TRANSFER SPENDING, TAXES, AND THE AMERICAN WELFARE STATE

Wallace C. Peterson

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by
Wallace C. Peterson, Ph.d.

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Wallace C. Peterson
Lincoln, Nebraska

Introduction

In 1989 the federal government spent $1197 billion, a mind-boggling sum that is almost impossible to visualize. Since there were 248.8 million people living in the United States in that year, the government spent an average of $4811 for every man, woman, and child in the nation. For a hypothetical family of four, federal spending in 1989 amounted to an average of $19,244. To put this sum in perspective, the money income of an American family averaged $35,270 in the same year.

To finance spending $1197 billion, the government collected taxes from American citizens and residents in an amount of $1047 billion. Because of a shortfall between what it spent and what it took in taxes, the government had to borrow $150 billion, partly from individuals, but mostly from banks, insurance companies, and foreigners.

How, where, and on whom did the federal government spend all this money? Since federal spending in 1989 totaled 23 cents in comparison to every dollar spent for the buying of goods and services, finding an answer to this question is not a trivial matter. Spending by Washington reaches into every nook and cranny of the economy, touching the lives and fortunes of almost everyone in the nation. Thus, answers to these questions are of more than academic interest. The main purpose of this book is to provide answers, ones that will not only surprise many people, but that will probably change their perspective about how our national government works and what it really does with all that it borrows and collects in taxes.

A sizeable chunk of federal spending involves the government going into the marketplace and buying goods and services. Goods purchased by Washington range from paper clips to missiles, while the services bought are mostly labor, including pay to the military and the civil services as well as to the Congress, all political appointees, and the President himself. All

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told, the federal government in 1989 spent $404 billion in the marketplace buying goods and services. This amounted to slightly more than one third —33.8%, to be exact—of all the money spent by the federal government in 1989. In this spending, the federal government acts no differently than do consumers or business firms; it enters the marketplace and buys goods, goods which for the most part are produced by private firms. It also enters the marketplace to hire labor, much in the same fashion as any business firm. A major difference between the government and the rest of us—consumers and business firms alike—is that the federal government has nearly unlimited power to get the money it needs, either by taxing us or by borrowing. No private persons or firms have such power, and lesser units of government—states, counties, and cities—have far less taxing or borrowing power than does the federal government.

Where and for what purpose did the government spend the rest of the money? The sum of $404 billion is large, but it is still only a bit more than one third of total federal spending. The balance of $793 billion was spent for what are technically called *transfer payments*. The term is well chosen. The federal government pays out billions of dollars every month and year to millions of people and thousands of businesses, sums for which it receives nothing in return. Unlike the government's marketplace transactions, it does not get goods or services in exchange for the money it pays out. The federal government is simply transferring either money income or services (like Medicare) to people, to businesses, to other government units, and even to foreigners without a quid pro quo—an equivalent value in exchange. Simply put, the federal government taxes the population at large, including business firms, or borrows money, and then transfers a part of the money received as either income or services to people and other entities entitled by law to receive the income or services. The latter point is important. The federal government does not do this in willy-nilly fashion, paying out such huge sums just to be big-hearted. Persons, businesses, and other governments, including foreign governments, that are on the receiving end of federal largess are there by virtue of laws—duly enacted, constitutional laws that create legal claims for income or services from the national government.[1]

For example, Census Bureau data show that in 1987 (the latest year for which full data are available) over 33 million families—50.8% of all families—got some form of cash income from the federal government. The kinds of income received ranged from Social Security benefits, the largest single type of transfer payment, to cash assistance for mothers with dependent children (AFDC) and unemployment compensation. Noncash assistance or services—what economists call *income-in-kind*—went to almost as large a

proportion of the nation's families. In 1987, an estimated 30 million families got in-kind help, from food stamps to school lunches to medical care in the form of Medicaid or Medicare. The billions of dollars paid out in subsidies to business, including $24 billion in farm aid in 1988, as well as the $151 billion for interest on the federal debt in 1988 are also forms of transfer spending.

Basically, this is what the *welfare state* is about—the use of the taxing and borrowing power of the national government to transfer either cash or in-kind income to people, businesses, and other units of government. That, too, is what this book is about. Since the transfer and redistribution of income has become the major activity of the federal government, at least insofar as the federal government's activities are measured by how it spends its money, it is important to explore and seek answers to questions such as these: Who benefits and who pays for the structure of transfer spending that constitutes America's welfare state? How did this structure come about? How has it evolved? What has been its impact upon poverty in the nation? Does federal transfer spending make the rich less rich and the poor less poor, or does it make the rich richer and the poor poorer? What was the impact of the Reagan "Revolution" on America's welfare state? And what of the future? Is the system, or some parts of it, such as Social Security, facing collapse, or is the system basically healthy? These are but a few of the questions that this book seeks to answer.

Specifically, the discussion will proceed as follows. In the first chapter the meaning of the "*welfare state*" is examined, including comment upon its historic origins and development in the United States. By showing in this chapter the explosive growth in transfer spending in the post-World War II era, especially in the 1970s, the stage is set for a detailed analysis in chapter 2 of the structure of transfer spending in the country. Here we get to the heart of the matter: who benefits and to what degree from the contemporary transfer spending by the federal government.

Chapter 3 looks at the redistributional activities of the federal government from another perspective, namely through the impact of *tax expenditures* on the income of people and businesses in our society. Tax expenditures are little known to the public, yet like direct income transfers, they have a major impact upon the distribution of income and wealth. Briefly put, tax expenditures represent tax revenue lost to the federal government because of favored or special treatment of some income in the tax laws. From an economic perspective, tax expenditures have the same impact as direct money-income transfers, since persons or businesses who benefit from them end up with more income than otherwise would be the case. The picture that emerges from the analysis in chapters 2 and 3 is that

of a three-tiered welfare state, one tier for the rich, one for the middle class, and one for the poor. This picture will surprise many, for it runs counter to the popular view that the welfare state takes from the rich and gives to the poor. But this three-tiered structure is the reality.

Chapter 4 moves in a different direction. It contains a detailed analysis and critique of the conservative "revolution" launched by the Reagan administration, a revolution directed not only at the basic concept of the welfare state, but also at the overall role played by the federal government in the nation's economic life. This chapter examines what the Reagan Revolution sought to accomplish, how well it succeeded, and what its effects mean for the future of America's welfare state.

Chapter 4 sets the stage for the book's final chapter, which is an exercise in social and economic forecasting. Here some of the problems confronting our complicated welfare state are discussed, and an attempt is made "through a glass darkly" to foresee the future dimensions of the welfare state. Reforms are also suggested.

Wallace C. Peterson

Notes

1. Other governmental units in our society—states, counties, and cities—do this also, but since most of their transfer-type spending is financed ultimately by the federal government, the focus in this book will be almost entirely upon what Washington does in this realm.

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1 ON THE MEANING OF THE WELFARE STATE

Like many things in economics, there is no precise definition of the *welfare state*. Even though its antecedents stretch back into the nineteenth century, modern usage of the phrase grew out of the Beveridge Report on social insurance, a document presented to the British government in November 1942.[1] This document, with its call for sweeping reforms in British social legislation, became the basis for a system of "cradle-to-the-grave" social insurance for the people of Great Britain. When the Labour government came into power after Winston Churchill's defeat in 1945, the party used its nearly 150-seat majority in the Parliament to develop Britain's postwar welfare state.

The Beveridge Report and the Welfare State

The Beveridge Report asserted that the prime objective of social policy in Britain after the war should be "the abolition of want." This was to be achieved by establishment of a system of "social insurance" designed to guarantee that no citizen's standard of life would fall below a minimum level of material subsistence. How could this be done? Studies of life in a

number of the principal towns in Britain before World War II showed that loss of earning power was the primary cause that plunged people and families into poverty. Further, income was lost mostly because of unemployment, disability resulting from sickness or accidents, the premature death of a family's principal breadwinner, or insufficient pension income upon retirement. In this view, "want" (or poverty) resulted essentially from events beyond the control of the individual, events tied up with the workings of an industrial economy. Poverty, in other words, was seen as a social phenomenon rather than the result of any personal failing on the part of the individual or the family. Therefore, it was felt that compassion should be extended to those who fell out of the system into poverty through no fault of their own. This was the philosophic outlook held by the liberal architects of the modern welfare state, a view that many conservatives accepted only grudgingly, if at all.

Given this perspective, the answer to the problem of want necessarily must come from social rather than private action. Such was the stance taken by the Beveridge Report. What is required, the Report said, is a system of "social insurance" that will protect the individual and the individual's family against the "interruption or destruction of earning power" because of any of the special circumstances described earlier. Furthermore, the Report argued, because all families confront extra expenses arising from birth, marriage, and death, the scheme for social insurance should cope with these needs in addition to meeting the threat of poverty because of income loss.

Before describing more fully the details of the Beveridge *Plan for Social Security*, a word is in order on the use of the term *social insurance* in the Report. This is important because the label *insurance* is attached to practically all contemporary variants of the welfare state, including our own Social Security system. The words *transfer expenditures* do not appear in the Report. Lord Beveridge argued that what made his scheme one of insurance was its adherence to several key principles. These included, first, a flat-rate compulsory contribution (or tax) to be paid by every person covered by the scheme, as well as by that person's employer; second, provision of a flat-rate benefit without a means test, irrespective of the amount of earnings interrupted by unemployment, disability, or retirement; and, third, benefits sufficient to provide the minimum income needed for subsistence in all normal situations. Contributions from the covered persons and his or her employer were to be paid into a Social Insurance Fund, out of which benefits would be paid. These benefits are what we now describe as transfer expenditures or income transfers. Any shortfall in the fund because of benefits paid out would be made up by general revenues flowing into the British Treasury.

The structure is similar to the system now used in this country for Social Security. In the United States, the payroll taxes used to finance Social Security benefits (sometimes euphemistically called "contributions") are paid into so-called Trust Funds, the proceeds of which must be "invested" in U.S. government obligations. The practical import of this is that money collected from employees and their employers becomes a part of the general revenue of the government. In the Beveridge Report it was argued that because of the contributory principle, the proposed scheme could properly be described as one of insurance, and because contributions were mandatory for all persons covered, the name *social insurance* was justified.

A key, controversial point, still unresolved by economists and insurance scholars,[2] is whether schemes for income maintenance like that proposed in the Beveridge Report and America's current Social Security system should be described as systems of insurance. No attempt is made in this book to resolve this controversy. The fundamental difference between private insurance and various social insurance arrangements is this: for a private insurance plan to succeed, a fund must accumulate out of which future obligations can be met. Without such a fund, the insurance company simply fails. In the case of social insurance systems, however, this is not the case. Though the term *fund* may be used, as with the Social Security Trust Funds, the reality is that through the device of "investing" money collected under the system in government obligations, the "contributions" for social insurance become a part of the revenue stream of the government. The long and short of the matter is that all such schemes are basically systems for the transfer of income from persons and businesses subject to the mandatory contribution—payroll taxes in the United States—to those who may be the beneficiaries of the system. Stripped of rhetoric about insurance, these systems tax the working population in order to finance the benefits paid out to those eligible to receive benefits under the system. In this sense, the Beveridge plan, our own social Security system, and similar arrangements in other nations are fundamentally income transfer programs. They are also "pay-as-you-go" systems.

Let us return now to the more specific proposals of the Beveridge Plan. The plan consisted of four essential elements. First, and at the heart of the plan, was the arrangement whereby each British citizen (and his or her employer) paid a weekly sum into the Social Insurance Fund, out of which benefits were paid for unemployment, disability, and retirement. Second, the extra expenses arising from marriage, birth, and death were to be met, respectively, by a marriage grant to women, maternity leave benefits and a system of children's allowances, and a funeral grant for all covered persons. These features gave the plan its cradle-to-the-grave character. Third, the

plan called for establishment of a national health service to make available to every citizen medical and dental care as needed. The report did not call for the socialization of all medical services, only for a system of national health insurance. Finally, there was a commitment to maintaining employment and preventing the reemergence of mass unemployment like that of the Great Depression of the 1930s. This was a major and logical part of the plan, given the basic underlying assumptions that poverty (or want) results primarily from a loss of income, and that unemployment is the major reason for such a loss in the modern industrial economy. As the Report stated,

> ...income security which is all that can be given by social insurance is so inadequate a provision for human happiness that to put it forward by itself as a sole or principal measure of reconstruction hardly seems worth doing. It should be accompanied by an announced determination to use the powers of the state to whatever extent may prove necessary to ensure for all, not indeed absolute continuity of work, but a reasonable chance of productive employment.[3]

There is yet another important point to note about the Beveridge proposals, one that has an important bearing on both the nature of the modern welfare state and, more specifically, how it has evolved in the United States. The Report baldly stated that the abolition of want in modern society required a redistribution of income and wealth. In contrast to what has probably been the majority and more popular view in the United States that, as President Kennedy said, a "rising tide lifts all boats," the Beveridge Report explicitly said, "Abolition of want cannot be brought about merely by increasing production, without seeing to a *correct* distribution of the product..."[4] Further, both "social insurance and children's allowances are primarily methods of re-distributing wealth,"[5] something not to be feared, according to Lord Beveridge, since a better distribution can increase wealth by "maintaining physical vigor." The conservative opposition to the whole idea of the welfare state stems primarily from this, namely that it is redistributive in intent as well as in fact. The great conservative fear is that any tampering with the market-determined distribution of income and wealth will affect incentives adversely, thus damaging production and the creation of new wealth.

All the foregoing is, of course, history. Not only did the Labour government in 1945 enact into law the main feature of the Beveridge Report, but by its action also established the broad contours for the modern welfare state, in Britain and throughout the western economic world. The welfare state has become a part of contemporary market capitalism. In its bedrock essentials, the welfare state involves the use of the power of the central

government to protect people from income losses inherent in an industrial economy—especially income losses arising out of unemployment, accidents and illness, and retirement—and to provide for a minimun standard of material well-being for all citizens, irrespective of circumstances. Taxes and transfer spending (or income transfers) are the primary means used by modern governments to construct and administer the welfare state.

The foregoing represents the classic definition of the welfare state, one rooted in the abolition of personal want as perceived by the Beveridge Report. This classic definition of the welfare state is crucial to the entire analysis of this book. We shall subsequently examine the transfer spending structure of the American government in terms of this definition, one basic objective being to demonstrate the extent to which total transfer spending by the federal government has exploded far beyond the boundries established by the basic, classic definition of the welfare state. Further, the use of an analytical structure built around this definition enables us better to come to grips with the problem of poverty in our society and particularly to understand how and why some kinds of poverty persist and remain untouched by the formal apparatus of welfare state spending. First, however, we need to examine briefly the major features of America's welfare state and to explore how they came into being.

America's Welfare State

Although many critics would argue that America's welfare state is niggardly by British and European standards, lacking both children's allowances and a system of universal medical care and insurance, a structure of taxes and benefits roughly conforming to the classic definition of the welfare state explained above exists in the United States. It was created in two stages that were separated by three decades and that were responses to drastically different economic circumstances.

Although at the federal level there are about 40 separate programs that provide income support in one form or another, the bulk of them fall into two major categories: Social Insurance programs and Public Assistance programs. The nature of these categories and the basic distinction between them is best understood by a brief review of their history.

The key element in the legislative structure of America's welfare state is the Social Security Act, passed on August 14, 1935. This landmark legislation grew directly out of the recommendation of a Committee on Economic Security created by President Franklin D. Roosevelt in 1934, the major purpose of which was to study the problem of economic insecurity in the

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