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Social Insurance Benefits Need Not Limit Economic Growth: New Evidence

Report of a seminar with Peter H. Lindert and others, prepared by Joni Lavery

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Summary

Public programs can help protect Americans from economic insecurity without impairing economic growth, according to participants in a seminar sponsored by the National Academy of Social Insurance (NASI). Providing economic security for families also encourages people to take the risks necessary to foster innovation, which drives productivity.

Economist Peter Lindert finds that high levels of social spending in European democracies have not slowed economic growth, as long as the benefits and taxes are well designed. Social programs that cover nearly the entire population and are financed by broad-based low-rate taxes, such as payroll taxes or value-added taxes, have almost no effect on a country's ability to grow and prosper. Lindert's research contradicts the oft-stated assertion that social welfare spending necessarily slows economic growth because the benefits and taxes discourage recipients and taxpayers from being as productive as they otherwise would be.

Political scientist Kimberly Morgan identifies two reasons why social benefits have maintained stronger political support in Europe than in the United States. First, in Europe, the connection between taxes paid and benefits received is very visible. In the U.S., by contrast, the tax system is very visible, but much support for health care, housing and pensions is provided through tax expenditures, which often go unrecognized. Also, European countries place greater reliance on consumption and payroll taxes than on personal and corporate income taxes, which are more progressive and more likely to antagonize powerful groups.

Itai Grinberg, Peter Orszag, Jack Ebeler, and Rudolph Penner provide additional comments on Lindert's findings. For a transcript of the seminar and copies of the papers and presentations, visit the NASI website and go to "Conferences and Events" → "Past Conferences and Events" → "Family Well-Being, Public Policy, and Economic Growth: Lessons from History and Insights for the Future."

Many families face difficult choices as they adjust to the rapidly changing U.S. economy. Policymakers want to help, but they are often stymied by the assertion that any programs that buffer economic losses will harm the economy. Is this theory true? To find out, the National Academy of Social Insurance brought together several experts to examine this question.

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William Spriggs, chair of the Department of Economics at Howard University, moderated the seminar. Spriggs began by noting that we may need to consider fundamentally different social and economic policies than those of the past. If conventional assumptions are barriers to innovative policy choices, those assumptions need to be questioned and reassessed. "Adhering to conventional wisdom often results in policies favoring the politically and economically powerful, so it is good to question conventional wisdom, especially if you want programs that can benefit the politically and economically weak," he said.

Does High Social Spending Reduce Economic Growth?

Peter Lindert, Distinguished Professor of Economics at the University of California (Davis), examined whether high social spending adversely affects economic growth. In his two-volume work, *Growing Public: Social Spending and Economic Growth since the Eighteenth Century* (Cambridge University Press, 2004), Professor Lindert reports that the evidence does not support this argument. His analysis of democratic European countries that spend 20 percent or more of their gross domestic product (GDP) on social benefits (see Table 1) finds that the impact of these social programs on each country's economy was negligible. The reason for this result is that these countries did not commit the blunders we often imagine when they designed tax and spending policies.

How Social Policies Affect Productivity

To understand how social policies can affect productivity, it is helpful to look at particular policies. For instance, if a worker receives unemployment compensation to help with daily expenses when he or she loses a job, won't that worker stay unemployed longer? Lindert finds this to be true. He also finds, however, that this outcome has a very small effect on GDP, so that the loss of output can be offset fairly easily with other policies.

> "There is no race to the bottom, whereby countries might compete against each other to slash their programs the most, in order to slash taxes the most, and bring all social spending down." ***- Peter Lindert***

U.S. welfare benefits in the 1980s provide another illustration of how poorly designed programs can harm productivity. Lindert argued that tightening eligibility for family support benefits, and the loss of those payments quickly after becoming employed, discouraged many who were living below the poverty line from seeking employment.

In the early 1990s, the U.S. Congress expanded the Earned Income Tax Credit (EITC). This program excuses low-income workers from paying federal income taxes and, in many cases, provides these workers with a refund. In Lindert's view, the EITC encourages work and is at least partly responsible (along with time limits on welfare payments) for the increased participation in the workforce of low-income workers.

In examining countries with high social spending, Lindert finds that part of the reason their policies have not harmed their economies is that the policies cover almost everyone. For instance, northern European countries are much better than the United States at providing support for all working mothers. "Mothers' human capital, their ability to become productive over the lifecycle, is very much affected by society's willingness to give them help with childcare and early-parental leave."

These high-spending countries are also better at providing health care to their families. In the United States, "we have more bureaucracy than an all-public system, we have higher administrative costs, and we save fewer lives," Lindert said. Part of the problem with the U.S. healthcare system, which is not a problem in the other nations included in his study, is that access to affordable health insurance is usually dependent upon having a job.

Even if income support policies do not inherently impede economic growth, theory argues that paying for these programs surely would. It is commonly believed that higher taxes reduce incentives to work and save; yet here, too, Lindert's research refutes the conventional view.

Table 1.
Social Spending in OECD Countries as a Percentage of Gross Domestic Product, 2001

Country	% of GDP
Denmark	29.2
Sweden	28.9
France	28.5
Germany	27.4
Belgium	27.2
Switzerland	26.4
Austria	26.0
Finland	24.8
Italy	24.4
Greece	24.3
Norway	23.9
Median	**23.9**
Netherlands	21.8
United Kingdom	21.8
Portugal	21.1
Spain	19.6
New Zealand	18.5
Australia	18.0
Canada	17.8
Japan	16.1
United States	14.8
Ireland	13.8

Note: Social spending includes: means-tested assistance for the poor; unemployment compensation and help in securing new jobs; social insurance for retirement, disability and survivors insurance; public spending for health care; and housing subsidies.

Source: OECD *Social Expenditures Database*.

The Details: A Better Mix of Tax Policies

A common misconception about nations that spend more on social programs is that they tax corporations, top income earners, and capital gains the most. According to Lindert, though, labor income is taxed more in these countries. He notes that the people who are paying for the social insurance programs largely overlap with the people who benefit from them. "So it's not quite the Robin Hood story that I think many people had in mind," he said. The higher-spending European countries do employ a better mix of taxes than low-spending nations, and this mix of taxes also helps explain the discrepancy between actual experience and economic theory.

In addition to taxing labor income, high-spending nations tax general consumption more heavily than low-spending nations. In many European countries a value-added tax (VAT) provides the means to pay for social programs. Along with general consumption taxes, many European countries tax addictive products that have bad health consequences (like tobacco and alcohol) and gasoline at comparatively high rates. Consumption (sales) tax rates in the United States are quite low compared to VAT rates in Europe.

Lindert's study strongly challenges the notion that high spending on health and income security programs results in slower economic growth. His research shows, instead, that universal social insurance programs and broad-based taxes do not harm a nation's ability to grow and prosper.

No Race to the Bottom

Lindert's final point is that, despite predictions to the contrary, high-spending countries are not an endangered species. Instead, Lindert argues, "There is no race to the bottom, whereby countries might compete against each other to slash their programs the most, in order to slash taxes the most, and bring all social spending down." Since the late 1960s the group of high-spending European countries hasn't changed very much, with few new entrants and almost none dropping out.

The high level of political support for European social programs, and the high level of spending associated with the programs, is in sharp contrast to the ambivalence Americans feel toward programs of social protection in the United States. The design and financing of European programs may help reveal why they have proved so durable.

Sources of Political Support for the Western European Model

Political scientist Kimberly Morgan, co-author of "Financing the Welfare State: Elite Politics and the Decline of the Social Insurance Model in America" (*Studies in American Political Development*, 2005), offered several observations on why European social insurance programs have maintained strong political support. As pointed out by Lindert, these social insurance programs are universal, and thus are likely to have more political strength than means-tested programs targeting a much narrower, and less politically powerful, constituency. The second critical piece of this model is how these programs are financed, with a particularly heavy reliance on consumption taxes and payroll taxes. Morgan stated that consumption taxes paid at the time of purchase are less visible than income taxes, which are reported annually to the government. And consumption and payroll taxes may be more acceptable to groups that might otherwise lead an anti-tax movement, namely the wealthy or business groups.

Another potential reason for the durability of the European model is that benefits are visible and clearly connected to the taxes that pay for the benefits—such as health care, housing support, old-age pensions, parental leave, and unemployment insurance. In the United States, in contrast, many broad-based supports are provided indirectly through tax expenditures—such as the mortgage interest deduction and the exclusion from income of employer contributions for health insurance and pensions.

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- ***Kimberly Morgan***

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less likely to antagonize powerful groups in society and are simply less visible to the public, basically fund progressive redistribution through social benefits," Morgan said.

The European model is also constantly changing as economies change. Countries are trying to reduce spending in certain areas and redirect social spending to areas that could be seen as more productive. Social welfare spending has not been reduced overall, Morgan said, but there have been ongoing reforms and efforts to improve the workings of the European model.

The rise of women's employment over the last few decades has put pressure on European countries to recast their programs, reorient their spending, and take account of the changing needs of the population. This has led to attempts to create policies that support mothers' employment, policies such as universal childcare, generous paid parental leave policies, and part-time work supports. In the face of aging populations, increasing the labor force by promoting women's employment is good economic policy.

Ins and Outs of a Value-Added Tax (VAT)

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Itai Grinberg, tax attorney with Skadden, Arps, Slate, Meagher & Flom, argued that a VAT is a fairer and more efficient way to raise revenue. The United States is a very low-tax country, collecting only 25 percent of GDP in taxes compared to about 40 percent for 15 European Union countries, according to OECD data. The U.S. tax system is very complex, resulting in roughly $150 billion spent on compliance each year. Yet the tax gap, the difference between the amount that should be paid and the amount that is actually collected, is more than $300 billion annually. "Relying excessively on income tax to fund government is sub-optimal, and by doing so the U.S. fails to take advantage of our status as a low-tax country," Grinberg said.

Average U.S. sales tax rates are well below the consumption tax rates among our trading partners. Grinberg said that implementing a broad-based 15-percent VAT could collect 65 percent of the revenue of the current income tax—around $750 billion per year. This level of tax receipts would allow the U.S. to take 100 million people off the income tax rolls, reduce the top individual and corporate income tax rates, and repeal the alternative minimum tax. "The U.S. could and should have one of the lowest income taxes in the world without reducing government services or making our overall system less progressive," he said.

A VAT is like a sales tax but it is assessed in smaller pieces and collected at every level of production and distribution. This method of taxing consumption increases compliance and simplifies reporting.

Grinberg pointed out that the main objections to the VAT have been, on the one hand, that the tax is regressive and, on the other hand, that the VAT is a money machine that will allow the government to grow. "The debate over appropriate amounts of redistribution and size of government, to my mind, should be largely distinct from the debate about whether to use a VAT to help fund whatever level of benefits and size of government we choose," Grinberg said.

Providing Economic Security in Growth-Enhancing Ways

Peter Orszag, formerly a senior fellow at the Brookings Institution and now director of the Congressional Budget Office, built on Lindert's findings, arguing that excessive economic risk or economic insecurity is harmful to economic growth as well as to family well-being. Lacking an adequate degree of economic security can discourage people from taking risks that lead to stronger economic performance. Without a core level of economic security, people don't get back onto a productive path again quickly enough when bad shocks happen. And, inadequate economic security is likely to result in calls for protectionist policies or direct-market interventions that would impede growth.

One way to enhance the economic security of American families is through social insurance: providing some assistance after the fact, when bad things do happen, in a market-friendly way to help families get back on their feet. Getting the protections and incentives right, as Lindert showed, is the key to creating growth-enhancing social insurance programs.

Orszag suggests that U.S. policymakers need to move beyond the erroneous assumption that providing any financial protection to American families necessarily harms the economy, and instead begin looking at specific cases of how to balance incentives correctly.

For example, he said, we should be moving away from an unemployment insurance system that focuses much of its resources on short-term bouts of unemployment and towards insuring against the real risk that most American families face, which is that after experiencing that short bout of unemployment, a worker gets a new job at a lower wage. Having a lower wage over 10, 15, or 20 years is much more harmful to most families than experiencing two months of unemployment, especially if workers have some savings that could be drawn upon in that period. One option is to provide wage insurance, which would make up part of any loss in earnings when a worker is re-employed. This example illustrates how social insurance programs can help alleviate financial insecurity and help bolster the economy at the same time.

Another Way to Think About Health Care in the United States

Jack Ebeler, independent consultant and member of the Medicare Payment Advisory Commission, argued that the health care financing system in the United States is much more complex than those in the European countries Lindert examined. Ebeler pointed out two important elements of the U.S. system that must be considered: the way we finance health care and variations in the quantity and quality of health care provided within the United States.

Multiple revenue streams—both public and private—finance the American health care system. The public programs, largely Medicare and Medicaid, are financed through payroll taxes, premiums, and federal and state general revenues. The private system is financed through employer and individual premiums and tax subsidies. Given this complexity, early reform may combine some type of revised private-plus-public combination.

Another element of the U.S. health care system that should be examined closely is the variations in care and costs within the United States. One recent study divided the country into hospital referral regions and examined Medicare spending in those areas. The researchers found that Medicare costs in the highest quintile of regions was 28 percent higher than in the middle-spending quintile, and about 61 percent higher than in the lowest-spending quintile, yet the

quality of care reported across those quintiles is at best flat. What is the cause of these variations? "The key variant in this country appears to be the delivery system—the supply side. It is supply-induced demand," Ebeler said. It may be possible to match the efficiencies achieved in the lower cost areas of the country—which are comparable to Western European spending levels—while enhancing the quality of care provided. If so, this step would begin to slow the growth in the cost of health care in the United States.

What It All Means

Rudolph Penner, senior fellow at the Urban Institute, pointed out the importance of Professor Lindert's work. "It finally explains to economists in general, and conservative economists in particular, how on earth the countries of Western Europe could have such generous social programs without paying much of a cost in foregone economic growth. And basically it's because their tax systems are very efficient. That is the main Lindert message," he said. These tax systems are efficient because they are not very progressive, tax consumption rather than capital, and place a high burden on goods like cigarettes, alcohol, and gasoline, whose demand is not very responsive to price.

Penner believes the debate about financing health care in the United States is about how to improve the average quality of healthcare as technology progresses. "The economic problem that we face stems from our totally open-ended budget that promises to fund almost any new medical procedure that comes along, no matter how expensive it may be, and with only slight regard to its benefit-cost ratio," he argued. Penner believes that reducing the cost of health care in the U.S. will require some type of rationing, which can be done in such a way as to prove beneficial for the overall health of Americans.

Why Should Young People Care About Social Insurance?

Participants took advantage of the question-and-answer period to clarify some of the points raised during the seminar. One question in particular stood out from the rest. A Howard University student asked, "What is the importance of these social and health insurance policies to young people, including students, because all I ever hear a lot about is old people."

Professor Lindert addressed the student's question first, acknowledging that most 20-year-olds are in the healthiest phase of life. He cautioned, however, that having children changes one's experience of our health care system. Other wealthy countries spend relatively more on basic preventive outpatient care, including prenatal care that can be lifesaving for infants. "In America we have this problem that we undervalue broad simple preventive healthcare for the young, especially for infants," he said.

Peter Orszag acknowledged the bright future the college students should be anticipating, but he also issued a note of caution. "Lots of things happen in the course of life that you cannot anticipate now, and social insurance provides a backstop if and when you should need it," he said. College-aged students have roughly a one-third probability of becoming disabled or dying before retirement age—a non-trivial risk. Additionally, most college students believe they will have high-earning careers, but that is not always the case. Social Security provides a form of earnings insurance unavailable in the private market that, due to its progressive formula, helps mitigate the consequences of lower-earning careers.

Biographical Information

Peter H. Lindert is Distinguished Professor of Economics at the University of California (Davis). His latest book, *Growing Public: Social Spending and Economic Growth since the Eighteenth Century*, has been covered in the *Economist, Newsweek*, the *New York Times*, and other media and has received the Allan Sharlin Award for Best Book in Social Science History and the Gyorgy Ranki Prize for best book in European Economic History. He has served as the elected President of the Economic History Association.

Jack C. Ebeler is an independent consultant and a member of the Medicare Payment Advisory Commission. Previously, he was president and CEO of the Alliance of Community Health Plans. Prior to joining ACHP, he served as senior vice president and director of the health care group at the Robert Wood Johnson Foundation. In 1995 and 1996 he was Deputy Assistant Secretary for Planning and Evaluation/Health Policy at the U.S. Department of Health and Human Services. Ebeler is a member of NASI's board of directors.

Itai Grinberg is a tax attorney at Skadden, Arps, Slate, Meagher & Flom LLP. In 2006, Mr. Grinberg served as counsel to the President's Advisory Panel on Federal Tax Reform.

Kimberly Morgan is an assistant professor of political science and international affairs at the George Washington University. Her research and teaching interests include European politics, comparative social policy, and women and politics.

Peter R. Orszag is director of the Congressional Budget Office. He participated in this seminar while he was the Joseph A. Pechman Senior Fellow at The Brookings Institution. During the Clinton Administration he served as Special Assistant to the President for Economic Policy and as a senior economist at the Council of Economic Advisers.

Rudolph G. Penner is a senior fellow at the Urban Institute, where he holds the Arjay and Frances Miller Chair in Public Policy. He was formerly a managing director in the Barents Group of KPMG Peat Marwick, a resident scholar at the American Enterprise Institute, and director of the Congressional Budget Office from 1983 to 1987.

William E. Spriggs is Chair of the Department of Economics at Howard University. He was formerly executive director of the National Urban League Institute for Opportunity and Equality.

The National Academy of Social Insurance (NASI) is a nonprofit, nonpartisan organization made up of the nation's leading experts on social insurance. Its mission is to promote understanding and informed policymaking on social insurance and related programs through research, public education, training, and the open exchange of ideas.

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