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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.

Commentary

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RUDOLPH PENNER: Well, coming last in this distinguished array of speakers, I won't be very original, but I'll claim my 10 minutes of fame anyway. I have been a big admirer of Peter Lindert's work since I first learned about it by reading the Economist a couple of years ago. And I do think it is extremely important 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 welfare 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. They are not very progressive; they place a particularly heavy burden on consumption rather than on capital, and a very heavy burden on sin.

It's not much of an exaggeration to say they tax the poor in order to give money to the poor. But while the economic efficiency costs of the systems may be low, there is change in the air. There are reforms taking place on the spending side of the budget and they are important reforms. I was a little taken aback by just one remark in Professor Lindert's presentation, and that was that deficits aren't much of a problem for welfare states, because I saw the prospects of huge budget deficits being a motivator of reform in Sweden certainly, in Italy -- which admittedly he said was an exception -- but I think also of a series of reforms in Germany.

But not all of the adjustment is on the spending side; taxes are still going up with especially big increases in prospect in countries like Italy and Germany. Now, so far the focus of the reform has been on the pension systems. I can't believe that health systems are that far behind because while Europeans start with a lower level of costs than in the United States, those costs are increasing at an unsustainable rate.

The odd man out in all of this is my own home country of Canada that has moved to partially fund their Social Security system with major payroll tax increases while only very modestly curbing benefit growth. But one of the many important points that Lindert makes is that the reforms on the pension side are not really reducing real per-capita benefits much, if anything, below pre-reform levels. Instead, the reforms are simply reducing the rate of growth of benefits below the projected growth rate of wages. That is to say, they are reducing replacement rates at every age of retirement.

I think it's really important to understand that we can do exactly the same thing in this country. Current payroll tax rates are sufficient, or almost sufficient, to maintain average real Social Security benefits for the next 30 years or so, if we reform the system soon. That is to say we are not really talking about the cutting the standard of living of the elderly. What we are debating is how much to increase real benefits as the standard of living of the working population improves.

I fear, though, that the language of the debate may unnecessarily scare people because when you talk about benefit cuts, I'm sure many people interpret that as being cuts in the absolute standard of living.

Now, maybe more controversially, I think that the same kind of argument can be made about healthcare. I don't really think there is any problem maintaining the quality of healthcare for the elderly at today's levels. The economic problem that we face steps 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. And there is the further threat to costs if currently available procedures are demanded more widely.

So again, what I think what we are debating here is how much to improve the average quality of healthcare as technology progresses. Ultimately, despite the inefficiencies of the system that were just discussed, some kind of rationing will have to occur, and one would hope that if it is bureaucratic rationing that it will have some basis in benefit-cost analysis.

But I think that the socialized systems of the world show how hard that is to pull off politically because scientific findings are often rejected, and administratively, as the skilled and well connected are so much better than others at circumventing any rationing system that happens to be in place.

Now, part of Professor Lindert's paper, which he did not discuss today, but which I found very interesting, involved the development of tax-transfer systems in developing countries. And I think the dominant factor there is the difficulty of collecting any taxes at all, which implies great difficulty in getting high levels of participation in any social insurance program. Indeed, even a country as advanced as Italy has a major problem collecting taxes.

I once discussed this problem with an Undersecretary of Finance in Italy. I asked her about the difficulty of collecting payroll taxes in the south of the country, and she it really wasn't a problem because their offices were so inefficient, they didn't pay earned benefits either.

(Laughter.) Now, I suspect if the truth were known, this problem, though slight in the United States, is not so slight as to be unimportant.

Very obviously, our illegal immigrants don't participate very extensively in our social insurance system. But other segments of the economy also have some problems. For example, our inability to collect taxes from small business is legend in this country. Indeed, the Bureau of Economic Analysis generally increases the income reported on tax returns of non-foreign proprietors by 50 percent when they compute the income side of our national accounts. So what that implies is that the small-business people are probably not accumulating the Social Security credits that they would if they honestly reported their income.

Well, going back to the basic point, I suppose that the most interesting question raised by the Lindert paper is whether the United States will follow the European path as aging and health costs continually push up Social Security, Medicare and Medicaid outlays as a percent of GDP. That is to say, are we going to invent new consumption taxes and sin taxes that impact the poor heavily? It would be a mechanism for getting the elderly to pay a share of their own benefits.

Now, one important thing, though, about non-progressive systems is that you just can't sit back and let bracket creeper or its equivalent raise tax burdens and revenues for you, while legislators do nothing. And I think that helps to explain why so many European countries are now being pressured to reform the spending side of their system. On the other hand, you would think that would be an option in a country like the United States with a relatively progressive system, especially with the alternative minimum tax bringing in a flood of revenues if you do nothing at all.

And yet, we have never availed ourselves of that option for an extended time period. I think that one of the most remarkable features of our long-run fiscal history is the stability of our overall tax burden. Maybe you can see an upward trend, but not much of one.

The burdens today are little different than the burdens at the end of World War II. In fact, there is some kind of magic law; every time the overall tax burden creeps over 19 percent, we have a big tax cut. We did that at the end of World War II; we did that at the end of the Korean and Vietnam Wars, it happened with the Reagan tax cuts, and most recently with the Bush tax cuts when the burden had been above 19 percent of the GDP for the longest period in history. And in 2006, the overall burden is likely to be almost precisely equal to the average burden over the last 30 years. To me that is just an amazing miscellaneous fact.

So I think it very unlikely that we are going to solve much our fiscal problem with do-nothingness, that is, letting tax burdens increase of their own accord. Now, it is interesting how much one hears about the possibility of value-added taxation in the United States these days both from liberals and from old-fashioned fiscal conservatives. Henry Aaron, Michael Graetz, and Charlie Walker have all discussed variants on the theme, and that is quite a diverse group ideologically. Does that mean we will go that route and emulate Western European countries?

Unfortunately, I differ from Mr. Grinberg in this regard. I'm afraid we're not going to be so deliberative as to even consider the option seriously. I think that in almost every case of

Social Security reform in Western Europe, it was provoked by some sort of budget or economic crisis or both. In some cases, the budget crisis was artificial in that the Maastricht Treaty limitations on deficits provoked reforms that probably would not have happened otherwise. I think that happened in Italy and now in Germany. But in other cases, the crises were more serious. I believe that the Swedish GDP fell three years in a row before their very radical reforms.

I guess I'm a real pessimist because I find it very hard to believe that we're going to act absent a crisis of some sort, and under those conditions, I think that it's very difficult to design and implement a brand-new tax system like that quickly. It's much more likely that the adjustment will come on the benefit side with perhaps some increase in the payroll tax, which is an established tax. In the case of health programs, the easiest thing to do is to cut provider payments, not that that is real easy, but it seems to me the most likely outcome.

It is a really strange thing to say, but I think it's unfortunate that it's hard to imagine a crisis coming very soon. Things are just too good. I know people are disgruntled, but if you look at the basic facts, unemployment, inflation, and interest rates are very low. The budget deficit is way down from its recent highs. Indeed, the debt-GDP ratio is actually declining, and I expect to decline for several years, even though CPO projections are slightly more pessimistic. So it's very hard to see severe budget problems in this country until some time after the first baby boomer applies for Medicare in 2011.

Now, I suspect that if the next president serves two terms, he or she will have to deal with the issue. But it's really a shame it could not come to a head sooner. It would just be so much easier to deal with the problem without almost 10 more years of increased pension benefits and health costs. Thank you very much.

(Applause.)