### **A Radical Tax Solution**

Michael Lind, April 24, 2012, *Salon*

### **The Progressive Case for Corporate Tax Reform**

Bruce Stokes, January 26, 2012

### **Public Purpose Finance**

Michael Lind, September 9, 2010

### **The Fiscal Crisis in State Government – And What Should Be Done About It**

Linda Bilmes, June 17, 2010

### **Effects of Imposing a Value-Added Tax to Replace Payroll Taxes or Corporate Taxes**

Eric Toder and Joseph Rosenberg, March 22, 2010

### **The Fiscal Austerity Trap**

Thomas Palley, September 15, 2009

1899 L Street, NW  
Suite 400  
Washington, DC 20036  
Phone 202 986 2700  
Fax 202 986 3696



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