NATIONAL ACADEMY OF SOCIAL INSURANCE

Family Well-Being, Public Policy and Economic Growth: Lessons from History and Insights for the Future

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Social Welfare Spending and Economic Growth

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PETER LINDERT: Thank you very much, Bill, and my thanks to the National Academy for Social Insurance for doing all the hard legwork to make the event happen, and of course, to the Annie E. Casey Foundation.

I am delighted to be here. I know that I am going to learn a lot because I certainly know the work of the other panelists, so I'll be taking notes.

The academy correctly described to you my role in the materials they sent you. I have a book and an ongoing research project, because I have found a subject I love and I am going to do more of this kind of empirical historical work. Think of any big issue today and realize that people have not fully figured out how it's been moving over time. Basically, that's because economists are clueless about history, historians are frightened about economics, and there is an arbitrage opportunity for a few people like me who are absolutely nutty about this kind of material, I love it. (Laughter.) Let's get into it.

I always start with the conclusions to make sure things don't get lost along the way. And here, I will go through them really quickly in fast introduction, partly because I will come back to the same points, also because you have the materials with you, both in paper and in PowerPoint form.

The first is an empirical point that has just turned out to be true in recent years, as are all of these conclusions. The welfare state is not an endangered species; it is not shrinking. 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.

Second, the point for which my book has been most discussed, I suppose, is this free-lunch puzzle. If you look at the experience of the rich industrial OECD countries, what you find is something that is seldom said. The actual cost in terms of GDP of the real-world package of many different kinds of social transfers that are often called the welfare state is indistinguishable from zero. So it’s a free lunch nationally in that sense – of course, not a free lunch for everybody within the nation. About 10 or 12 European countries have achieved longer life through better healthcare facilities and more equality of income without losing any GDP. How? I won’t just give it to you as a statistical result; we want to figure out how that could be.

First, I want to add to the puzzle and make it look even stranger because we can list all sorts of ways in which relatively low spending countries – the United States, Canada, Australia, and Japan, and until recently, Switzerland actually have better institutions than the Western Europeans.

There are plenty of mistakes that I can list on the European side of the transatlantic comparisons of who’s got the right institutions for economic growth. But as you can see, those European mistakes are unrelated to the welfare state. That is, they are mistakes, but they aren’t related to what we do with the poor, the sick, and the elderly. The mistakes do relate to protections against competition, something the Americans tended to get more right. Note also, this sliding geography of Europe – there are certain countries in Europe that have this problem more than others, and you can see on the screen that Southern Europe will have some trouble.

The screen first lists advantages in favor of welfare states: better tax mix – that’s not tax levels but that’s tax mix, and we can discuss that; investment in mothers’ careers, especially healthcare insurance; relatively cleaner governments – that’s slightly – there’s only a slight difference among the rich countries, but in fact the countries that have the best sort of no-corruption ratings are those welfare states of Northern Europe; and perhaps something on the screen there with the four letters ALMP, that is, active labor market policy. I’ll come back to that.

Okay, we will want to worry about the big question of how the future might differ from the past. If I give you evidence that shows that in the 20th century having a large welfare state has not yet been a huge problem, you can still say, as we’ve all been sensing from our watching of the media that things will break down in the 21st century. The population-aging crisis means trouble for pensions, healthcare, and other things related to age. You can see on the screen a couple points I want to make about that.

First of all, we’ve already got a hint from OECD experience how public programs will adjust because they will have to in the 21st century. This is not a phony issue raised by someone who didn’t like entitlements programs, there is a real issue here relating aging populations.

And then finally, an even more sweeping gloss at the end. Now this one is less empirical, but I’ll stand by it and if we had the chance, I’d elaborate. It’s not true that you have to choose between equality and efficiency. The political process often does, because one side or the other gets the upper hand, but you don't have to. Every country has passed up the 20-dollar bills on the sidewalk where they could have made people more equal and the whole country richer. Let's go into these six conclusions.

First, I'll use the terms "social transfers" and "welfare state." The paper, the long version, tells you more about what I do and don't mean here. But on the screen, you can see the kinds of social transfers that I want to focus on here. Most of them are what the national product accountants would call transfers; that's not true of all of them. In particular, not everybody would have used the term transfers to describe public health expenditures, but I will just for convenience.

A country will be called a "welfare state" if those social transfers added up to 20 percent of gross domestic product or more. I choose that definition because it makes my quantitative yardstick for what's a welfare state happen to match the way the media usually decide which countries are welfare states.

I won't talk about public education spending here. It's not so controversial; it's a separate subject, worth a whole separate conference or seminar. And anti-market policies are also defined as not part of the welfare state – so, for example, minimum wage, protecting people against firing, protecting businesses against foreign competition, none of them count as welfare state policies. People have used the phrase, "social protection" to defend such programs, but they're not in my definition of the welfare state.

Okay, very quickly, that point about there being no race to the bottom. This is like the old conclusion number one, the one I first listed. If you look at the set of countries that are in this category, ever since the late 1960s, the group has basically not changed much at all: very few new members in this group of welfare-state countries, and almost nobody dropping out. Ireland dropped out, and it's a very interesting case to discuss. Switzerland has just come in, a bit surprisingly for such a conservative country. Some Eastern European countries now qualify as democracies and therefore as welfare states. I guess I didn't tell you earlier that only democracies count in the way I use the term welfare states.

Conclusion number two is the free-lunch puzzle. At the moment, what is being said on the screen is the result of a lot of statistical work. The OECD shows no net effect of greater social transfers on GDP. I'm not the only one to say so. Several authors had said so before me, but I said it at more length and with what I considered some improvements in the way the statistics were done. I try to be as transparent as I can. If you want to see my data, there they are. They're on a website, they're in a boring volume two of this book. By the way, you would only be interested in volume one, which I recommend as a Christmas present, you know – (laughter) –because volume one is written for human beings. Volume two is for quantitative social scientists to keep them off my back, basically. (Laughter.)

Okay, that's the statistical result, and you can often get a statistical result where something looks like it could be zero, and who knows if that's really true or not. But there are good reasons why this might be true. And under "A" here I really want to emphasize an important point about discourse on controversial social issues like these. How many times have you seen somebody say, oh, we know this to be true, some great economist has shown it?

The example that I want you to think about at the moment in connection with A is, we supposedly "know it's true" that the welfare state costs an enormous amount of GDP because just think of it; you are taxing people on the basis of their being productive and you're giving more to people, the less productive they are. And that's the basic tale. But, that is fiction, to put it in a stark way. It's good imagination, socially responsible imagination – you better worry about that possibility.

But I'm saying it is fiction in the sense that real-world welfare states don't make such basic mistakes. They don't say to somebody leaving high school, do you feel like not working ever? Would you like to strum your guitar? We'll give you 70 percent of the wage you might have earned for the rest of your life. Enjoy. But the parables, the way it's often told certainly in academia, and sometimes in the press, would make it sound that simple. There is no country that has done something as bad as that.

Rather, there are policy mistakes on all sides, and on the European sides, the mistakes don't happen to center on the welfare state. Let me tell you about different policies where these countries first got it really bad, and then they got it really good. First, I want to add to the puzzle by telling you reasons why these countries are doing things that would keep them behind the United States. And these all have that common denominator of being anti-competition policies; that's what I'm emphasizing here.

Higher education is a social sector where the Americans, I think, got it about right. It's the social sector that has the least to do with the poor, the elderly, and the sick. It's a sector where all countries wisely saw that there's some case for public subsidy because there are gains to knowledge being generated by this sector. But American practice makes everybody compete. Berkeley has to compete against public-sector UCLA, as well as private-sector Stanford. They have to compete against them for good students, for good faculty, for federal grants, and so forth. And so they are actually all are competing against each other. And when you look at the international rankings of institutions in higher education, it's a bit embarrassing for most of the non-Americans. The Americans got that one about right. We don't give free rides to everybody in that sector.

Competition in product markets – I'll show you on the next screen a diagram of this. The United States and other low-spending countries, outside of Europe especially, are leading the way and the Europeans are slowly following toward having more competition in the main product markets, and this is an advantage for the outsiders over Western Europe. Western and Southern Europe, in particular – think Mediterranean and France and Belgium – have a lot of other barriers to competition.

Here was that graph of what is happening to product market competition. This is an OECD indicator for how restrictive you are. It only covers part of the economy, and there's actually more that's actually going on than those OECD economists in Paris could have shown you with that graph, but this is just for sectors like public utilities, et cetera. You see the USA at the bottom, that is to say the least restriction, probably the best policy in that respect, and others catching up. The continental Europeans are still just catching up in that respect.

Let me talk about that other kind of restriction, the employee protection laws (EPLs). Now, I've just coauthored a National Bureau paper with more statistical work on this. Employee protection laws make it extremely hard to fire anybody who is a regular employee. You would have to go to great trouble to do that, and it is true of much of Europe, especially Southern Europe.

Does it raise or lower jobs overall, and does it raise or lower productivity overall? My argument will be it lowers productivity in the long run; it makes the economy less productive. And in red and green here, I've given you some examples of countries that differ very much in this kind of policy. I can't describe here how that EPL strictness is measured, but you know the a high number there means they really restrict the ability of employers to lay off senior workers or mid-career workers. Greece and Italy are very restrictive in that respect; Ireland and Denmark are not.

One thing I can show you – tell you for sure, is what I've already begun advertising in this language on the screen -- is that EPLs tilt unemployment toward youths and toward women. They have more of it. It takes them far longer to start their careers in those countries like were shown in red. On the screen, at the moment, is the result for youth. Another screen that you have and that I'll skip past in a second, shows the same thing for women.

How do I know that this lowers productivity? Well, aside from my telling you we worked on it statistically, you can just work it out over as you go through a generation or more. What happens is this: Consider somebody who was subject to these restrictions was shut out, forced to stay home and live with their parents for longer, in, say, Italy, in the late 1960s and early '70s, even now late in their career, they're still suffering a productivity and pay effect from it because it took them longer, basically, to start their main career. And since so much of learning is done on the job in your main career that is a loss of productivity. The same was true for women: Again, on that right-hand column, higher ratio of unemployment for women than for men in the working-age range.

Non-Europeans, like the United States, look best drifting toward the other end of the spectrum. Next let's go back to a classic argument: If you actually pay people unemployment compensation to stay out of work for a while, won't they stay out of work longer? Won't that cost jobs, et cetera? It does. That's what many other scholars have found; that's what I find. It has a very small effect on GDP, however, so that if there were something else in the bundle of national policies that was good, it could easily offset this.

Okay, so here's your first exam question. The basic point here is that when you think about the way in which people with low incomes or unemployed are being treated, the issue of what gives them the right incentives is a subtle one.

So, exam question number one, multiple choice: Which of these gave a poor single mother, my definite – the group that I want to focus on here – the least incentive to get a job? It is A. Of those cases it would have been the U.S. under Reagan in the first administration.

Now, the red clarification of the answer gives it to you a little more directly. The big disincentive happened twice. The Johnson administration made this same kind of fateful step, as Charles Murray and others said so very eloquently. The work disincentive was reformed away under Nixon, Ford, and Carter, came back under early Reagan. What happened there?

Well, what happened is you had an environment, to say in the Reagan case, where it was so abhorrent to many people that somebody a little bit above the poverty line might actually get welfare payments. This was called welfare cheating. So they toughened the system and make sure that everybody would lose benefits at a pretty fast rate, as soon as they took a job. So think of poor single mom who is getting a hamburger-flipping job. When she does that, the benefits are taken away. The implicit tax rate at the margin was very high in both of those eras, for opposing political reasons.

USA under Clinton – here I have to give you a little more of the political flavor of that. I'm actually referring here to the 1993 initiation of more generous Earned Income Tax Credit (EITC). You can find it on Form 1040. It means that if you have a really low income, you'll not only be excused from taxes, you can get money back. While it says on the screen "under Clinton," it's actually a bi-partisan improvement, something that worked out very well in American policy. Other countries have begun to imitate it because it says, in effect, someday if you get a job and go up the career ladder someday you'll be a taxpayer like everybody else. But for a long time, while we get you into that career habit, at initially low rates of pay, you're not going to be paying those taxes.

Raising the EITC in 1993 had bi-partisan appeal. For Republicans, it's tax relief for working people. For Democrats, it's a relief for people with low income. So it worked politically. Tony Blair imitated it in the year 2000; they gave it a different name in Britain. Sweden's welfare state does not quite take everything away from you. There has been a debate between me and somebody else in the blogosphere about this. But Sweden will make sure she continues to get the childcare benefits, the healthcare benefits, and things like this, universal benefits that are not taken away by any kinds of means testing.

Okay, this being an American audience let me ask specifically: Who deserves the credit for the drop in U.S. welfare caseload? Is it this EITC, giving a tax break to low-income workers? Is it sort of the tough love of the 1996 welfare reform, which said block grants of the states and people are going to face their welfare limits very soon?

Here I rely on the other economists, and you can see on the screen what the best experts on that seem to say. Nada Eissa and Hilary Hoynes have found that EITC, that tax break for the low-income workers is definitely making more of them work. There's some cutting of hours. That wouldn't be too surprising down at that end of the spectrum, that there'd be a lot of part-time work involved. But, definitely you're raising work participation. And that's one of the reasons why other countries have begun to imitate it. This is a respect in which the Americans are getting high marks from those who are concerned about such social programs.

The EITC and the toughness of the welfare reform of 1996, with the term limits, and the combination of that and all of the other degrees of flexibility that that program actually gives to states, and to welfare mothers is responsible for increasing work participation. Rebecca Blank's portrayal of this as being something that got gains by putting people more back to work with a mixture of continuing benefits and some restrictions is probably all right.

Now, let's come to the tax mix. And Itai will want to talk about these issues too. But here is something, I think, it's still news for many people. So there's your next exam question. Which of the following tax rates do the big welfare states not levy as the higher tax rate than in the United States? Which of these kinds of taxes? Again, the right answer is A.

Let's talk about that a bit. You know, there are many people who imagine that the big-budget welfare states are countries that soak the rich and tax corporations and top incomes the most. Not true. There is not a clear distinguishable difference. And on many of those fronts, it looks a little odd if you said a country would be foolish to double tax dividends, say, both at the corporate and at the personal level, because that might discourage growth and accumulation. Well, that would be the United States and they've only partly changed that under the Bush administration. It's not the welfare states that tax dividends most heavily.

No, labor income is taxed more in the high-budget welfare states. A political corollary is that the people who are actually paying for that social insurance are largely overlapping with the people who would have voted for it. So it's not quite the Robin Hood story that I think many people had in mind.

And then C and D, on which I have particular points. C is a tax on general consumption, the VAT in Europe, or sales tax, you would say in the United States. That is quite high in Europe, as you've known if you've been there as a tourist. Is that good for economic growth? Here's my particular way of putting it right now: Every conservative in a low-budget country, like the United States, says it is. Isn't it interesting that it happens elsewhere, and not here?

And then finally the sin taxes on these addictive products that have bad health consequences – you can see those three here, and in Europe it's over five dollars a gallon for gasoline. Alcohol and tobacco are also taxed very highly. And my rhetorical point about that is, what's so bad about such taxes for economic growth?

Now I want to go on the other side where the welfare states have some advantage over the United States. And others I think will be discussing this too, so I'll just be brief here. I'll give you a little bit of historical twist on this.

Public health is the clearest social sector where the U.S. is severely disadvantaged. We have more bureaucracy than an all-public system, we have higher administrative costs, we save fewer lives. That's only partly because of ideology and the unwillingness to have "socialized medicine."

It's also due to oddities of American history. First, our history has tied healthcare to your job; the secret is out. And if you change jobs, you have a serious problem in the United States. How did we get that? What is the logic of that? It's very elusive. It goes back to wage-price controls in the 1940s and tax rulings of the Supreme Court in the 1950s. We decided that there should be special tax advantages for healthcare insurance through your employer. And, that being the case, we have created a giant healthcare-and-pensions group-plan industry, which can be guaranteed to lobby against any reform that would ever make them unnecessary. Second, since 1965, Medicare has caused soaring costs of civilian health care provided only to the age group for which the cost of each extra year of life is the highest.

On support for mothers' careers in Europe, I'm going to be a little quick on that because I need to save time, but there is a big effect in welfare states. Mothers' human capital, their ability to become productive over the lifecycle is very much affected by society's willingness to give them the help with childcare and early-parental leave, and the welfare states, especially the northern ones, do a lot better on that. I cannot elaborate on cleaner government and ALMP, since I'm short on time.

The pension crisis of the 21st century: What's going to happen now when we have everybody really old? Well, that's the first of three familiar sources that we want to just remember here quickly about how you get into trouble with pensions. These remarks will be on the pension side, not on the healthcare side.

First, it's really inconvenient to live a long time – (laughter) – not a good idea. And Japan and Italy have really fallen into this trap. Their defect demographically is that they live forever, they have no children, and they have no immigrants. I might have exaggerated a bit, but that's the idea. They're going to be in serious trouble; some other countries will too.

Trouble with pensions can come in two other ways. The next way is something I do not define as being part of the welfare state because William Beveridge and others who set it up didn't either. This is subsidizing earlier retirements so that a male who's 52 gets more or less full benefits and stops working forever. That's a feature of the Mediterranean countries, in particular. If people are going to be living longer and longer, why should you take taxpayer money to make them retire earlier? There's going to be a real problem for the budget and for paying for the pensions later on.

Having an overall government deficit is likewise problematic. After all, pensions in the end rely on all government money. You can ignore what you heard about special reserves for the pension fund. The countries that have the biggest deficits among the rich countries – well, that would be Japan. They are bringing it down now but they are still in the number-one category. The United States has been in second or third place since 2001. It's not the welfare states that have been running large deficits.

How can we get out of this and grow older gracefully? Any provision for old age will have to face this issue. Something has to give. As you get older and older, you have to somehow change the ratio of how much you get in retirement to how much an average worker pays into retirement. Everybody has to make an adjustment described in the screen, whereby the pensions that each elderly person in a certain position gets are going to have to grow more slowly than the average working income. It has to be true. Just work it out. If the ratio of old people to currently working people is going up, there has got to be an adjustment to keep this budget from rising as a share of people's incomes.

Some countries will have to make only small pension adjustments, by international standards. We are in that category. You know, for all of the attention we deserve to give to this problem in the United States, we don't have it the worst, nor do the other immigration countries or Norway or Sweden. It's really continental Europe that is going to face this problem in a very big way.

I want to stress, though, that the problem is basic and unavoidable. If the population is going to live longer and consume during all of those extra years, something does have to give; it really doesn't matter what kind of pension system we were talking about.

That basic point about aging transcends the choice of pension institution. Suppose there was no pension system from your job or the government or anything. Suppose you saved everything for yourself. You would have the same problem. The more people realize that they are going to live a long time, and the more they feel it would be nice to retire earlier, the more there is this problem. What is available for consumption every year in retirement will be lower and lower relative to what a person earns. So, you have to make some kind of adjustment in the system no matter what the system is. The pay-as-you-go system that we have now, where the young are paying for today's elderly is not the only one that shows the problems. In fact, if you were to reform all of this and go back to where everybody is only receiving in old age what he or she themselves put away into a lockbox, politically the system would undo it sooner or later. That is what we did with Social Security before; we all started with a lockbox, save-for-yourself-because-you're-forced-to kind of plan, and we walked away from it.

The final point relates to my sixth conclusion. If you hear that there is a tradeoff between equality and efficiency, you should know that that is false if they're saying you have to choose one or the other. Every country passes up ways in which they could make people more equal and make the economy grow faster due to political pressures. Just think: have you ever seen a political system that took advantage of every chance to have egalitarian growth?

I know of no such case. I'll leave on the screen a very nice description by Alberto Alesina on what options a country does have. He was speaking of Europe when he said, "You can have efficient competitive markets as long as you can couple them with efficient redistribution system, social programs like some of the Northern Europeans are doing." Thanks.

(Applause.)