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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This policy seminar convened at 2:00 PM in the Ballroom of the National Press Club, 529 14th Street, NW, Washington, DC.

Strengthening Security and Promoting Growth
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PETER ORSZAG: Thank you. Itai's remarks actually reminded me of Larry Summers' barb that we don't have a VAT because Democrats think it is regressive, and Republicans think it is a money machine, and we will have a VAT as soon as Democrats realize that it is a money machine and Republicans realize that it is regressive. (Laughter.)

I want to talk about the central topic of how and why we should provide additional economic security to American families in a growth-enhancing way, and it will feed into much of what Peter Lindert has already briefed us on.

American families in the middle of the income distribution are not only facing stagnant real wages and real incomes, but also a very significant increase of income volatility or economic risk. For example, the probability of a 50-percent or larger decline in family income from one year to the next has more than doubled since the early 1970s, from about 7 percent then, to about 17 percent now.

And this degree of economic risk or economic insecurity is not only harmful to family well-being, it is also directly harmful to economic growth, for a variety of reasons. For example, lacking an adequate degree of economic security can discourage people from taking risks that lead to stronger economic performance. Lacking a core level of economic security means that when bad shocks happen, people don't get back on their feet, back on to a productive path again, quickly enough. They get locked into a low-productivity state, as it were.

And then finally, and perhaps most importantly, the political economy of not providing adequate security is likely to induce a backlash, in which directly growth-reducing policies like protectionism or direct-market interventions are where people try to grab for security rather than providing it through alternative means. So for all of those reasons, providing some form of economic security can increase growth.

Now, how do you go about doing that in a growth-enhancing way? There are three different approaches to providing economic security. The first is to try to provide better preparation ahead of time before adverse shocks happen to families and workers, and that is primarily in the form of education and saving, and I'm going to come back to that.

The second is through social insurance: providing some assistance after the fact, when bad things do happen in a market-friendly way to help people get back on their feet. And then the third category is direct-market interventions. So that means protectionism or hiring and firing restrictions or trying to protect particular firms even, to somehow stop the underlying cause of the need for some adjustment.

I think both sides of the political aisle would agree that we should do the first category. It is clearly beneficial to provide more education and saving. Education is beneficial, not only because it raises future productivity, but also because better-educated workers are better able to adjust to shocks and so it is not only an investment, but also an insurance policy. There is a lot that we can do to provide better education in the United States.

And then personal saving, also, provides a buffer against shocks occurring when you have some assets that you can draw on to weather the storm, as it were. There is also a lot that we can do to promote personal saving in the United States. Most of you have heard my shtick on this before, but just because some of you are new – (laughter) – the single best step that we could take in the United States to increase personal saving is to make it more automatic.

Families are busy with other things. The evidence is overwhelming that if you force people to wade through a binder of complicated materials, they will put that off, but that if saving is automatic, even low-income and moderate-income workers do it. We should be moving very aggressively to a system of universal-, automatic-savings accounts in which, regardless of where you go to work, the default is that you are saving in a 401K or an IRA.

And you are allowed to opt out of that if you want to so it is not forced saving but it turns inertia in a pro-saving way rather than an anti-saving way. Not only are you enrolled in a savings vehicle, unless you opt out, but your contribution rate is increasing over time. You are automatically invested in the diversified fund, and at each step of the savings process, you can opt out of the default, but all the defaults should be pro-saving. And the evidence is overwhelming that this type of approach works, frankly, far better than providing direct-financial incentives or tax breaks or any other step that we could take to boost personal saving.

There is also a very interesting discussion, and both Kimberly and Itai touched upon this, about the distinction between the political hostility to an income tax versus a payroll tax. I agree that this differential exists, about whether it is the salience or the visibility of the income tax that is the problem, or it is the hassle factor of even having to complete a simple form

And a way of testing this would be to see if people who were sent their annual payroll-tax bills so that they could see much it amounted to would oppose those taxes as much as the income tax. And the irony is, of course, very strong because the vast majority of American families pay more in payroll than income taxes and yet the payroll tax does not attract as much hostility. I honestly don't know whether it is because the payroll tax is automatic or it is because you never see the total bill, or it is because you are less likely to think that somehow someone is gaming the system and getting an advantage that you don't have. But I think it is a topic that is worth exploring.

In any case, that was all the first category. The second category is more complicated; I want to come back to it in a second. The third category is these direct-market interventions. And what I think is particularly dangerous in the U.S. political context today, is growing attraction to reaching out to those sort of direct-market interventions in the form of protectionism, to prohibit certain retailers from entering certain to create sand in the wheels that would somehow try to shut down the process of creative destruction that leads to some of the necessary adjustments that could better handled in other ways.

And as Peter's work and other work demonstrates quite convincingly, this approach is clearly not the way to go. It has a very deleterious effect from the perspective of economic growth and doesn't lead to good outcomes. It may be well intentioned, but in trying to provide more security by providing protections, you ultimately wind up killing the goose that lays the golden egg, as it were, in the form of reducing economic growth.

So that leaves me with that second category. And I think this is the hardest category – social insurance and providing market-friendly assistance after bad events occur; there is a complicated tradeoff here. On the one hand, as I mentioned before, failing to provide economic security can be growth reducing. On the other hand, as we know, providing insurance or assistance in various different forms can distort economic behavior and that can be growth reducing.

So careful attention must be paid to incentives to get that balance right. But I would say the vast bulk of the policy debate in the United States has been dominated by this simple and wrong view that providing any security whatsoever is necessarily growth reducing; as soon as you provide any assistance at all, you are distorting behavior and therefore, reducing growth.

And for many of the reasons that Peter delineated and that I have tried to highlight also, I think that is just wrong. We need to move beyond that to looking at specific cases of how to correctly balance those incentives. So let me mention a couple specific examples. In your packet you have a paper that we just put out through the Hamilton Project, which is a new project at Brookings that involves a lot of leading scholars and former prominent policymakers and others, in which we try to lay out some specifics in this second category. In particular, we also released three new discussion papers last week that attempt the same thing.

Let me give one example. My colleague Jeff Kling at Brookings has argued that the unemployment system, which was mentioned earlier, should be updated. In the United States, it has not been updated to any significant degree since the mid 1930s, even though the nature of both employment and the nature of risk facing most American families have changed dramatically.

His view is that we should be moving away from a system in which we focus much of our resources on short-term bouts of unemployment and moving more towards the real risk that most American families face, which is that after experiencing that short bout of unemployment, they get re-employed at a lower wage, and that lasts over a long period of time.

Having a lower wage over 10, 15, or 20 years is much more harmful to most families than experiencing a two-month period of unemployment, especially if you had some savings that you could draw on in that intervening period. So Kling proposes moving the system towards providing wage insurance on a revenue-neutral basis and away from a system of simple cash transfers during unemployment. This means that if you get re-employed at a lower wage, then the government would partially make up the difference. He argues this would not only improve incentives for work and efficiency, but it would also be more progressive and provide better insurance than the current system.

I would also point out that a progressive income tax system is a form of social insurance in itself. A progressive income tax system provides some protection against volatility in your after-tax income because during bad years, the tax system more than proportionally makes up the difference. And there are a variety of ways that we can make the income tax system both more progressive and more efficient at the same time.

Let me mention one. In a co-authored paper with Lily Batchelder of NYU and Fred Goldberg of Skadden and Arps, we argue that the federal government currently provides $500 billion a year – and you heard a bit about this earlier – $500 billion a year in incentives through the tax code, for various kinds of socially beneficial activities: healthcare, retirement, homeownership, and more.

The vast majority of that, over $400 billion, is provided in the form of a deduction or exclusion, which links the size of the tax incentive or the subsidy to your marginal tax rate. People have noted that this is not fair because it provides larger tax benefits to high-income households than to low-income households. We argue that it is not only unfair, but that it is also inefficient, because unless you know that high-income households are more responsive to that tax break or they generate larger social benefits from their behavior, it doesn't make any economic sense to be providing them a disproportionately larger incentive.

Four hundred billion dollars a year is a lot of money. We could take all of those incentives and on a revenue-neutral basis, transform them into universal credits, which would be not only more fair, but also more efficient and provide a more progressive tax code, which would then provide protection against fluctuations and after-tax earnings.

So I’m going to end it there just by saying these key issue are exactly where the balance should be in this second category. I want to emphasize the sixth conclusion on Peter Lindert’s slide. I think this cannot be emphasized strongly enough: the trade off between equality and efficiency is false. Many of us, and I know there are many students in the room, have been trained in Economics 101 to believe that tradeoff is true, that somehow providing any additional security and equality necessarily reduces efficiency.

Many of the key tenets behind this new Hamilton Project are dedicated precisely to taking that on headfirst. I don’t think it is true; I think there are a whole variety of ways in which we can improve both efficiency and equality and risk protection, and we should be doing that. Thank you.

(Applause.)