Health for Sale

By Jeff Madrick

That the US has adopted a more and more constricted view of the uses of government is especially evident in the recent debate over a prescription drug plan for the elderly. After bitter negotiations to reconcile the House and Senate versions of the legislation, a bill was reported on November 17 to Congress for a vote. If it passes, it will be the most expensive addition to federal health care since the 1960s. Even so, at a projected cost of $400 billion over ten years, it is widely considered inadequate. Medicare, the federal health plan for the elderly, now reimburses recipients almost exclusively for drugs administered in hospitals. But the costs of outpatient prescription drugs for the average Medicare beneficiary are reaching punitive levels. Out-of-pocket costs are expected to rise from $644 a year in 2000 to $1,454 in 2006.
Even with $400 billion, the new legislation will reimburse only about one third of the beneficiaries' total out-of-pocket drug costs, and the program will not even begin until 2006. The current bill will also make it possible to impose a limit on future increases in Medicare expenditures and create tax-free savings plans for individuals to pay for private services.

In a clear sign of the times, the new federal program will be administered privately. Both the plan originally passed by the House as well as the Senate plan, backed by many Democrats, had the prescription drugs distributed not by government but entirely by private insurance companies or specialized drug distribution firms. Even Senator Edward Kennedy, long the nation's leading defender of government-run social welfare, agreed to private distribution for the drug plan.

In a different political atmosphere, Kennedy probably would not have taken that position. The government could have administered the distribution of drugs, for example, and reimbursed beneficiaries for their use; it could also have used its buying power to negotiate lower prices for drugs instead of leaving it to the free market. But given the prevailing ideology of the Republicans in control of Congress, Kennedy believes that supporting private distribution of drugs is the only way to get any drug bill for the elderly at all, even if it allocates only half the funds he thinks necessary. "This private-sector delivery system was not the Democrats' first choice, but it was a reasonable compromise with a Republican Congress and a Republican President," Kennedy has said. Some of his Democratic colleagues, such as Senators Jay Rockefeller, John Kerry, and John Edwards, have refused to support the plan. And Kennedy has said he will not vote for a bill that contains a limit on future spending.

The intricacies of such legislative battles as the one concerning drugs for the elderly have distracted Americans from recognizing the scale of change that is now being proposed. Over the last twenty-five years, the attitude that government is often more an impediment to economic growth and social justice than a necessity has taken an ever-deeper hold in America. It is fair to say that a battle to determine the future of America's traditional welfare state is now underway. Always more modest than in Europe, the American "safety net" includes Social Security, unemployment insurance, a minimum wage, Medicare, poverty relief programs like welfare and Medicaid, industry regulations, and at least some support for unionization.

Most of these programs were started during the New Deal and were expanded in succeeding decades. They were painstakingly enacted into law in the face of constant opposition from political opponents and private vested interests. Since Ronald Reagan's presidency, they have been under effective attack. Reagan narrowed the coverage of unemployment insurance significantly and made benefits taxable. He refused to raise the minimum wage, even when consumer prices were rising rapidly. He cut back welfare programs, eliminated
several hundred thousand public service jobs, deregulated industries, and weakened unions. 

Even under the Democratic president Bill Clinton, as the economist Robert Pollin points out, total expenditures of the federal government fell from 21.9 percent of the Gross Domestic Product in 1992 to 18.1 percent in 2000.\(^2\) Military cutbacks made up a large part of this reduction but there were also substantial cuts, as a percentage of GDP, in transportation, education, and welfare. Clinton was constantly battling a Republican Congress intent on further reductions and eliminating some social programs outright, as well as partially privatizing Social Security and Medicare. But his own preference was for a Third Way that would be less dependent on government to guarantee social welfare. One of his proudest achievements was the dismantling of the old federal welfare program by placing time limits on benefits and imposing work requirements to qualify for them.

Today, the Democratic candidates for president continue to argue over who among them is the most profligate, even as they compete with one another to promote the social programs that will have the most appeal to different groups of voters. Joseph Lieberman, who claims to support the Third Way, criticizes Howard Dean for being naively liberal with government money, while many of the candidates have criticized Dean for supporting reduced Medicare spending in the 1990s. Dean often boasts of his balanced budget in Vermont, and criticizes Congressman Richard Gephardt for promising social benefits like an old-style Democrat. Wesley Clark has proposed the only federal program to create jobs directly, costing some $50 billion, by giving tax incentives to employers.

During his presidency, Clinton himself considered partially privatizing Social Security, which essentially meant that government would no longer guarantee full benefits when people retire. Rather, workers would be responsible for investing part of their payroll taxes in individual retirement accounts. Judging by his recent eagerness to place the blame for such scandals as Enron on Republicans in Congress, Clinton also seems to have forgotten how much he deregulated the financial industry himself.

George Bush has vowed to cut back the new welfare program still further. He has resisted the extension of unemployment insurance in the worst job market since the Depression. He has refused to propose full funding for his own federal education legislation, the much-publicized No Child Left Behind plan. Most important, he has cut taxes so deeply that the nation will be unable to pay for adequate new social programs, and very likely for existing ones. The federal budget deficit will probably exceed $500 billion in the coming fiscal year—nearly 5 percent of GDP. Reasonable projections suggest that when baby boomers start to retire in roughly ten years, and the Social Security surplus dissipates, budget deficits will still be high.
A second term for President Bush, plus continued control of both houses of Congress by the Republicans, would likely mean that Social Security and Medicare would be privatized—as Bush promised in his first presidential campaign. We can also expect that Bush will strongly advocate providing private vouchers for education and reducing the regulation of many industries, ranging from natural gas to telecommunications. We saw the true motives of the Bush administration when it decided, under intense political pressure, to propose its own prescription drug plan for the elderly last spring. Bush's original proposal made beneficiaries eligible for new drug benefits only if they signed on to private programs. If they stayed with traditional Medicare, they would receive no drug reimbursement whatever. The administration has since backed off this proposal, but in a second Bush term, it could be revived.

In fact, however, the new prescription drug bill for the elderly also now includes a highly controversial plan to subsidize private health companies to compete with traditional Medicare beginning in 2010. Even though the plan will be tested in only six metropolitan areas, what began as a prescription drug plan for the elderly has been turned into a major revision of the entire Medicare program. Many experts say that the subsidies are designed to drive up Medicare premiums above the cost of private programs, encouraging seniors to abandon it. Senator Kennedy is adamantly opposed to this, but as of this writing the House is holding to its position. "Privatizing the longstanding Medicare benefits for hospital and doctor bills is very different from a distribution system that makes use of the private sector," Kennedy has said. "It's an unacceptable right-wing effort to undermine Medicare and destroy a system that has served senior citizens well for almost forty years. No elderly American should have to choose between the doctors they trust and the medical care they need." Medicare, as we know it, he believes, would be finished.

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One has to wonder how conscious the nation has been of the piecemeal but steady destruction of the commitments to social welfare that the US governments have made beginning a century ago. Many think of these programs as the nation's greatest political achievement. It is true, however, that the nation has become less trusting of government and more parsimonious about social spending. To the extent that there is public discussion of a new government approach to welfare, it has been dominated by slogans like the Third Way and expressions of vehement anger toward government that have had several disturbing sources. One source has been a nostalgic, over-simplified return to America's individualistic national character—thus, we hear exhortations to self-reliance and personal
responsibility as social programs are cut. This excerpt from the introduction to the libertarian Cato Institute's Handbook for Congress in the 1990s is typical:

The "bourgeois virtues" of work, thrift, sobriety, prudence, fidelity, self-reliance, and a concern for one's reputation developed and endured in part because they are the virtues necessary for survival and progress in a world where wealth must be produced and people are responsible for their own flourishing. Government can't do much to instill these virtues in people, but it can do much to undermine them.

Another source of anger toward the government has been a racially prejudiced resistance to social programs that seemed designed to help African-Americans in particular, even though the main beneficiaries of programs like welfare are white Americans.

The political scientist Neil Gilbert, who teaches at the University of California at Berkeley, has long been concerned with providing a clear, consistent, and broad justification for advocating reduced government social policies. He is often cited by proponents of this view as both a disciplined observer and an enlightened advocate. He and his wife Barbara were authors in 1989 of a useful book, The Enabling State, which showed that the US had already adopted a new conception of the role of government based on indirect subsidies such as tax deductions for corporate pension and health care programs, retirement savings programs like Individual Retirement Accounts and 401(k)s, home mortgage interest, and tax credits for the working poor—the Earned Income Tax Credit. When all those were added up, they argued, America's social generosity was considerably greater than recognized.

Last year, Gilbert published Transformation of the Welfare State, which, though objective in tone, essentially provides a theoretical justification for replacing the old welfare systems with his "enabling state," which is very close to the Cato Institute's own philosophy:

The protective blanket of the welfare state has become widely perceived as smothering the vigorous virtues—initiative, diligence, commitment, fair play, and enthusiasm—in the name of charity, patience, kindness, and sympathy. From increasing the age of retirement to narrowing the criteria of disability, from tax credits for the working poor to competitive bidding on social service contracts, the norms and values that frame the design of social welfare policies for the enabling state, in all its renditions, tend to celebrate economic productivity and private responsibility over social protection and public aid.
In this new model of government, according to Gilbert, there is more "steering than rowing." Citizens will take responsibility for themselves through tax deductions and credits, thus avoiding the allegedly debilitating dependencies created by generous, unrestricted government outlays. Gilbert also, where possible, relies on the free market to distribute benefits and create incentives to work, save, and invest. His enabling state is designed to be efficient, keep taxes down, and thus presumably encourage work, investment, and entrepreneurial activity.

Gilbert argues that even the Scandinavian countries, not to mention much of continental Europe and of course Britain, are now discarding the old model and moving toward the enabling state. The Scandinavians, he notes, famously established the purest model of the traditional welfare state after World War II. Benefits in the Scandinavian countries were and, to a large degree, still are provided by direct government outlay, citizens are universally eligible for them, and welfare is seen as a social right, not something to be earned or limited. In general, the objective was to protect labor from the vicissitudes of the market, whose ravages were fresh in the public mind after the Great Depression. As a matter of practice in Scandinavia and other European countries, this has usually meant generous unemployment benefits, retirement pensions, health care, income guarantees, market regulations, and free or low-cost education.

All that is changing, however. Italy, Denmark, Spain, Finland, the Netherlands, France, and Britain, Gilbert writes, have reduced their unemployment benefits or narrowed the coverage. Norway has adopted work requirements for welfare eligibility. Dutch governments have significantly tightened the requirements for disability insurance. Sweden has partially privatized its public pensions by setting aside a portion of payroll taxes for individual investment in retirement accounts. Germany is considering a similar plan, and the World Bank has advocated pension privatization.

But Gilbert admits that he may be overstating the case. Direct social spending in such countries as Germany, Sweden, Italy, the Netherlands, and Denmark remains around 30 percent of GDP, compared to only 17 percent of GDP in the US. Even in Britain, it is about 10 percent higher than in the US. Recognizing this, Gilbert argues that the OECD countries are replacing direct social spending with tax-based programs, just as the US has been doing for decades. These programs are at the heart of his idea of the enabling state and, because they result in lost government tax revenues, many of them are termed tax expenditures. In the US, such "private" social spending, which includes tax deductions for corporate pension and health care benefits, as well as individual retirement accounts and the Earned Income Tax Credit, accounts for 35 percent of all social spending in the nation. It raises overall social spending from 17 percent to 25 percent of GDP.

Gilbert points out that in Denmark, for example, similarly privatized or indirect spending has quadrupled since 1980 as a proportion of all social spending.
Sweden's is up by more than 50 percent in this period. Britain's is up 70 percent. But for all that increase, the proportion of overall social spending remains far smaller than America's. In Denmark, these indirect programs have risen from 1 percent to 4 percent of social spending, in Sweden to 7 percent, and even in Britain, they amount to 17 percent. This hardly supports Gilbert's point that the enabling state is fast becoming the accepted model in Europe.

Nevertheless, both in action and in rhetoric, the old welfare state is under challenge. Why is this so? Gilbert proposes several major causes.
—In Europe, North America, and Japan, populations are aging. This is putting pressure on workers to finance ever-greater public pensions and expanding health and drug programs for the elderly.
—Globalization, according to Gilbert, is forcing governments to cut taxes and social benefits since investors prefer nations with lower business costs.
—There is increasing evidence that unconditional welfare policies diminish the incentive to work. This idea was the foundation of America's much-discussed welfare reform.
—There is a renewed faith in private markets, which Gilbert attributes to the failure of the Soviet Union and to the revival of neoclassical economics, among other factors.
All these claims are familiar but they don't lead inevitably or even desirably to an enabling state. Are reductions in social spending the only effective response to globalization? Is increased faith in private markets warranted by the evidence? Gilbert ignores the most important factor working against welfare—the sharp and completely unexpected slowdown in economic growth across the developed world since the 1970s. This slowdown has resulted in much lower GDP and worker incomes—and hence reduced tax revenues—than were expected when welfare programs were created. Had the twenty-four OECD nations grown 1 percent a year faster beginning in the 1970s, which still would have been considerably slower than their rates of growth in the 1950s and 1960s, taxes as a proportion of GDP would not have risen to a forbidding average of 36.9 percent by 1995—no doubt creating political pressure on social programs. Had Gilbert done some simple calculations, he would have found that the current level of taxes would have come to less than 30 percent. He would have found that it is not overgenerous social programs that are the problem so much as disappointing economic growth.

One question about the new enabling state, then, is what it does to encourage economic growth. Gilbert presents no evidence to support his assertion that enabling states are more productive. He seems to assume that America's economic boom in the late 1990s, and Europe's slow growth, is argument enough that the American system is superior to the European welfare state. The truth is considerably different. As the economists Joel Slemrod and Jon Bakija convincingly show in Taxing Ourselves, there is,
among the OECD nations, no demonstrable relationship between the size of government and economic growth or between the level of taxes and economic growth. The authors show that attempts to prove this relationship simply do not hold up under closer scrutiny.

In Taxing Ourselves Slemrod and Bakija observe that while Sweden has had slow economic growth in recent decades, Norway, a similarly high-tax nation, has grown rapidly. Between 1970 and 1990, the United States grew slowly but a similarly low-tax nation such as Japan grew rapidly; in the 1990s, the reverse was true. In the early 2000s, we now see, low-tax America could not create more jobs, wages have been falling across the board, and the proportion of poor people has again risen sharply.

How can it be that the size of government has so little impact on economic growth? For one thing, the economy is probably more responsive to factors such as new commercial technologies, new products, and rapidly growing markets than to deterrence from taxes or relatively high levels of government spending. For another, claims made by well-known economists such as Martin Feldstein, former chairman of President Reagan's Council of Economic Advisers, that high taxes discourage people from working hard and investing more have not held up. Clinton's tax increases in 1992, which Feldstein and others warned would reduce incentives to work and invest, helped or at least did not impede the economic boom of the late 1990s.

Finally, as Slemrod and others note, the state often spends money in ways that benefit economic growth. Public investment in education, transportation, and other infrastructure sustains economic growth. Programs that help maintain income can at times also support growth by keeping up demand for goods and services. Government spending also contributes to political and economic stability and confidence in the functioning of private markets.

Neil Gilbert also implies that free markets will generally be more efficient at distributing services than direct government spending. No doubt, this is sometimes true, but by no means is it a universal rule. Consider the demand for further privatization of Medicare. Through competition and increased efficiency, privatization would supposedly hold down Medicare costs, which are expected to rise more rapidly than for any other major program over the next thirty years. But as the economists Marilyn Moon and Cristina Boccuti point out in a study for the Urban Institute, spending by private insurers per person has risen 20 percent faster than spending by Medicare since 1970. In a market as complex as health care, with information both scarce and hard to decipher for the average consumer, some regulation and standardization is often useful.

It is true that welfare programs encourage some people to avoid work. But the extent of such effects are usually exaggerated. Clinton's reforms, Gilbert notes, significantly reduced the number of people receiving welfare from more than five million in 1994 to fewer than three million when he left office. Many of these welfare recipients are now working and few would now argue that
welfare should not have been reformed at that time. Work requirements, if not too strict, were generally desirable, particularly if they took account of the needs of mothers with young children. But the experiment, as Gilbert points out, also took place in a strong job market. Moreover, a large proportion of those who left the welfare rolls still live at or near official poverty levels. In short, welfare reform needs itself to be reformed, as Amitai Etzioni writes in a foreword to Gilbert's book, because it has gone too far:

Throwing mental patients, alcoholics, mothers with small children, or anyone else onto the streets and cutting off their benefits is not compatible with treating all people as ends in themselves.

Bush wants to make welfare still tougher. Gilbert, for his part, utterly ignores the rising inequality of incomes that have accompanied the enabling state. It is no small irony that in America in particular, the leading "enabling" state in the world, incomes and wealth have become much more unequal over the last thirty years. The number of Americans without health insurance has risen to more than 40 million; educational quality is highly unequal as well, and in many urban neighborhoods utterly inadequate. Child poverty remains the worst among the OECD nations while measures of health, such as infant mortality, though improved, are still near the bottom among advanced nations. For most workers, moreover, wages have fallen, stagnated, or grown at historically slow rates, and a huge proportion of African-American men are now in prison. Meanwhile, the rapidly rising costs of education, health care, public transit, and drugs have made life much harder for middle-income families. Gilbert discusses none of this in adequate detail.

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In his new book, The Divided Welfare State, Jacob S. Hacker, a Yale University political scientist, analyzes how the United States’ increasing reliance on private welfare has further scaled back what were already the least-generous social services in the developed world. Americans, he suggests, are largely unaware of this. The United States, he notes, "is the only affluent capitalist country that does not guarantee universal or near-universal health insurance," yet

the litany of complaints that flood today's headlines and airwaves suggests just the opposite: that government is too big, overbearing, and expensive; that it does too much at too high a cost and does it badly.
Tax deductions for corporate pension and health care benefits alone result in lost federal tax revenues of $200 billion a year. But only about 16 percent of workers with earnings in the bottom quintile of the nation—the lowest 20 percent—receive pension benefits, and only 24 percent receive health benefits. By contrast, some 50 percent of workers in the third quintile receive pension benefits and 60 percent health benefits. In the top quintile, roughly 70 percent of workers receive pension and health benefits. Similarly, the tax deduction for home mortgage interest, amounting to more than $50 billion of lost tax revenues, is tilted toward the well-off. IRAs and 401(k)s, which provide tax deductions for voluntary retirement savings, also favor the better-off, especially as corporations replace defined benefit plans, which provided pensioners a set income each year, with plans requiring pensioners to invest on their own, for better or worse. This is regressive social policy in the extreme. The Earned Income Tax Credit is one of the programs for tax benefit that reduce inequality, but it is a decided exception. As Hacker points out, there is a close correlation between privatizing social spending and income inequality in the nations of the OECD.

The case for reforming the traditional welfare state should rest on better arguments than those that have so far prevailed. Two concerns remain undeniable. First, aging populations present a serious challenge to all developed nations. There will inevitably be significantly fewer workers relative to pensioners in coming decades unless nations encourage significantly more immigration of young workers. The elderly will be living longer as well, as geriatric medicine becomes more advanced and therefore more expensive. Second, slow economic growth is reducing the tax revenues available for social welfare. People will naturally resist paying more taxes unless they believe social programs are just and benefit most of the population. There are more imaginative and effective responses to these changes, however, than the enabling state praised by Gilbert. Consider the future of Social Security. Robin Blackburn, who was the editor of the New Left Review for years and is a professor at both New York's New School University and the University of Essex, differs from many of his liberal colleagues in his approach to the aging population. While he acknowledges that many observers have exaggerated the future costs of Social Security, he maintains in his new book, Banking on Death, that these costs are forbidding enough that it is imperative to start saving right now to meet them. But he would do this collectively, not through privatization. Privatization, he argues, will create still further inequality; the poorer worker will have a harder time investing his or her privatized pension, and many will invest badly.

Blackburn sees the solution in an enlightened government program of pre-funding, a program similar to those advocated by some moderately liberal American economists, like Henry Aaron of the Brookings Institution. The Social Security system will eventually have a deficit each year (unless the nation's
economy grows much faster) as payments to retirees exceed income from payroll taxes when the baby boomers retire. But right now, because of the baby boom, many more workers pay payroll taxes than collect benefits, producing a surplus that is being used by the Bush administration to meet the other expenses of the federal government. If the surplus is set aside and invested in equities and bonds, the nation could more readily meet its future obligations. In the 2000 campaign Al Gore promised to set aside the surplus, as did George Bush, if less emphatically. Instead, the Bush administration is simply using the surplus to close the budget gap, as has been the case for years now. Blackburn would not stop there, however, as advocates of pre-funding usually do. He reminds workers that Wall Street and the big banks now invest the tens of billions of dollars in their pension funds and other savings in the private economy as they see fit. Recent performance suggests that they often do not do this wisely. He believes these funds should be used to support collective investment in better mass transit and other infrastructure, as well as education and other public goods that would stimulate economic growth. One possibility, he argues, is to have private pensions buy government bonds whose proceeds would be set aside specifically for such public purposes. There are already examples of such arrangements in other countries.

Blackburn’s views seem to me refreshing. His book is not only an excellent comprehensive history of social security programs in the developed world. It acknowledges that there are real strains on the old welfare state and proposes interesting ways to handle them that do not resort automatically to simplistic formulas of privatization. The nation badly needs such an open debate over its public purposes, not the narrow arguments we have been hearing in favor of the enabling state or a Third Way. Liberals, for example, should acknowledge that labor should be willing to accept new technologies and retraining and that high payroll taxes and corporate benefits can inhibit investment in new business ventures. But instead of cutting back Social Security benefits, we might provide fully portable pension and health care benefits that workers could take from job to job and use to protect them from the more erratic job market and global competition. We might reduce payroll taxes to encourage corporations to hire more people. The loss of revenue could be made up by raising corporate income taxes or the personal income taxes paid by more prosperous citizens. Similarly, workers might be more tolerant of free trade if we better protected the unemployed. The beneficiaries of capital flows around the world are often Wall Street companies, such as Goldman Sachs and Morgan Stanley, that provide financial services. Those companies could pay higher taxes in order to support workers who suffer job losses as a result of globalization; they would benefit at the same time by increasingly liberalized capital and trade flows.
Finally, perhaps the biggest question the US should face is whether it is capable of seriously considering a single-payer federal health insurance system to cover all Americans. Such a system is not perfect but works reasonably well at a significantly lower cost per patient in Canada and other countries. The inefficient hybrid system we now have is so costly that it could eventually ruin the economy. Contrary to the promises of its advocates, the enabling state neither automatically promotes economic growth nor enhances the social welfare. It appeals to voters who think their taxes will go down and to powerful corporations who think they will make greater profits from presiding over an increasingly privatized welfare system. The nation has on the whole been worse off as a result.

—November 17, 2003

Notes

[1] The original House and Senate versions differed substantially. In the new compromise bill, the government would pay 75 percent of all out-of-pocket drug costs up to an annual maximum of $2,200 after a deductible of $275 and a monthly fee of $35. It would pay nothing again until annual out-of-pocket costs reach $3,600, after which it would pay 95 percent of the remainder.


[4] See the most recent survey by the Organization for Economic Cooperation and Development (OECD).

[5] In a paper reviewed by his peers for the Brookings Institution, Slemrod carefully worked through the existing analyses to show how tentative they were. For a comprehensive and more technical summary see Joel Slemrod, "What Do Cross-Country Studies Teach About Government Involvement, Prosperity, and Economic Growth?" Brookings Papers on Economic Activity, No. 2 (1995), pp. 373–431.
