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Hurt Economic
Growth?*

Dr. Peter H. Lindert



Saint John's
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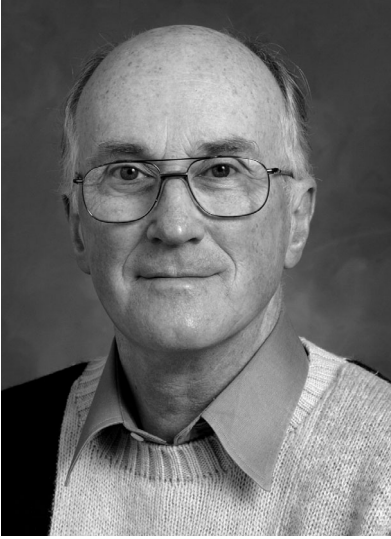
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Dr. Peter H. Lindert is currently Distinguished Professor of Economics and Director of the Agricultural History Center at the University of California, Davis, where he has taught since 1977. He received his Ph.D. in 1967 from Cornell University, and has also taught at the University of Wisconsin, the University of Essex, Colchester, England, and Harvard University. He has published many articles and more than a half dozen books, has received awards for both teaching and scholarship, and has been president of the Economic History Association. Professor Lindert's latest book, *Growing Public: Social Spending and Economic Growth since the Eighteenth Century* (2004), has earned this economic historian a lot of attention from the media as well as from economists of all stripes. Employing extensive historical data from many nations, he has contested the usual presumption of most economists that the bigger the government, the weaker the economy. This connection between government and economic growth is also the topic of his Clemens lecture at Saint John's.

“Does Big Government Hurt Economic Growth?”¹

Peter H. Lindert
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In any election in any democracy, the battle usually centers on the role of government in our lives. Is a larger government worth its cost? Does it raise or lower our livelihood, and does it raise or lower our basic individual freedoms?

This central conflict in the values of the political left and right cannot be fully resolved by better facts about how government works. We can, however, move closer to social peace just by learning where the facts reject the divisive claims of one side or the other. When it comes to the economic effects of big government, the time is ripe for rejecting some traditional bad arguments with the help of fresh facts.

A Road Map

The first step is to map out what government should do, what kinds of activity define big versus small government in democratic countries, and my main judgments, or “punch lines,” about how the size of government affects our lives.

For all their fights, economists broadly agree on two features of what governments should and should not do. Governments should intervene to correct for “externalities,” or spillover effects of private activities on the rest of society. When a private activity would benefit the rest of society as a whole, government should have those outsiders pay for part of the activity, through subsidies. Examples include public health and public education. When a private activity does something bad to the rest of society, government should tax or punish those who engage in that activity. Examples include pollution and crime. On the other hand, when the private market works pretty well, as with most private markets, government should leave it alone. A favorite example for most economists is international trade, which brings beneficial competition.

Industrialized democracies differ in the size of their governments mainly because they differ in the share of income taxed to pay for social programs. Not military spending or roads or postal service, but such social spending as welfare, unemployment benefits, public pensions, public health care, and public schools explain why countries like Sweden tax and spend over half of gross domestic product (GDP), while countries like the United States tax and spend less than forty percent. In other words, big government means the welfare state.

A welfare state, alias a big-government democracy, is one in which government spending on those safety nets and human investments takes more than a fifth of GDP. The leading examples are the Nordic countries, Austria, and the Netherlands. By contrast, less than fifteen percent of GDP is devoted to government safety nets and human investments in the low-tax and low-spending countries, especially the United States, Japan, Switzerland, and the poor countries of the Third World.

Many people think that getting the government involved in providing public schools and safety nets for the poor, the sick, and the elderly merely crowds out private and religious charity. In their view, people would get the same support from the rest of society whether or not the government was involved. If that were true, we would not need to pay taxes to offer that kind of help. We could leave it to those who volunteer their money and time. It has never been true, however. Back when the government stayed out of the business of giving, the poor and sick and elderly received only pittances from the churches or any other philanthropists. There were hundreds of charities, but they gave mainly to the *non*-poor by supporting elite education or religious worship itself. The poor got a lot of moral instruction, but little material support.² Now that the government has moved into the business of giving aid and social insurance, private giving has actually risen, not declined. Government transfer programs thus define the world of generous *total* aid, not just the world of generous government handouts.

As we turn our attention toward the social-spending definition of big government, now meaning the welfare state, we need to notice what kinds of government economic activity are not covered here. The welfare state does not include special aid to any powerful producer lobbies, other than those in health and education. It does not include farm programs, which benefit a small group of households with above-average income and wealth. It does not include Southwestern Europe's strict Job Protection Laws, which make it illegal to fire most senior workers, and therefore unprofitable to hire new workers. It does not include protection against imports, like the barriers imposed by the Bush administration against shrimp,

steel, TV sets, beds, and bras over these last three years. These exclusions are key to understanding how the welfare state affects growth, because these excluded activities happen to be the kinds of government economic activity that have the worst effects on overall national income. In fact, the welfare states tend to be fairly open small economies, as in Scandinavia, or Austria, or the Netherlands. They expose workers and firms to the competitive winds, but they help them adjust to those winds.

Now that big government has been defined in terms of social programs that transfer taxpayer money to the poor, the sick, the elderly, and school children, here are my key punch lines about its economic effects and its future:

- Larger welfare states have not had any net cost, either in terms of economic growth or in terms of budget deficits. Had our politics permitted it, we Americans could have had the same economic growth of GDP — with more security, more equality, and longer lives.
- The future may bring *budget* crisis for pensions and public health, even if there is no long-run loss of GDP. The tensions over public spending on pensions and health care are caused by three good things: Long life, prosperity, and medical advances.
- The budget crisis is not related to the choice between private markets and large welfare states, either today or in the geriatric future.
- The pension crisis is very serious in some countries, but not in America and not in most welfare states. The countries that have it worst are Japan and Italy.
- The health care crisis is more serious in the United States than in any other rich country. Our mixture of private and public health care doesn't work.

The “Free Lunch” Puzzle

The bad effects of big welfare states on economic growth are widely trumpeted — but they do not exist. There is no net loss in our GDP and incomes from the welfare state package as a whole.

So say the facts, both when you look at them in the raw and when you statistically measure the different forces that determine economic growth. Looking at the raw facts, you find that there is no international correlation at all between the share of social spending in the economy and either the level or the growth of GDP. If you hear somebody cite a case where a low-tax country grew faster than a welfare state, you need to know that they are being selective. The opposite is true just as often. For example, the US income advantage over Europe is smaller today than back

before Europe had any welfare states.

The costs are also invisible among the states of the U.S. States like Connecticut and California have higher taxes and more generous social benefits. Idaho and Alabama don't believe in taxes or social programs. That has been true for a century. So why haven't Connecticut and California become as poor as the national average? Why haven't Idaho and Alabama become as rich as the national average?

Of course, places differ in other ways than just their views of taxes and welfare. So we need a deeper statistical analysis that gives many forces their due. I have done that, and so have other economists.³ The net cost just isn't there. It's zero. The welfare state looks like a free lunch, for the nation as a whole.

How can that be? Some Secrets Americans Should Learn

Facing facts like these, if you have always believed that the social programs should be very costly, you have a tough choice to make. You can choose to be strong. Stand by your beliefs. Don't let the facts push you around. Or you can be a wimp. I am a wimp. I let the facts push me around. I react to them by asking "How could that be?" In fact, there are good reasons why the net cost is probably zero, when you look at how welfare states run in the real world. Let us survey a few of them here.

The welfare-state tax mix is better for growth

A closer look reveals that the high-budget welfare states, while taxing heavily overall, actually favor types of taxation that mainstream economists think are better for economic growth. To see how their choice of taxes departs from some common beliefs about the sloppy and bloated welfare state, consider the kinds of taxes shown in Exam Question #1. Many people think of the welfare state as a place where big government soaks the rich, taxing corporations, capital, and top property incomes so heavily that many of them try to take their money out of the country. Not so. The correct answer in Exam Question #1 is answer (a), that the welfare states do not tax corporations or capital or top property incomes more heavily than low-social-budget countries like the United States, Japan, or Switzerland. One might have been misled on this point back in the 1970s or 1980s when reading news that the top income tax rates were very high in, say, Sweden. Yet even back then corporations and the richest seldom paid the top statutory rates,

Exam Question #1 Which of the following tax rates is *not* higher in big-government welfare state than in a small-government country like the United States?

- (a) tax rate on corporations, capital, and top property incomes
 - (b) tax rate of labor
 - (c) tax rate on consumption (like sales tax)
 - (d) sin taxes (on tobacco, alcohol, gasoline)
-

thanks to a host of deductions and loopholes. And since the early 1990s Sweden and other European countries have simplified their tax systems so as to levy lower top tax rates.

If the high-budget welfare states don't tax corporations, capital, and top property incomes any more heavily than does the United States, what other taxes do they levy to pay for those bigger social budgets? For one thing, they do levy higher taxes on the human earnings of everybody from janitors up through doctors and lawyers, labeled as "labor income" in answer (b). This kind of tax could by itself have negative effects on economic growth. Yet North American economists, when polled on the subject of taxation, feel that taxing labor income is definitely better for economic growth, because labor supply is less sensitive to taxation than is capital supply. One should also note that the heavy taxes on labor bring the tax burden to rest on the same income groups that vote in favor of the welfare state. To some extent, workers pay for the safety nets designed to protect the least fortunate among them.

Welfare-state governments also levy heavier taxes on general consumption, the kind of levy mentioned in answer (c). Such taxes, in the efficient form of a European "value added tax" (VAT), are favorites among economic conservatives. They have the pro-growth virtue of not double-taxing savings. It is striking that this pro-growth kind of taxation takes a bigger tax bite in the welfare states of Europe than in the United States, where conservatives have traditionally called for it.

Finally, it is the welfare states, especially those in the Nordic countries, that have the heaviest "sin taxes." Again, they have chosen taxes that mainstream economists would defend. Such addictive products as alcohol, tobacco, and gasoline, bring negative externalities to society, in the form of bad health and bad air. How does relying on these kinds of taxes harm economic growth and well-being? Yet these are the kinds of taxes that are kept lower in the United States.

Their work disincentives are not much worse

Given that the average tax rate on labor is higher in Europe, one might expect that work, and therefore output, is more discouraged there. Work indeed bears some burdens from policy in many European countries. Yet the policies are both more and less than the average tax rates on labor would suggest. As far as the welfare state package of policies is concerned, the burden is less than one would think, because of how the aid to the unemployed is designed.

What hurts employment in Europe *beyond* the labor tax rate is something unrelated to the welfare state. The main policy culprit in cutting European jobs and output is that set of employee protection laws dating mainly from the 1960s and 1970s, not welfare-state safety nets payments like unemployment compensation. The employee protection laws made it very hard for employers to lay off workers. Two effects of protecting jobs for those who have them are (1) to lower productivity, by giving job tenure to less productive workers that an employer would have laid off,⁴ and (2) make employers more reluctant to hire new workers, for fear that they may not work out but then cannot be laid off. Such employee protection laws are a reason why many in Europe, especially young job seekers and women, find it hard to get jobs. Yet this is not a feature of the welfare state. The welfare-state countries that provide the strongest safety nets (Nordic countries, Netherlands, Austria) do not have particularly high unemployment rates. There is more unemployment in other European countries having less generous safety nets but tougher laws protecting senior workers (Belgium, France, Italy, and Spain).

The welfare-state safety nets, such as basic family assistance and unemployment compensation, are often designed so that they do not discourage work. The unemployed are given retraining and job search help, and are pressured to take it. To illustrate how a higher-budget welfare state has actually given people more incentive to take a job, consider the case of jobless single mothers. The realities of recent history on this front are well illustrated with Exam Questions #2.

Exam Question #2 In which case was a poor single mother given the *least* incentive to get a job?

- (a) U.S.A. under Reagan
 - (b) U.S.A. under Clinton
 - (c) Britain under Tony Blair today
 - (d) Sweden's welfare state today
-

What has given poor single mothers the least incentive to work has been a policy environment that takes away their welfare and other public benefits as soon as they get a job. What would make a country actually do that, and face such women with a huge marginal tax rate? The desire to keep welfare expenditures very low, so that not one person above the poverty line gets any aid. Such penny-pinching, known as strict means testing, was practiced by the conservative Thatcher-Reagan revival of the early 1980s. Hence (a) is the correct answer to Exam Question #2.

Later on, bipartisan reforms in the Clinton years improved work incentives at the bottom of the U.S. income spectrum. The first improvement came when the Earned Income Tax Credit (EITC) was made more generous in 1993. That, and accompanying adjustments of state-level benefits, gave jobless single mothers a stronger incentive to take that first low-paying job and get started on an employment history. Then the 1996 welfare reform added a tough-love dimension by setting term limits on welfare. The combination of the two has decreased welfare caseloads without raising poverty, even after the recession of 2001-2002. Meanwhile, Britain under Tony Blair made a similar reform to the EITC, undoing the strict means testing of the Thatcher era. And a welfare state like Sweden never had such a heavy tax on getting a first job, because family benefits were retained when one got a job, and the tax rate on extra earnings remained moderate.

Investing in mothers' careers

The welfare states also gain jobs and productivity through public policies that invest in career continuity and skills accumulation for mothers. This matters a lot, now that such a large share of women are career-oriented. Welfare states provide paid parental leaves and public day care with qualified providers. While it is not easy to estimate the gains in productivity from micro-data, there is at least one aggregate sign of strong gains: Women in such countries have market wage rates that are much closer to wage rates for men in the United States or Japan or Switzerland.

Health care: our Achilles heel

On the other side of the coin, the United States seems to have shortened life expectancy and wasted part of GDP by refusing to take a universalist approach that insures health care for all. The symptoms of this shortfall are many. Americans die younger than people in countries that have a greater share of their health expenses paid for by taxes. We rank 19th out of 20 rich countries in life expectancy.

Granted, not all of the extra U.S. mortality is due to our health care system. Americans have worse health habits and slightly more pollution exposure. Our health habits are world famous — especially bacon double cheeseburgers, fries, Krispie Kremes, and double lattés. But when you weigh all the separate sources of survival statistically, the health care system looks guilty of causing a significant part of our early death.

And it costs way more. We spend the world's greatest share of income on health care. We have the highest bureaucratic costs — our system imposes greater administrative costs trying to keep people from being insured and compensated than other countries spend administratively on providing care to all.

Obviously, for those with high incomes, we have the best cutting-edge medical care in the world. But few can afford it, and the young go on dying. Little wonder that in recent surveys of opinions about health care, Americans were more dissatisfied about their health care than any people in other country. The World Health Organization has ranked the United States 37th in the quality of health care delivery, mainly because health care is out of reach for so many in this country.

What social sector does America handle best?

If health care is the social sector that America handles worst among the top twenty rich democracies, what social sector do we handle best? What we handle best, by far, is the social sector that has the least to do with the poor, the sick, and the elderly: higher education. The American system of higher education is clearly the best by far. This country has wisely chosen about the right amount of government subsidy for higher education, an amount appropriate to the fact that higher education does bring some “external” benefits, some favorable spillovers to the general population through the advancement of knowledge. Yet we have wisely avoided making the government pay for all of higher education, or even half of it. We force the public universities to compete with each other and with private universities for research grants, for faculty talent, and for student talent. Individual faculty members have to compete by teaching well, since this country attaches more importance to student evaluations of faculty than does any other country. Good old American competition works well in higher education.

Let us turn to the two main threats to social budgets in the twenty-first century. Turning to threats after having explained that social transfers look comfortably costless in terms of GDP does not involve any slip of logic, any inconsistency. The threat and the comfort are both real, because they operate in different dimensions. Our solution to the free lunch puzzle showed how *actual* welfare-state policies

avoided any cost *in terms of national product*. The two threats on the horizon may also involve no loss of GDP, once the political process has stumbled toward its best way of adjusting to the threats. Yet there is an undeniable *budgetary* threat to *different interest groups*, which are already causing political tensions.

U.S. pensions — future tense

The big scare: Can you spare \$44 trillion?

Two years ago two economists working for the U.S. Treasury estimated that the current path of Social Security and Medicare will be \$44 trillion in the red over the next 75 years. To pay that off, we would have to sacrifice four years of GDP, four years of everything this country produces. The same alarm has been sounded in a new book by Laurence Kotlikoff and Scott Burns, two other Republican-leaning writers.⁵ Let us look at some reasons why their alarm is well timed, and reasons why they have sounded it too loudly.

The curse of longer life

One force setting off the alarm is real and undeniable. Our pension policies are cursed by the continuing advance in human life expectancy. The lengthening of life is especially bad (or good) in Japan and Italy, who will have the world's oldest populations by 2050.

The aging is less severe in the United States, however, because we take in more immigrants and we have more children. To keep our Social Security accounts in balance requires, over the next 30 years, only two percent of GDP. We could raise taxes by that much and solve it, but we won't need to. More likely, we'll continue on the good path we've already started down. Slowly raise the retirement age for receiving full benefits. Current law raises it to 67 by 2023. We could afford to raise it to 69 soon. And why not? Our life expectancy is growing fast enough so that the next generation could work two years longer without raising the share of life spent at work.

If just delaying the full-benefits retirement age doesn't achieve full balance, then we could let full-retirement benefits grow slightly less than the average income. It can all be done gently with without significant pain. In fact, we will achieve this decline in the ratio of average benefits to average wage just by doing nothing. We have already indexed Social Security benefits to the cost of living, which rises more slowly than the average wage in the long run. So without upsetting oldsters by cutting Social Security payments, and just staying with existing practice, we will quietly trim the relative benefit.

Indeed, these are the quiet steps already taken by Norway and Sweden when their populations became particularly elderly in the 1980s. They slowly lengthened the age for full retirement benefits, and they did not keep benefits per pensioner up with the advances in wages. The scare story is misleading.

It's both public and private

The pension crisis does not come from having the government involved, and privatizing pensions would not solve it. The first problem with telling everybody to save for their own private future concerns intergenerational politics. One generation or another would have to take a huge hit. If we said that young workers could save for their own retirement and be excused from contributing to Social Security, the current generation of retirees takes the hit, losing the pay-as-you-go benefits they had counted on. If instead the young workers are told to keep paying for the current oldsters' pensions while separately saving for their own later retirement, they would be paying for two generations of retirement out of one work career. This transition problem is probably fatal for the idea of re-privatizing Social Security.⁶

The other problem is that private pensions cost just as much and face the same pressures from aging as do public pensions. They too have to struggle with longer life expectancies than they had first projected. To this strain must be added the risk of default on private pensions. So troubled are some big private pensions, like United Airlines and Enron, that we as taxpayers may have to bail out their pensioners, through our Pension Benefit Guaranty Corporation established back in 1974. It could be as bad as the \$150-200 billion we taxpayers had to pay to bail out depositors in the Savings and Loan crisis of the 1980s.

But the US should have less of a pension problem than some other countries — as long as we control the whole government budget

As already noted, the United States does not face the greatest pension pressure from population aging. We are not aging as fast as other countries, for three demographic reasons. We have more children than the Japanese, the Italians, and some other countries. We let in more young adult immigrants, the same tendency that helps reduce the pension pressure on Canada, Australia, and New Zealand. And we die a little younger.

Even though the problem of population aging is real, it is easily eclipsed by even bigger budget problems caused by fiscal mismanagement. Fiscal mismanagement is the one worrying thing that the U.S. has in common with Japan and Italy. Here

is a quick reckoning of the dangers facing these three countries.

Japan has a looming pension crisis for two reasons. In addition to its rapid aging, Japan has to come to grips with its huge overall budget deficits, which have hovered near eight percent of GDP for about a dozen years. This stirs up trouble for pensions, or for any other item in the government budget. The trouble, however, has nothing to do with the welfare state. Japan doesn't have much of a welfare state, and their pension policies are not badly flawed. Rather the whole budget has been reeling under the poor growth of the whole economy ever since the asset market bubble burst around 1990. It's a story of not cleaning up the financial system, not a story of the welfare state.

Italy asked for trouble by offering many male workers generous subsidies for early retirement since the 1980s. It did so largely because its tight job protection laws denied employers any other way to shed their less productive senior workers. This is a dangerous approach when you have one of the world's oldest and healthiest populations. Italy is in deep trouble and will have to adjust soon. Watch the newspapers on this one. But core welfare states like Norway and Sweden have no such problem because they already make people work a long time to get full benefits.

The United States should have had little trouble, both because we are aging more slowly and because we wisely did not subsidize early retirement. However, we have asked for trouble by suddenly switching to what some have called faith-based budgeting: slash taxes for top income groups, crank up spending, and pray for the best. Suddenly we are in second place among rich deficit-running rich countries, with a deficit of over five percent of GDP, behind only Japan. September 11 is less than half the sudden deficit story. A bigger hole has been caused by the annual Bush tax cuts. These alone are costing the government at least 2.5 percent of GDP. Then there's the extra spending on prescription drug subsidies, farm subsidies, home security, and a home-grown war in Iraq. That's what really strains the budget — not the need to fine-tune Social Security in the years ahead.

Health Care — Future Tense

With health care, even more than with pensions, the social policy problem is complicated, though not insoluble. Part of the complexity comes from trend that should be good. Part comes from special problems, both with the nature of health care markets and with this country's policy history.

The curse of prosperity and medical progress

Just as the pension crisis shows a dark cloud next to a bright silver lining, so does the health care crisis. With pensions the bad good news was that we live longer. With health care, the bad good news is that we are richer and the practice of health care is getting better and better. As we get richer, we shift a greater and greater share of our expenditures toward health care, because the demand for health care is income-elastic. Meanwhile, across the twentieth century health care quality rose so dramatically that it became something worth spending heavily on. A hundred years ago, there was less reason to pour money into health care even if you were sick, because there was less prospect back then that buying a lot of care would do much good. Unfortunately, health care is an industry that does not meet the soaring demand so smoothly.

The underlying market problems with health care

The private marketplace beautifully solves many problems, but health care is not one of them.

Health care has big information problems. You lack information as a prospective patient. When your doctor says you need something, do you know otherwise? When your insurance company says they'll cover many things and not raise premiums, do you believe them? For their part, your health care providers also lack good information about which insurance plan will default or suddenly impose more red tape. Finally, your insurer doesn't know as much about your health as you do. Suppliers of health insurance face acute informational problems, unlike suppliers of auto insurance. To insure drivers, just knowing the driver's past driving record and his or her age solves most of the information problem. But health insurers find it much harder to get the corresponding information, especially when patients and physicians share an incentive to submit claims for excessive care and medication. The insurers invest a lot in bureaucratic administration to weed out high-risk patients and limit claims.

Under these conditions of massive uncertainty, a voluntary private insurance market breaks down, even in the best of private market worlds. A common scenario of health insurance breakdown runs like this: Private insurers try to offer insurance to the people who have the lowest risks. People who secretly know they are at more risk try to pay for the insurance, while the healthier ones don't buy it. Costs rise. The insurance companies raise the premiums, and this repels healthy people all the more. Poor and sick people stay uncovered, and throw themselves on the emergency rooms later. Thus the market for voluntary private health

insurance is inherently unstable. Good old competition doesn't work as well in health care as it works in, say, higher education.

How America stumbled into a system that's broken

How this country's health insurance and health care evolved has left us with a worse response to the basic challenges of health care than the responses worked out by other countries.

Our first misstep was to hook health insurance to jobs. This dates back to the 1940s and 1950s. During World War II, Milton Friedman has noted, the link to jobs arose from wage controls. Firms needed to compete for workers in a fully employed economy, but could not use wage hikes to attract them. So instead they turned to other enticements, including generous health insurance. Also in the 1940s and 1950s, as Melissa Thomasson has explained, tax rulings solidified the tax-exempt status of employer contributions to employees' company-based health insurance. Thus arose a subsidized demand for private job-group health insurance—and a powerful insurance industry determined to keep things that way. The defect in this, however, is that it gives rise to those scenarios of breakdown in the market for voluntary insurance. Coverage is increasingly limited, and premiums rise.

The second misstep came in 1965, when this country socialized medicine only for the elderly. At first, the arrival of Medicare may have seemed a victory for the health of seniors, and a defeat for the medical associations and insurance companies that opposed it. Yet Medicare developed a drawback already latent in the tax breaks for job-based health insurance plans: It subsidized demand in a market where prices were uncontrolled. As patients and doctors raised their use of insured health care, prices shot up faster than the overall cost of living. Soon enough, Medicare and private insurance budgets were strained.

The resulting war between insurers on the one side and alliances of providers and patients on the other was, and is still, unwinnable. In the late 1980s and early 1990s, the insurers stopped their losses by shifting to mechanisms they could better control, such as Health Maintenance Organizations. The HMOs and other managed-care institutions succeeded in stopping the escalation of costs, by denying a large share of claims. Providers and the general public fought back across the later 1990s. Claims, costs, prices, and premiums began to accelerate again. No national victory is possible. The cycle is now being repeated with the expensive Medicare Prescription Drug Act of 2003. It is a complex piece, including direct compensation to drug companies and insurance companies, and a prohibition

against the government's using its power to negotiate price discounts on drugs. To the extent that it actually subsidizes seniors' drug purchases through a complicated formula, the taxpayers' help will have the same effect as before: prices will be raised further.

Again, as with pensions, the underlying defects and dangers are as much with the private side of the economy as with the public. While some may say that the problem is with government-run Medicare, and may describe the Act of 2003 as a Medicare reform, Medicare's budgetary strains stem in large part from its being embedded in a private system with uncontrolled prices and not-so-sovereign consumers. Further privatization of American health care would yield some combination of more uninsured health risk and higher prices, the exact combination depending on the political supply of taxpayers' money.

How Does a Country Get Its Taxes and Universal Aid Right?

Could we ever have a world in which we do what economists think works best? That world would have those rules for government intervention introduced at the start of this address. In that good world, we would use government to correct for externalities. Use taxpayers' money to subsidize positive spillovers such as public health and public education. Tax other activities that are bad for the rest of society, such as pollution or crime. But don't mess with markets that work fine, without significant externalities, including international trade.

America's approaching that world is a possibility, but it's hardly easy given our political and social realities. It is not easy for a country like ours, with so much opposition to things public. But it can be done.

To see the political possibilities and the political hurdles in our way, let's look at how Sweden got its huge consumption taxes, and its welfare state, back in the 1950s. The wisdom of this choice was imposed not by any major political party or lobby, but by the competitive political *process*. Right after the war, nobody wanted the sales tax that later became Sweden's huge value added tax (VAT). The dominant Social Democratic Party and the dominant blue collar labor union did not want it. Their coalition allies, the Communists, hated any kind of sales tax, which fell heavily on workers. The bourgeois parties to the right also opposed the sales tax, or any tax for that matter, and were not persuaded by promises that it would make cuts in the income tax possible.

Yet the money had to be raised somehow, if the popular safety nets and pensions were to be provided. The Social Democrats began to waver, realizing that raising taxes on capital incomes would risk capital flight from Sweden. In the end Social

Democratic leaders correctly guessed that the Communists would not dare to vote no, and the sale tax came about. Once in place, it became an escalator that the Social Democrats rode to ever-higher social budgets.

By contrast, ask what the consumption tax looks like in the United States. Democrats dismiss it as a naked redistribution in favor of the rich. In the U.S. setting, they are right, given that it has been proposed only as a replacement for progressive taxes that fall more heavily on the rich, not as a way to fund universal care.

The only way that Americans would get to a better system with universal health insurance and other benefits, and with simpler flat taxes, would be through some major breakdown in our system. The country does respond well to obvious all-out crises. The most likely breakdown would happen in our health care sector. Perhaps the need for universal health insurance and controlled health-sector prices will become obvious enough that we will decide to phase out our whole job-related private health insurance industry, and replace it with a cheaper, more effective publicly funded system. Maybe we could pay for the cheaper public system with consumption taxes and sin taxes, the kind that do little harm to economic growth. Perhaps the better system could start at the state level in some bold North Central state.

It's possible, though not easy.

Footnotes

- 1 This paper draws on my current book, *Growing Public: Social Spending and Economic Growth since the Eighteenth Century*, two volumes (Cambridge University Press, 2004).
- 2 The main exceptions before the twentieth century were the noticeable amounts giving through churches in the Netherlands and England. The fragmentary evidence on early modern private philanthropy is surveyed in Peter Lindert, *Growing Public*, United Kingdom: Cambridge University Press, 2004, Chapter 3.
- 3 See *Growing Public*, Chapter 18 and Appendix E. An earlier version of this evidence was aired in Lindert, “Why the Welfare State Looks Like a Free Lunch,” National Bureau of Economic Research Working Paper 9689 (2003), available at [www.nber.org / Publications / Working Papers](http://www.nber.org/Publications/WorkingPapers).
- 4 Some might think that forcing employers to keep their workers longer would make the employers invest more in making those workers productive. Yet on balance any such favorable effect on productivity is outweighed by the inability to lay off those that turn out to be less productive, according to the international statistical patterns (*Growing Public*, Ch. 19).
- 5 See Laurence J. Kotlikoff and Scott Burns, *The Coming Generational Storm* (MIT Press, 2004). The projection actually relates to Medicare as well as to Social Security. Most of the \$44 trillion in projected costs were forecast for the second half of this century, the more distant part of their 75-year span and the hardest to predict reliably.
- 6 It might appear that other countries have already made the transition back to privatized pensions, but the appearance is deceiving. Pinochet gradually imposed privatization on Chile, but he did not have to run for public office. Thatcher partially imposed it in Britain, but British policy has since retreated back toward more public and pay-as-you-go pensions. Enthusiasts for privatization have pointed to the increasing choice of pension plans offered to workers in Sweden, but the share of implicit exit from public pension schemes is very small there.



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