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Whither the Welfare State?

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Over the last three decades the extent to which governments have built and maintained an institutional structure and spent on the social safety net—together generally referred to as the welfare state—has become one of the most contentious areas of public policy debate.

Members of the Organization of Economic Cooperation and Development—countries with institutional structures as diverse as those of the United States and Sweden—have rolled back the welfare state, basing their actions in part on a rationale offered by mainstream economists: because the welfare state produces a drag on economic activity and reduces economic performance, cutbacks are necessary in order to raise economic growth and lower unemployment or, in the case of the United States, to maintain high future growth rates. Expenditures such as those for unemployment insurance and income transfers to the poor, the elderly, and the indigent are the primary targets of this new social policy orientation.

This brief explains why increasing household saving, which mainstream economists assert is the essential vehicle for financing productive investment, in fact may not stimulate growth; and why, in any case, rolling back the welfare state in the United States has not succeeded in raising household saving. We argue that because investment is financed primarily out of business retained earnings (rather than household saving), policies that stimulate investment may not conflict with the maintenance of a robust welfare state. To make our argument, we do the following:

- Examine mainstream analyses of the welfare state as articulated by Martin Feldstein and Anthony Atkinson. These two authors represent different views of the welfare state that can be considered variants of the mainstream paradigm that helped discredit the Keynesian social policies implemented during the "golden years" following World War II.
- Suggest that higher government spending can be supported and a greater degree of investment spending can be stimulated through a combination of lower taxes on business income and higher taxes on the personal income of upper-income households and certain types of financial market transactions.[1]
- Examine the extent to which the mainstream objective of cutting back the welfare state has achieved the stated goal of raising the private saving rate and find that in the United States it has failed miserably.

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We conclude that the attacks against the welfare state should be seen as part of the general weakening of labor in its interaction with management during the 1980s and 1990s, which has contributed to a decline in the share of wages in national income and played a crucial role in raising the economy's long-run profitability.

Saving, Investment, and the Welfare State: The Mainstream Perspective

Household saving plays a key role in mainstream macroeconomics. Thus, it is not surprising that in his analysis of Social Security, Feldstein investigates the impact of Social Security benefits on household saving (Feldstein 1974, 1996). A central concept in his work is *Social Security wealth*, today's value of Social Security benefits that the current adult population will receive at age 65 minus today's value of Social Security taxes that those adults will pay before reaching that age. Feldstein finds that Social Security wealth functions much like private sector wealth in that it stimulates private sector consumption and thereby lowers private sector investment. He also argues that the greater the difference between what beneficiaries receive and what they pay into the system as taxes (the replacement rate), the greater the disincentive will be for households to save. Feldstein's solution is to privatize Social Security so that private funds would be mandatorily invested in private capital markets, which would stimulate capital accumulation.

Feldstein (1974) also discusses the impact of business saving on private investment. He concludes that when business's retained earnings rise, the value of their equities increases as well. Assuming that households were able to learn immediately about firms' retained earnings positions, the rise in equity values would result in an increase in capital gains and a boost to private consumption. Thus, total private saving and private investment do not rise as much as business saving.

Feldstein's analysis does not consider the possible independent effect that retained earnings might have on business investment, despite numerous studies that show the crucial importance of this variable (see Blecker 1997 for a summary of this literature). Further, Feldstein does not explain how households might learn immediately of firms' decisions about retained earnings. Moreover, his analysis implicitly assumes that the economy is operating at full employment (only then can a rise in the level of consumption be translated into a fall in household saving).[2] Finally, it is not clear why a fall in the household saving rate necessarily implies a decline in the social saving rate, since businesses have been shown to adjust their retained earnings to meet their investment needs.

Atkinson's work (1999) is critical of contemporary social policies; in our opinion, however, his critique does not go far enough. The thrust of Atkinson's criticism is that since the real-world economy departs from the idealized economy used in most mainstream analyses, the impact of the welfare state is more complicated than the standard finding of unambiguously negative effects. He points out some of the countervailing factors that may operate so that the long-run growth rate does not rise when social spending is scaled back.

As an example of Atkinson's ambivalence, consider his analysis of the government retirement benefits program. He argues, using the same logic as Feldstein, that such a program reduces aggregate saving and therefore the long-run growth rate of the economy. According to Atkinson, however, a cutback in a government pay-as-you-go retirement program does not necessarily raise the long-run growth rate. Suppose the pay-as-you-go program is replaced by a means-tested program in which the level of government benefits remains the same for those with no other income and is reduced progressively for those with other income sources. Such a program would still serve as an antipoverty measure while it allowed public expenditure to be scaled back. The disadvantage, Atkinson argues, is that such a program might cause some people to save less; indeed, they might reduce their saving to zero and rely on government benefits. Thus, a means-tested program might have uncertain net effects on saving and therefore on long-run growth.

As with other mainstream analyses, Atkinson's arguments do not consider that a pay-as-you-go program is financed by taxes on wage income; therefore, the *social* saving rate may not be affected. The impact on the social saving rate would also depend on the saving of nonwage-earning households and the saving of firms, which choose their saving rate on the basis of objectives that are very different from those of households.

Macroeconomics and the Welfare State: An Alternative Perspective

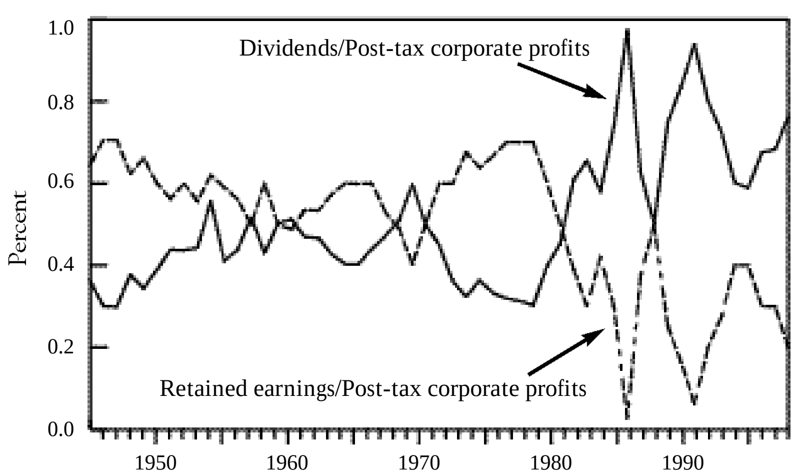
Two aspects of our alternative perspective are particularly pertinent to discussion of the welfare state. First, wages are determined primarily by institutional and historical factors, not solely by market forces; wages cannot rise and fall automatically to equate supply and demand and lead to full employment. Second, economic decisions made under conditions of uncertainty mean that the economy will not always operate at full capacity, so that business cycles are built-in and recurrent features of a market economy. These two aspects imply that increased government spending on social programs will both lower the rate of unemployment (by injecting demand) and provide a safety net for those who are unemployed. These positive effects can be amplified by expansionary monetary policies. Thus, the rationale for demand management policies is still valid as long as underutilized capacity exists, although these policies must be discussed in a (long-run) growth context. We do, however, take the view that over the long run firms will tend to eliminate excess or redundant capacity, so that supply-side factors become the central determinants of the economy's long-run growth path.

In mainstream analyses, saving decisions by households drive long-run growth because the economy's total public and private saving determines interest rates and investment. According to our perspective, interest rates are not determined by the supply and demand for saving. Saving does matter, though for different reasons. As Moudud (1999b) discusses, the two key determinants of long-run growth are *profitability* and what we call the *investable surplus*. Profitability is the ratio of surplus product—loosely defined as the portion of net national output that is left after deducting employee compensation, or the National Income and Product Accounts category of property-type income—to capital invested. What is important for capital accumulation is not aggregate saving but the investable surplus, which is that portion of private (business and household) saving that is available for investment in the business sector after the rest of the saving in the private sector has been set aside as money and bonds.

The key implications of our framework can be summarized as follows. First, a one-time rise in the *level* of government spending has to be distinguished from a corresponding increase in the *share* of government spending in total output. Both kinds of policies raise short-run output growth, but a rise in the level of spending leaves the long-run growth path unchanged, while a rise in the share lowers it. Fiscal policy in general and welfare policy in particular therefore need to be studied within this context. One important implication is that if businesses were given appropriate tax cuts, while taxes on other kinds of capital income, such as capital gains and STETs (securities transactions excise taxes), were raised, then the private saving rate would increase, thereby allowing the rise of the ratio of budget deficit to output. If net movements result in an increase in the social saving rate, the long-run growth rate will rise as well.

An important tax policy measure we propose is one that has been discussed extensively by Pechman (1987). Pechman has argued that higher marginal tax rates on wealthy households can stimulate corporations to reduce their dividend payout rates. Feldstein (1970) finds similar evidence for British firms. In looking at data for retained earnings and dividends (as shares of post-tax profits) of U.S. nonfinancial corporations over the last five decades, one pattern stands out: Before the early 1980s, the share of retained

Figure 1 Retained Earnings and Dividends (Percentage of Post-Tax Profits of Nonfinancial Corporate Businesses)



Source: Haver Analytics.

earnings exceeded the share of dividends. Following the household tax cuts of the early 1980s, however, the pattern reversed itself dramatically (see Figure 1). Put simply, as Feldstein and Pechman argue, firms retained a greater proportion of their profits when tax policy was more progressive; that is, when upper-income households paid higher marginal tax rates. Since numerous empirical studies have shown that business retained earnings are important in firms' investment decisions, this tax policy, if combined with higher taxes on certain kinds of financial activities (such as speculative ones), would raise the social saving rate and allow both the level and the share of government spending to rise as well.

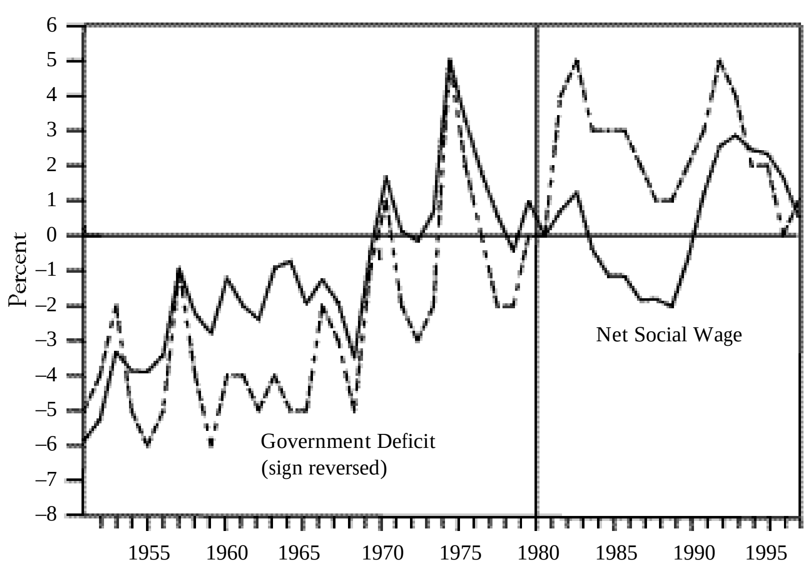
Recent Social Policy: Rhetoric and Reality

Our framework provides a rationale for active public policies to stimulate growth and provide a social safety net for the unemployed and the poor during economic upturns *and* downturns. In contrast, the recent trend has been toward regressive social policies favoring a pattern of private sector capital accumulation, which, in turn, has encouraged rising inequality along with growth. The rationale for regressive policies is not supported by the macroeconomic experience of the United States during the last 20 years or so.

First, we note that the relevant quantity to use in examining the two positions is the total (that is, combined federal, state, and local) amount of social expenditure, less the total amount of taxes collected to support these expenditures. This quantity is the *net social wage* (Shaikh and Tonak 1987); its movements and the government budget deficit are shown in Figure 2. A positive net social wage indicates that the government is spending more in benefits than it is receiving in taxes; the converse holds for a negative social wage. The government deficit is shown with the sign reversed to make it consistent with the sign convention for the net social wage.

It is clear from Figure 2 that the net social wage was negative during much of the 1980s. It became positive in 1991, but the current cyclical expansion, which began in 1992, and "welfare reform" are driving it—along with the government deficit—down to zero. As a whole, during the last 20 years or so the net social wage (outside of cyclical variations) had virtually zero growth. Yet the private saving rate, especially for households, fell dramatically in these years, contrary to the mainstream prediction. These facts immediately raise a key question regarding the effects of dismantling the social safety net: If this dismantling has not succeeded in promoting the virtue of thrift, what has it done?

Figure 2 Net Social Wage and Government Deficit: 1952–1997
(Percentage of Employee Compensation)



A negative net social wage = net tax payment
A negative government deficit = net tax receipt

Source: A. Shaikh and A. E. Tonak, "The Welfare State and the Myth of the Social Wage," in R. Cherry et al., eds., *The Imperiled Economy*. Book 1. New York: URPE, 2000.

The main long-run impact of dismantling the social safety net has been not on saving but on profits. The formal and informal tightening of eligibility requirements for various program benefits, shortening of the duration of benefits, reductions in the real value of benefits, and "workfare" are all means by which the pool of employable workers has been expanded. At the same time, the growing holes in the social safety net contribute to muting workers' demands regarding pay and working conditions. When placed alongside other developments—declining union membership rates, recurring breakdowns of collective bargaining agreements, lax enforcement of labor laws—we can easily surmise that the net effect of these transformations in the "rules of the game" has been a general weakening of the bargaining power of labor.

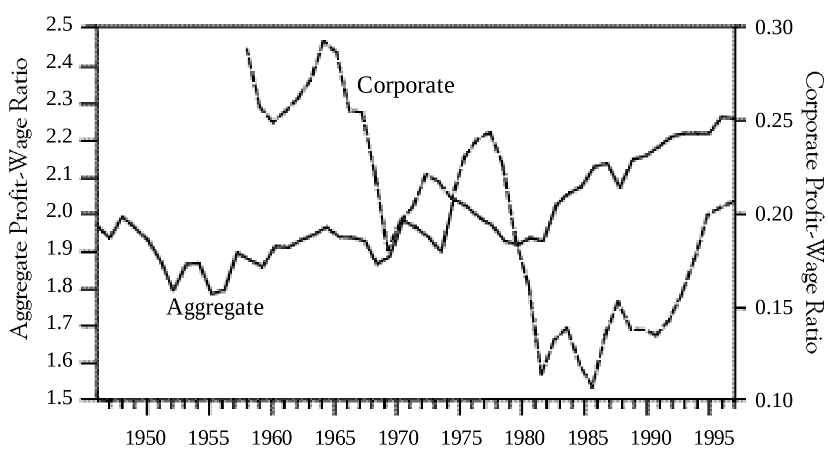
A manifestation of this general weakening has been a pronounced change in the distribution of income between capital and labor in favor of capital. Figure 3 shows that from the early 1980s on, the aggregate profit-to-wage ratio accelerated substantially and the corporate profit-to-wage ratio moved steadily upward. As might be expected, our calculations show that the rise in the profit-to-wage ratios has been the dominant factor behind the dramatic rise in overall profitability and in corporate profitability. Rising profitability combined with falling saving rates suggest that the recovery and expansion in the Reagan-Bush-Clinton era has been accomplished mainly by rising profitability.

The social policy stance during the last two decades reversed the social policy of the 1950s and 1960s, which was aimed at building a set of rules and institutions that stood against the socially undesirable consequences of the capital accumulation process. The dismantling of the social safety net also implies that if the current fiscal targets are to be pursued, government expenditures are likely to expand more slowly during the next downturn than they have during prior downturns, with a correspondingly smaller (percentage) decline in the budget surplus. The countercyclical effects of the government budget will be weakened, thereby allowing for a deeper recession, which in turn will exacerbate poverty and inequality in both the short and the long run.

Conclusions

Our framework emphasizes both demand- and supply-side factors to analyze fiscal policy. As both Keynes and Minsky (1986) asserted, when the economy is in a downswing,

Figure 3 Aggregate and Corporate Profit-Wage Ratios: 1947–1997



Source: Authors' calculations based on data from the Bureau of Economic Analysis. The data are available at www.bea.doc.gov/.

Notes: (1) Aggregate profits are defined as the difference between aggregate value added and the aggregate wage bill for productive labor. We approximate the former by the gross domestic product. The latter is approximated by the combined employee compensation of the productive sectors (agriculture, mining, manufacturing, transportation, storage, communication, and all services except business services, legal services, miscellaneous professional services, and private households). (2) Data for the corporate sector are available only from 1959. (3) Corporate profits are corporate profits before taxes for the corporate sector; the corporate wage bill is employee compensation in the corporate sector.

increases in demand via government spending play a crucial role in providing a "floor" to recessions. We also argue that when the economy is operating close to its trend growth rate (when there is no excess demand, and capacity utilization rate is at the normal level), the social saving rate is of central importance. Social spending policy should deal with both of these poles of the accumulation process.

The health of the U.S. economy does not provide any economic justification for the social retrenchment measures enacted in the 1990s in the name of "welfare reform." In our opinion, budget surpluses should be used to finance public sector investment projects, increased public education, and a national health care program, policies that would raise both the net social wage and the long-run growth trend. Although government spending on welfare does constitute a deduction from the annual surplus product, public policy could take advantage of the current boom and budget surplus to help unemployed and underemployed people develop genuine and advanced skills that would assist them in finding good jobs in the private or public sector. Such alternative policies would not only "get people off welfare" but also lead to greater social equity. Equally important, such labor market policies, accompanied by industrial policies to stimulate productive investment in *both* the private and public sectors, would lead to macroeconomic gains over the long run.

In our view, the current political climate appears to favor a single-minded pursuit of a budget surplus as an end in itself. According to conventional wisdom, this pursuit represents national probity and thriftiness. Along with moral stipulations to "encourage" work effort, such government policies remind us of those in the pre–New Deal era. Bearing in mind that economic fluctuations reoccur, the next downturn will be exacerbated by fiscal policies enacted in the Balanced Budget Act. The consequences for American society will be grave to an extent, we are tempted to speculate, that might well require the radical overhaul of those policies.

Notes

1. This conclusion is based on an alternative growth perspective, rooted in the tradition of classical economists and Sir Roy Harrod, developed by Shaikh (1992), and extended by Moudud (1999b).

2. The continuous full employment assumption is, of course, standard to the mainstream perspective, but we question how realistic that assumption is.

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