ISSUE BRIEF
IPI Institute For Policy Innovation

The Market Alternative to the Welfare State

by Peter Ferrara

Synopsis: Fear of projected fiscal problems is driving many policy thinkers, including some prominent conservatives, to accept the inevitability of large tax increases as a partial solution. This course is a mistake, as it will lead to economic stagnation. Instead, conservatives should confidently advocate the package of reforms presented in this study that will deliver superior benefits to U.S. taxpayers and citizens.

The latest projections of the Congressional Budget Office (CBO) show that even with a substantial reduction in the long-term growth trends of health care costs and with defense spending returning to peacetime levels, the federal budget will still consume 37.7 percent of GDP by 2050. This would be a decisive increase over the post-World War II trend of federal spending averaging around 20 percent of GDP. The central cause of this spending explosion is the major entitlement programs, Social Security, Medicare, and Medicaid.

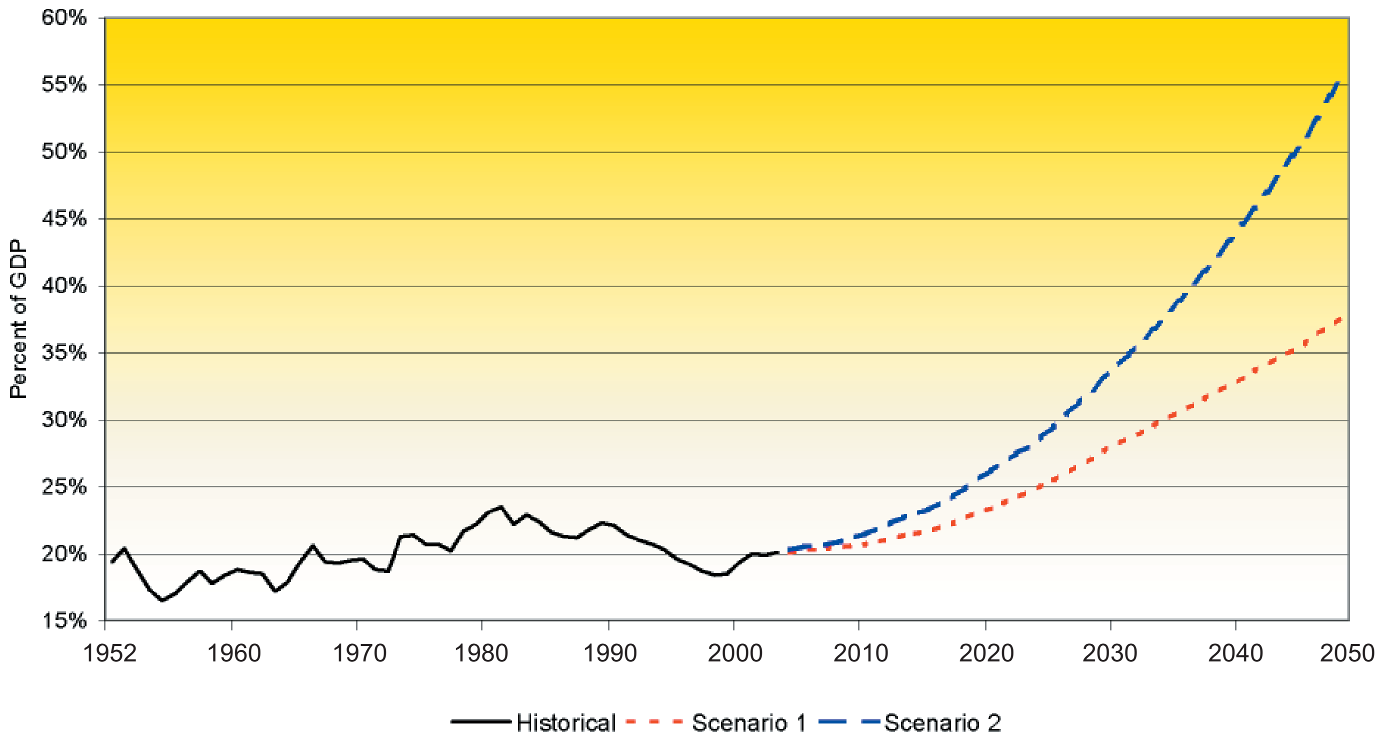
In other words, federal spending is projected to almost double relative to GDP over the next 40 years. If anything even close to this happens, those who believe in limited government will have been routed. Adding in state and local spending, total government spending would then be close to 50 percent of GDP. The American model of a robust private sector that thrives in the absence of the burden of stifling government will have been replaced by a European-style welfare state.

This nightmare scenario, however, is not inevitable. This disastrous trend toward Big Government not only can be stopped, but actually can be reversed through reforms that would garner broad popular support, if structured and explained correctly. Indeed, these reforms together would actually substantially reduce federal spending as a percent of GDP. Unfortunately, a plot currently developing in Washington would take us in exactly the opposite direction.

The Tax Collectors for the Welfare State

Supporters of large entitlement programs are concerned about continuing to obtain the revenues

Figure 1 Federal Spending as a Percent of GDP 1952-2050



Scenario 1 assumes continued long term growth trends in medical costs affecting Medicare and Medicaid, though somewhat higher than the more recent 15 year trend, the funding of the Bush Administration long term defense buildup, no major tax increase, among other common assumptions.
Scenario 2 assumes a major reduction in long term, historic medical cost growth affecting Medicare and Medicaid, and a return to a peacetime defense budget, no major tax increase, among other common assumptions.

Source: *2007 Budget of the United States, Historical Tables, Table 1.2; Congressional Budget Office, The Long Term Budget Outlook, December 2005*

necessary to finance their spending programs. Consequently, they are promoting a grand compromise deal between Republicans and Democrats, conservatives and liberals. That deal would be a major tax increase in return for cuts in entitlement spending.

The mechanism for this grand compromise plan is being provided by legislation proposed by Rep. Frank Wolf (R-VA). Columnist David Broder reported what is behind the bill in a May 20, 2006 *Washington Post* column.

The bill picks up on President Bush's proposal in this year's State of the Union address for a bipartisan commission to study ways to address the long-term problems of federal entitlements such as Social Security, Medicaid, and Medicare. But the bill explicitly provides that the commission is to consider tax increases as well as other reforms.

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Moreover, the commission is to operate like the Base Realignment and Closure process. When the entitlements commission makes its proposals, including tax increases, the House and Senate are each required to take an up-or-down vote on the proposals, without any amendments, which might otherwise pick apart the deal the commission has struck. Just like the Base Realignment and Closure process enables controversial base closings to be rammed through Congress, this provision in the Wolf bill would enable enormous tax increases to be rammed through as well.

Broder reports that former Clinton Treasury Secretary Robert Rubin would now possibly be willing to serve on the commission. President Bush has personally appealed to Rubin to help lead such a commission, but he has refused to do so unless tax increases were "on the table."

Broder also notes the support for this effort from the Urban Institute, Brookings Institution economists, the Concord Coalition, and the business-backed Committee for Economic Development. Broder even cites Heritage Foundation Vice President Stuart Butler as saying at a recent Concord Coalition conference that conservatives could support tax increases as part of an overall package if the tax measures also simplified the code and enhanced economic growth.

Cato Institute economist Jagadeesh Gokhale joined the chorus in calling for a compromise including tax increases, in a May 26 column on the TechCentralStation website.

Further, on May 22 President Bush's National Economic Council Chairman Al Hubbard told *National Journal* that President Bush would, indeed, accept an entitlements commission where tax increases are on the table.

This disastrous compromise will inevitably lead to an effective reversal of the Bush tax cuts. But its fundamental folly is more basic than that. If federal spending as a percent of GDP is already slated to rise from 20 percent to at least 38 percent under the status quo, where is a grand compromise going to leave it? Surely not at 20 percent, and probably not even 25 percent. How much in benefits can we expect to cut to bring the current projections down, even without liberal support? The truth is that the backdoor consensus is to settle in with this compromise around a disastrous 30 percent. That would increase the federal government by 50 percent relative to GDP.

> *Through these reforms, Social Security, Medicaid, and Medicare would no longer contribute to increasing federal spending relative to GDP. Instead, federal spending on these programs would be reduced as a percent of GDP.*

Such a compromise package of tax increases and benefit cuts is a suicide mission for Republicans. It is the 1990 budget deal writ large, which led to the defeat of the first President Bush two years later. Republicans supporting a package of reforms involving a huge tax increase and an historic increase in federal spending relative to GDP will find themselves in a political no man's land with no political base whatsoever. True conservatives will vigorously oppose any such plan, despite the Beltway insiders now being seduced into playing the power game with the establishment. Democratic politicians, rather than following some high-minded think tank plan, are likely instead to use the issue to beat up on and defeat Republicans, before they even begin to consider adopting any reforms.

The Conservative, Free-Market Alternative

Fortunately, there already is a package of well developed, alternative reform plans that conservatives have been working on for years. These reforms not only would stop the run-up of federal spending relative to GDP. They actually would reverse the trend and reduce federal spending to less than 15 percent of GDP.

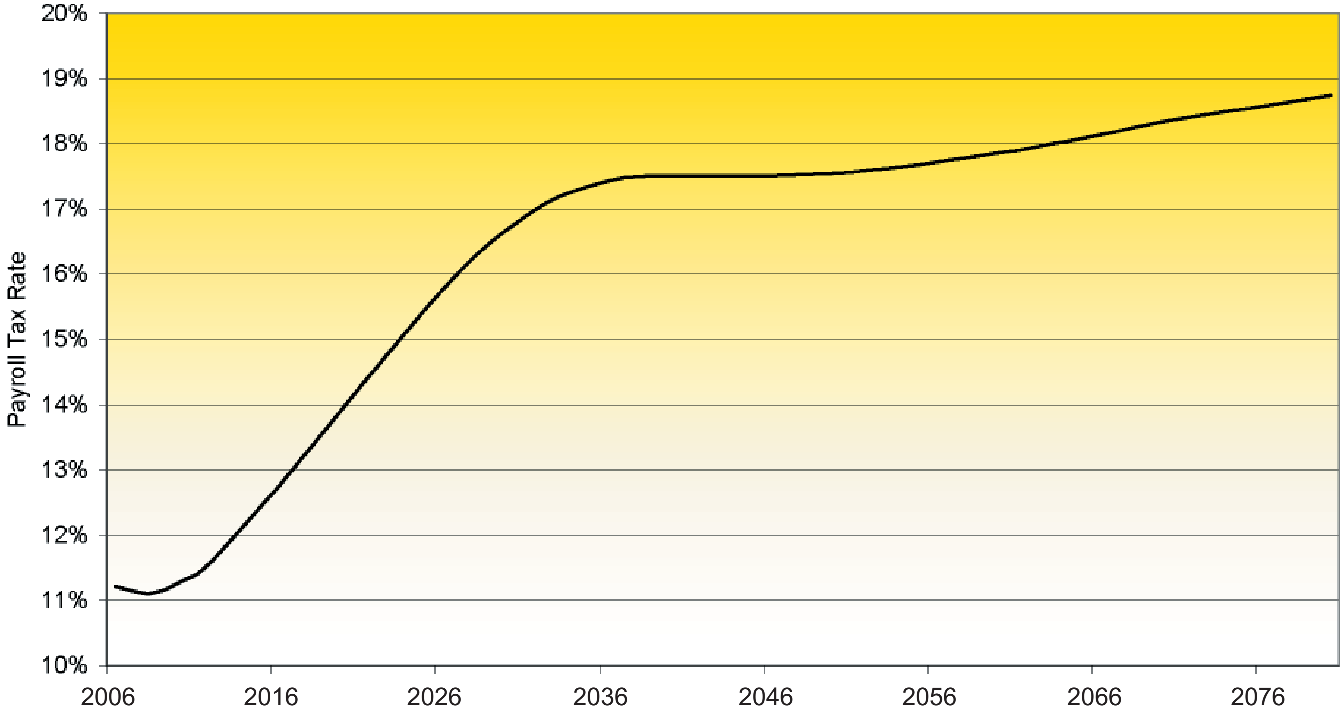
These are not extreme proposals. They are designed to be politically practical, ultimately quite popular reforms that real-world politicians can run on in real campaigns and win. Indeed, many already have.

Personal Accounts for Social Security. Central to successful long-term entitlement reform is the idea of personal accounts for Social Security, so ineptly advanced by the Bush Administration last year. These accounts are critical because they don't just limit the growth of federal spending. They shift huge chunks of that spending from the public to the private sector, dramatically reducing federal spending over the long run.

If we adopt personal accounts roughly equal to the employee share of the Social Security payroll tax, as proposed in the bill introduced by Rep. Paul Ryan (R-WI) and Sen. John Sununu (R-NH), all Social Security retirement spending eventually would be shifted to the private sector. This would reduce future federal spending by about 5 percent of GDP, an historic, massive reduction in itself. If we later expand the accounts to handle survivors and disability benefits, future federal spending would fall by another 1.5 percent of GDP.

We know personal accounts can succeed politically. Many Congressional races already have been won where support for personal accounts was

FIGURE 2 PAYROLL TAX RATE NEEDED TO PAY ALL PROMISED SOCIAL SECURITY BENEFITS



(Total Social Security payroll tax rate under current law is 12.4%)

Source: *2006 Annual Report of the Old-Age and Survivors Insurance and Disability Insurance Trust Funds, May 1, 2006, Office of the Actuary, Social Security Administration, Table VI.F2, Intermediate Assumptions*

central to the campaign, and up to this point none have been lost, despite the most furious attacks from opponents. The key to winning is to focus on all the ways that personal accounts offer a much better deal to working people.

These accounts would provide workers with much better benefits than Social Security now promises, let alone what it can pay, at standard, long-term, market investment returns. Workers would accumulate major sums in their accounts by retirement, close to a million dollars in real terms for average-income two-earner couples. They could choose to leave much of these accumulated sums to their families at death, providing a foundation for the family's future economic prosperity. The accounts would provide personal ownership, control, and freedom of choice. They would lead to more jobs and higher wages.

But after winning two elections on this approach, the President and his people got lost in the Washington policy swamps. They wandered off into proposing cuts in future promised benefits, delaying the retirement age, even tax increases. This castor oil changed the debate from populism to pain and suffering, and sunk the whole effort, as we predicted.

None of these additional pain elements was necessary. If the payment of future Social Security benefits is shifted to personal accounts, then there no longer is any Social Security deficit to worry about. It is eliminated in the transition. This was confirmed by the Chief Actuary of Social Security, who scored several bills involving personal accounts alone as eliminating the long-term deficit of Social Security. But by contaminating the personal accounts solution with unnecessary pain elements, the President and many of his advisors sunk the effort.

In the context of the broad package of reforms proposed here, the transition to these personal accounts can be financed by the other spending reduction reforms discussed below and by the sharply increased economic growth resulting from the personal accounts. These accounts effectively embody a massive reduction in payroll taxes, and a massive increase in savings and investment. Spending reduction and economic growth are economically the best ways to finance the transition.

The Bush blunder on Social Security is starkly revealed in the polls. Even though Bush was mediocre in defending the personal accounts from the assaults of the Left, and even effectively criticized the accounts, several polls late last year still showed 50 to 60 percent of the public supporting the idea of personal accounts. But when the public was asked about "the President's plan" for Social Security reform, support dropped by half, to the range of 25 to 30 percent.

If the full scale of the Ryan-Sununu accounts seems too daunting, then Congress can start with whatever size of the accounts seems manageable at the beginning, and expand them later. It can start with accounts about half the size of the Ryan-Sununu proposal, financed to start mostly with the short-term Social Security surpluses. But the key is to keep the focus on the accounts and stay away from cutting future promised benefits, delaying the retirement age, etc. If we are shifting the system to personal accounts, then we need not worry about trying to cut future benefits as well. Future benefits would be paid through the private sector, again at much higher levels than Social Security even promises today.

Finish Welfare Reform. Most people think welfare reform was already achieved in the 1990s. But that legislation reformed just one program, Aid to Families with Dependent Children (AFDC). There are three more major federal welfare programs: Medicaid, food stamps, and housing assistance, and many smaller ones.

The past reform block-granted AFDC to the states, which means that each state is given a federal grant each year of a specific dollar amount to run the program. The amount is determined by a specific federal formula based on population, poverty, income and other factors in each state. Each state then designs its own program to serve the purposes of the old AFDC program. If the state program costs more than the federal grant amount, the state must pay the entire difference. In addition, the federal reform legislation mandated that each state program must include a strong work requirement for the program beneficiaries to receive funds.

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These reforms dramatically changed incentives under the old AFDC program. Since recipients had to work anyway, they may as well take available jobs in the private sector, where they can get pay raises and promotions over time. But at least as important was the changed incentives for state officials. Under the old system, the more recipients they signed up for the program, the more matching federal funds they got for their state. But under the new system, the state effectively pays for extra recipients itself. The more people they get off welfare and into work, the more money the state saves. This changed the whole culture of welfare administration. It soon became all about getting recipients off of welfare and into work.

The reforms were amazingly successful, due to the powerful effects of these changed incentives. The old AFDC rolls declined by over 50 percent nationwide, with declines of 80 percent where the work requirement was most strictly enforced.

These same reforms should now be extended to the other federal welfare programs. Medicaid, food stamps, and housing assistance should be block-granted to the states as well, with the states using the money again for their own programs for the poor based on work. Again, each state would itself bear the increased cost of the program above the federal grant amount. Means-tested vouchers to buy health insurance could be provided to the poor who worked for a certain period each month. The vouchers could be used to buy coverage through Health Savings Accounts (HSAs) in particular.

These changed incentives would likely reduce the rolls of the able-bodied on these programs. If federal spending on these programs was nevertheless maintained at a flat level for 10 years, the states would gain sharply from the reduced rolls. But the federal government would save well over $1 trillion during that period over what it would have had to spend on the growth of these programs. As long as growth in block grants after this period was maintained at or below the level of GDP growth each year, the total effect would again be to reduce federal spending as a percent of GDP. Most importantly, Medicaid in particular would no longer contribute to increasing

TABLE A Change in TANF Caseloads Since Enactment of New Welfare Law

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Total TANF Families and Recipients (in thousands)

	August 1996	June 2000	Change 1996-2000
Families	4,415	2,208	-50%
2,207,000 fewer families			
Recipients	12,241	5,781	-53%
6,460,000 fewer recipients			

Total TANF Recipients by State

STATE	AUGUST 1996	JUNE 2000	1996-2000	STATE	AUGUST 1996	JUNE 2000	1996-2000
Alabama	100,662	55,168	-45%	Montana	29,130	14,001	-52%
Alaska	35,544	24,389	-31%	Nebraska	38,592	26,841	-30%
Arizona	169,442	82,851	-51%	Nevada	34,261	16,478	-52%
Arkansas	56,343	28,113	-50%	New Hamp-	22,937	13,862	-40%
California	2,581,948	1,272,468	-51%	New Jersey	275,637	125,258	-55%
Colorado	95,788	27,699	-71%	New Mexico	99,661	67,950	-32%
Connecticutt	159,246	63,589	-60%	New York	1,143,962	693,012	-39%
Delaware	23,654	17,262	-27%	North Carolina	267,326	97,171	-64%
Dist. Of Col.	69,292	44,487	-36%	North Dakota	13,146	7,734	-41%
Florida	533,801	135,903	-75%	Ohio	549,312	238,351	-57%
Georgia	330,302	135,381	-59%	Oklahoma	96,201	13,606	-86%
Guam	8,314	9,550	15%	Oregon	78,419	42,374	-46%
Hawaii	66,482	42,824	-36%	Pennsylvania	531,059	232,976	-56%
Idaho	21,780	1,382	-94%	Puerto Rico	151,023	90,630	-40%
Illinois	642,644	259,242	-60%	Rhode Island	56,560	44,826	-21%
Indiana	142,604	96,854	-32%	South Carolina	114,273	35,721	-69%
Iowa	86,146	52,293	-39%	South Dakota	15,896	6,702	-58%
Kansas	63,783	36,557	-43%	Tennessee	254,818	143,823	-44%
Kentucky	172,193	85,696	-50%	Texas	649,018	343,464	-47%
Louisiana	228,115	79,745	-65%	Utah	39,073	24,101	-38%
Maine	53,873	14,813	-73%	Vermont	24,331	15,528	-36%
Maryland	194,127	70,910	-63%	Virgin Islands	4,898	2,920	-40%
Massachusetts	226,030	93,890	-58%	Virginia	152,845	67,388	-56%
Michigan	502,354	195,101	-61%	Washington	268,927	146,375	-46%
Minnesota	169,744	116,589	-31%	West Virginia	89,039	31,500	-65%
Mississippi	123,828	33,781	-73%	Wisconsin	148,888	37,381	-75%
Missouri	222,820	122,930	-45%	Wyoming	11,398	1,103	-90%
				U.S. Total	**12,241,489**	**5,780,543**	**-53%**

Note: Several states made changes in the definitions of their caseloads - California removed two parent families, Texas added families enrolled during a month, Wisconsin added child only cases.
Source: *U.S. Dept. of Health & Human Services Administration for Children and Families Dec-00*

federal spending relative to GDP, which is a big part of the overall problem under the current system.

The financial savings from these reforms would go a long way toward financing the transition to personal accounts, as noted above. But large personal accounts would also limit the Medicaid block grants to grow no faster than GDP. About half of Medicaid spending is for nursing home care for retirees. With working families reaching retirement with several hundred thousand dollars in their accounts, these families would be able to use part of these accumulated funds to buy private nursing home care insurance to protect the rest of the funds from such costs. As a result, the personal account reforms would effectively privatize most of the nursing home expenditures of Medicaid.

Welfare reform was politically quite popular even in the 1990s. With the astounding success of the AFDC reforms, expanding these reforms should be even more popular. Indeed, these reforms greatly benefit recipients as well as taxpayers, because they get the recipients off of welfare dependency and into work. That greatly expands the appeal of such reform. In fact, Congress did pass block grants for Medicaid in the late 1990s, but the legislation was vetoed by President Clinton.

Tax reform involving a large tax increase is not going to be pro-growth. The extra tax burden would only stunt economic growth through one mechanism or another.

Reform Medicare. Reforming Medicare will be the most difficult politically because the long-term financing gaps under the current system are so huge. But once successes with personal accounts for Social Security and health insurance vouchers and HSAs for Medicaid are firmly established, that creates the opportunity to make fundamental Medicare reform politically viable.

That reform would involve personal accounts for the portion of Medicare financed with the payroll tax. The market returns earned on these accounts over the years would stretch these funds much further. In retirement, the funds from personal accounts would then be used to buy private-sector health insurance chosen by retirees. These personal accounts would have the same effect as personal accounts for Social Security in dramatically reducing federal spending because they would shift a major portion of Medicare spending off of the federal budget to the private sector.

General revenues now used for Medicare would be used for means-tested health insurance vouchers for lower income retirees to help them buy such insurance. Among the options retirees could choose would be HSAs, which again would stretch these funds a lot further, through greatly improved incentives. These general revenue contributions to the program would be limited to grow no faster than the rate of growth of GDP.

These reforms would stop Medicare spending from growing faster than GDP. Medicare would then no longer contribute to increasing federal spending relative to GDP in the future.

Cap Discretionary Spending. Another component of a successful strategy to stop runaway Big Government is to adopt a cap for non-defense federal discretionary spending like the caps on spending in some states under Taxpayer Bills of Rights. Those caps limit state spending to grow no faster than the rate of inflation plus population growth.

Besides just limiting the growth of any federal program under this cap, Congress could adopt more fundamental reforms to reduce the growth of this spending and stay under the cap. Agricultural subsidies could be sharply reduced or phased out. The federal government also spends over $50 billion a year on programs correctly identified as corporate welfare, such as subsidies for overseas investment that outsource American jobs.

Since over the long run the rate of inflation plus population growth is less than GDP growth, this cap ultimately would reduce non-defense discretionary spending relative to GDP.

Pro-Growth Tax Reform. A final component of a comprehensive package would be pro-growth tax reform, such as a flat tax or national sales tax. With a bigger GDP due to the increased growth, federal spending as a percent of GDP would be further reduced. It should be noted, however, that tax reform involving a large tax increase is not going to be pro-growth. The extra tax burden would only stunt economic growth through one mechanism or another. The reform must be revenue neutral at least, and that neutrality should be scored on a dynamic basis, taking into account the increased growth resulting from the reform.

No Substitute for Victory

Through these reforms, Social Security, Medicaid, and Medicare would no longer contribute to increasing federal spending relative to GDP. Instead, federal spending on these programs would be reduced as a percent of GDP. Personal accounts would dramatically reduce spending on these programs relative to GDP, as so much of the current spending would be shifted to the private sector. Altogether, these reforms are estimated to reduce federal spending relative over the long run to less than 15 percent of GDP.

At the same time, these reforms are positive, popular measures, which would make workers, retirees and the poor much better off. Consequently, these measures are politically viable in the real world. This is in sharp contrast to the pain-caucus package of huge tax increases and major benefit cuts, which would be a suicide mission for Republicans. And the pain-caucus approach, moreover, would still sharply increase federal spending relative to GDP rather than reduce it.

The current challenge to conservatives on government spending is very similar to the challenge presented by the Soviet Union in the 1970s. At that time, the Soviets were on the march worldwide. Their economy was failing, but they were focusing their resources on an aggressive military buildup and worldwide expansionism.

After Watergate destroyed Nixon, President Ford's secretary of state Henry Kissinger concluded that we couldn't beat the Soviets. He set about to negotiate an accommodation with the Soviets on the best terms he thought we could get.

But Reagan challenged this view, and argued there was no substitute for victory. This was one of the central themes of his Presidential races in 1976 and 1980. To his credit, Kissinger had come around to this view by 1980 as well. Reagan got the chance to implement his more aggressive approach, and we all know what happened. What we don't remember now is how daunting and impossible Reagan's challenge seemed in the mid-1970s.

Similarly, in regard to federal spending, are we going to try to just negotiate the best surrender to the coming crisis of big government? Are we going to just settle for 30 or 40 percent of GDP in federal spending, and be happy we didn't go to 50 or 60 percent? Or are we going to fight for what we believe in and win?

About the Author

Peter Ferrara is Director of Entitlement and Budget Policy for the Institute for Policy Innovation, and a Senior Fellow for the Free Enterprise Fund.

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Direct inquiries to: **Institute for Policy Innovation**
1660 S. Stemmons Freeway, Suite 475
Lewisville, TX 75067

(972) 874-5139 (Voice) **Email:** ipi@ipi.org
(972) 874-5144 (FAX) **Internet Web site:** www.ipi.org