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Whither the welfare state? The macroeconomics of social policy

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The Jerome Levy Economics Institute of Bard College

Public Policy Brief

Whither the Welfare State? The Macroeconomics of Social Policy

Jamee K. Moudud
Ajit Zacharias

No. 61, 2000

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Preface

The idea that saving is the force driving private investment and economic growth has become ever more entrenched in mainstream economic thought as well as in the minds of policymakers and the general public. According to this argument, public sector spending—especially for social programs—produces a drag on economic activity and reduces economic performance below what it would be if those same dollars were spent in the private sector. Consequently, if public policy is used to stimulate economic growth, it should aim to both reduce public sector spending and stimulate household saving; such policies would lead, so the argument goes, to more funds accumulating in financial institutions, which, in turn, would lend to firms for investment purposes. Higher rates of investment would then stimulate growth.

Although empirical evidence that increased household saving will directly stimulate private investment and economic growth is scant, the idea remains prominent and underlies policy debates on topics ranging from Social Security to a balanced federal budget to reducing the national debt. Indeed, the argument that public spending was putting future U.S. economic growth at risk is one of several reasons used to justify the present fiscal stance that reduces expenditures that maintain the social safety net.

In this brief, Moudud and Zacharias counter popular theory underlying these cuts by showing that private sector investment is financed primarily out of business retained earnings, not bank credit; this explains why current policies aimed at raising household saving via cuts to social spending programs have been unsuccessful at raising saving rates. The authors also find that government spending on social programs does not necessarily reduce economic growth. They suggest instead that higher government spending

can be supported, and a greater degree of investment spending can be stimulated, through a combination of lower taxes on business income and higher taxes on personal incomes of upper-income households.

I trust that you will find the analysis of Moudud and Zacharias a thorough and insightful comment on the debate about the role of the federal government in helping or hindering private sector investment and growth. As always, I welcome your comments.

Dimitri B. Papadimitriou, *President*

November 2000

Whither the Welfare State?

Over the last three decades, the institutions of social insurance and government spending devoted to the maintenance of the social safety net—generally referred to as the welfare state—have become one of the most contentious areas of debate in public policy. In recent years most countries in the Organization for Economic Cooperation and Development (OECD), with institutional structures as diverse as the United States and Sweden, have rolled back the welfare state. The rationale given by mainstream economists for these austerity measures is that the welfare state has been a drag on economic activity and has reduced economic performance. Thus, it is held, cutbacks are necessary to raise economic growth and lower unemployment or, in the case of the United States, to maintain high future growth rates. Social transfer expenditures, such as unemployment insurance and income transfers to the poor, the elderly, and the indigent, are the primary targets in this new social policy orientation (Atkinson 1999).

Until the mid 1960s a broad consensus held that some optimal combination of social justice and economic efficiency could be attained. This particular approach to social policy was consistent with the Keynesian approach to macroeconomic management that was dominant at the time.¹ This consensus began to unravel, however, with the onset of worldwide economic crises in the 1970s and the demise of Keynesianism. Since the 1970s the conventional wisdom has held that at some fundamental level, the pursuit of policies that reduce social inequalities conflicts with the logic of capital accumulation and the resulting gains to long-term growth.

As articulated in an important document of the European Union, prepared by Jacques Drèze and Edmond Malinvaud, the current mainstream standpoint rests on three main objections to welfare programs: 1) They introduce labor market distortions. 2) They increase the level of government spending and the rates of taxation needed to fund such spending, both of which reduce the efficiency of the private sector. 3) They lead to rising deficits and public debt.

The first objection stems from the mainstream view of the labor market as a perfectly competitive market that ensures full employment. Unemployment insurance or other forms of income support introduce distortions that lead to inefficiency. The other two objections follow from the standard mainstream analysis of government spending. A rise in the budget deficit needed to finance welfare provisions stimulates household consumption and leads to a fall in the household saving rate. Lower household saving raises the interest rate and lowers (“crowds out”) investment, thus reducing economic growth. A reduction in welfare expenditure therefore will, other things remaining the same, increase saving, investment, and growth. The proposed solution is to make the welfare state “leaner and more efficient” (Drèze and Malinvaud 1994, 83).

This brief demonstrates that increasing household saving may not stimulate growth and that rolling back the welfare state in the United States has not succeeded in raising household saving. We argue that since investment is financed primarily out of the retained earnings of businesses rather than out of household saving, policies to stimulate investment may not conflict with maintaining a robust welfare state. To make our argument, we first examine mainstream analysis of the welfare state, as articulated by Feldstein (1974, 1976, 1995, 1996) and Atkinson (1999). Although these two authors represent opposing views on the welfare state, they still can be considered variants of the mainstream paradigm, which helped discredit the Keynesian social policies implemented during the “golden years” following World War II. We take issue with the authors’ shared assumption of full employment and attribution of a paramount role attributed to household saving in determining economic growth. We argue that contrary to their theoretical perspective, unemployment is a persistent feature and underutilized capacity a recurrent one in a market economy.

Second, we suggest that higher government spending can be supported and a greater degree of investment spending can be stimulated through a combination of lower taxes on business income and higher taxes on the personal income of upper-income households and certain types of financial market transactions. This conclusion is based on an alternative growth perspective, rooted in the tradition of classical economists and Sir Roy Harrod, developed by Shaikh (1989, 1991, 1992), and extended by Moudud (1999b).²

Third, we examine the extent to which the mainstream objective of cutting back the welfare state has achieved the stated goal of raising the private saving rate and find that it has failed miserably. We suggest that the attacks against the welfare state in the United States should be seen as part of the general weakening of labor in its interaction with management during the 1980s and 1990s (Moody 1988; Harrison and Bluestone 1988), which has contributed to a decline in the share of wages in national income and played a crucial role in raising the economy's long-run profitability.

We do not claim that appropriate policy levers can always control and steer the economy toward desired progressive policy objectives. The margin of maneuver of progressive economic and social policies will, in the final instance, be determined by the structural imperatives of a market economy. The extent of the margin within which such policies are likely to be effective depends crucially on the time and the place and is difficult to gauge on purely theoretical grounds. Our analysis of policy options is therefore aimed not at producing blueprints but at presenting some of the possibilities and limits of progressive policies.

Macroeconomics and the Welfare State: The Mainstream Perspective

Household saving plays a key role in mainstream macroeconomics. Thus, it is not surprising that in Feldstein's analysis of Social Security, he investigates the impact of Social Security benefits on household saving (Feldstein 1974, 1976, 1995, 1996). A central concept in his work is *social security wealth*, the value today of Social Security benefits that the

current adult population will receive at age 65 minus the value today of Social Security taxes that they will pay before reaching that age. Feldstein finds that Social Security wealth functions much like private sector wealth in that it stimulates private sector consumption and thereby lowers private sector investment. He also argues that the greater the difference between what beneficiaries receive in benefits and what they pay into the system as taxes (the replacement rate), the greater the disincentive for households to save. Feldstein's solution is to privatize Social Security so that private funds would be mandatorily invested in private capital markets, stimulating private saving and capital accumulation.

Feldstein (1974, 1976) also discusses the impact of business saving on private investment. He concludes that an increase in retained earnings by businesses raises the value of their shares. The resulting increase in capital gains boosts private consumption, assuming that households are able to learn immediately of firms' decisions about retained earnings. Thus the fall in personal saving partially offsets higher business saving, so that private investment does not get a sufficiently large boost.

Feldstein's analysis does not consider the independent effect that retained earnings might have on business investment, despite numerous studies that show the crucial importance of this variable (see Blecker 1997 for a summary of this literature). Further, he provides no mechanism by which households might learn immediately of firms' decisions about retained earnings. Moreover, he implicitly assumes that national income is at the full employment level, since only then can a rise in the level of consumption be translated into a fall in household saving. This continuous full employment assumption is, of course, standard to the neoclassical perspective, but it raises the question about its realism. Finally, it is not clear why a fall in the household saving rate necessarily implies a decline in the social saving rate, since it has been shown that businesses adjust their retained earnings to meet their investment needs.

The Economic Consequences of Rolling Back the Welfare State by Anthony Atkinson (1999) is an important contribution to a growing literature critical of contemporary social policies. It is not, however, critical of Feldstein's analysis. Atkinson warns his readers at the outset that his

book “does not attempt to determine whether or not spending should in fact be cut” (1999, 3); his main goal is to point out that the welfare state can make both positive and negative contributions to efficiency and economic performance. Thus, spending cuts may well raise more problems than they were intended to solve.

The thrust of Atkinson’s criticism is directed toward the mainstream model of a perfectly competitive economy in which all markets clear. He contends that since the real-world economy departs from this model, the impact of the welfare state is more complicated than the standard finding of unambiguously negative effects. Put simply, Atkinson points out some of the countervailing factors that may operate so that the long-run growth rate does not rise when social spending is scaled back.

What is the impact of social transfers according to Atkinson? The salient point to note is that the existence of a government retirement benefits program (or any similar social insurance system) reduces aggregate saving and therefore the long-run growth rate of the economy. The rationale is the same as in the case of Feldstein, that is, the fall in saving increases the interest rate, which lowers investment.

Atkinson argues, however, that it does not follow that a cutback in a government pay-as-you-go retirement program will necessarily raise the long-run growth rate. Suppose the pay-as-you-go program is replaced by a means-tested program in which the level of government benefits provided is kept unchanged for those with no other resources but is reduced progressively for those with other income sources. Such a program would still serve as an antipoverty measure while allowing public expenditure to be scaled back. The disadvantage, Atkinson argues, is that such a program might provide a disincentive for some people to save: they could reduce their saving to zero and rely on the government benefits. Thus, a means-tested program might have uncertain net effects on saving and therefore on long-run growth.

As with other mainstream analyses, Atkinson’s arguments do not consider that since a pay-as-you-go program is financed by taxes on wage income, there is no necessity at all that the *social* saving rate would be

adversely affected. The impact on the social saving rate would depend as well on the saving propensities of wealthy non-wage-earning households and of firms, which choose their saving rate on the basis of objectives that are very different from those of households. This is a common problem with mainstream analyses, which are based on an undifferentiated household sector (that is, do not distinguish between the saving propensities of wage and nonwage income earners) and make no distinction between personal and business saving.

What, Atkinson asks, about a completely privatized retirement benefit system? From the mainstream perspective, a privatized system would have the dual positive effects of reducing government expenditure and infusing more private funds into the capital market; the additional injection of saving would lower interest rates and fuel new private investment. Here again, Atkinson argues that the final outcome of privatization may be more uncertain. His basic argument is that a tension might exist between the objectives of corporate managers, who seek to maximize the long-term growth of investment, and those of pension fund managers, who seek to maximize share values. The increased ownership of shares by pension funds might therefore influence the objective of corporate managers with the effect that long-run growth is, at least to some extent, sacrificed. While this may be a legitimate concern, it is doubtful that it is empirically relevant. The bulk of corporate investment in the OECD countries is financed by retained earnings, not by issuing equity or by borrowing from the credit markets. Insofar as the United States is concerned, an examination of flow of funds data for recent years shows that nonfinancial corporations have been *net* purchasers of equity.

The core theoretical framework that Atkinson uses in his analysis of the welfare state is questionable. The complete absence of money and uncertainty in the Keynesian sense in this framework removes the possibility for any imbalance to arise between the saving decisions of households and the investment plans of firms.³ Yet in a world characterized by Keynesian uncertainty, a rise in household liquidity preference could make households hoard their money (either as liquid bank deposits or government bonds) rather than purchase risky private securities. Thus, whether household saving is affected by a particular welfare policy, it is not at all

obvious that there has to be a one-to-one and direct correspondence between the saving decisions of households and business investment as mainstream theory suggests. Put differently, if the means-tested program does succeed in raising the social saving rate by boosting household saving, the additional saving could end up as higher bank deposits rather than as higher equities holdings. One does not have to invoke the mechanisms discussed by Atkinson to raise questions about the mainstream belief that higher household saving will raise the long-run growth rate.

Mainstream authors would counter this line of objection by arguing that even if the additional household saving ends up as higher bank deposits, banks will automatically loan them out to firms. Yet a critique of this automatic mechanism has been one of the most significant contributions of the Post Keynesian and endogenous money schools (Moore 1988; Wray 1990; Palley 1996), which have argued that the supply of credit to finance investment depends on the demand for credit and thus, in the final instance, on the rate of investment growth.

This line of argument also suggests that privatizing Social Security may not affect capital accumulation at all, if, faced with declining corporate profitability and a weak stock market, private pension fund managers choose to invest in more liquid, short-term financial assets rather than in long-term capital investments. This becomes particularly relevant in the late expansion–early recession phase of a business cycle, when interest rates on bonds and deposits are high and the rate of profit is low.

With the notable exception of the United States, the discussion of social insurance policies in the two decades or so after World War II generally took place within the context of macroeconomic policy (Skocpol 1987). As Harris (1941) points out, there was the “need for a study of social security that would utilize the recent developments in theory and especially in the fields of money, fiscal policy, and economic fluctuations” (cited in Atkinson 1999). It was recognized that the pursuit of social insurance policies killed two birds with one stone: it satisfied the goals of social justice and that of full employment through demand management policies. Lord Beveridge’s *Social Insurance and Allied Services* (1942) and *Full Employment in a Free Society* (1944) can be seen as mutually complementing plans. In fact, as Peacock (1952) points out, social insurance policy was subsumed

under the demand management policies of the state. Not surprisingly, the influence of Keynes was central to this dual policy goal.

The British government had a strong commitment to full employment and activist policies; the American version of Keynesian policy was much milder. With the severe downturn of the 1970s, however, Keynesian policies of every color came under attack. Not surprisingly, the breakup of the Keynesian consensus coincided roughly with the dismantling of the welfare state over the next three decades. Faltering economic growth and inflation in the 1970s made it the conventional wisdom for commentators of diverse political persuasions that there is a trade-off between long-run economic growth and social policy.

The rise to dominance of this point of view was to a large extent due to the emphasis on the short-term in Keynesian theory. Demand management as practiced in the 1950s and 1960s was far from adequate in dealing with the deep economic crisis of the 1970s. The replacement of Keynesian macroeconomics by supply-side macroeconomics shifted policy discourse away from demand management to the study of various supply-side measures that can be used to raise the long-run growth path of the economy.

Austerity is the key policy implication of this supply-side approach. Lucas (1990) argued that the best tax policy for an economy along a balanced growth path with a balanced budget is for all revenues to be raised from labor income (wages and salaries) and none at all from capital income, including capital gains. According to his own conservative estimates, such a policy would “more than double the annual growth rate of capital” (1990, 314). The rationale for balanced budgets and contractionary fiscal policy follows from analyses such as his: “. . . such an enormous capital expansion requires a *long period of severely reduced consumption* before the long-run gain can be enjoyed” (1990, 314, emphasis added).

Both the short-term nature of the old Keynesian policies and the unrealistic assumptions at the core of supply-side policies point to the need for an alternative perspective. Such a framework has to be able to analyze both the short-run fluctuations and the long-run determinants of economic activity. Moreover, it has to begin with what are surely the driving forces of capital accumulation: investment and profitability.

Macroeconomics and the Welfare State: An Alternative Perspective

Our perspective is one in which growth and cycles are generated by factors internal to the market economy (that is, they are endogenous). Two aspects of the framework are particularly pertinent to the discussion of the welfare state. First, wages are determined primarily by institutional and historical factors, not solely by market forces. Thus, flexible wages do not act, as in the mainstream perspective, as an automatic mechanism that equates supply and demand and leads to full employment. Second, because all economic decisions are made under uncertain conditions, underutilized capacity and business cycles are endogenous and recurrent features of a market economy. In a decentralized market economy, there is no direct coordination between the buyers and sellers of goods and services. Hence the matching of supply and demand occurs through a trial and error process. These two aspects of the framework imply that increased government spending on social programs will both lower the rate of unemployment by injecting demand and provide a safety net for those who are unemployed. These positive effects can be amplified by expansionary monetary policies. Thus, the rationale for demand management policies is still valid, but these policies must be discussed in a growth context.

In mainstream models, saving decisions by households drive long-run growth; this is so because the economy's total public and private saving determines interest rates and investment. According to our perspective, interest rates are not determined by the supply and demand for savings. Savings do matter, though for different reasons. As Moudud (1999b) discusses, the two key determinants of long-run growth are *profitability* and what we call the *investable surplus*. By profitability, we mean the ratio of surplus product to capital invested. Loosely speaking, the surplus product is the portion of net national output that is left after deducting employee compensation; it may be thought of as the National Income and Product Accounts (NIPA) category of property-type income. (A more precise definition is given later on.) We show that what is important for capital accumulation is not aggregate saving but the investable surplus, which is that portion of business and household saving that is available for investment in the business sector after the rest of the savings of these two sectors have been set aside as money and bonds (see appendix).

Further, we consider household saving as a *residual* element rather than a determinant of growth. The source of household saving is wage and dividend payments by businesses, which are thus subsumed under business investment and profitability. Our view is consistent with the empirical finding that business retained earnings constitute the single most important source of finance for investment for most OECD countries (Ruggles and Ruggles 1992; Corbett and Jenkinson 1989). Curiously, mainstream theory and policy remain fixated on household saving.

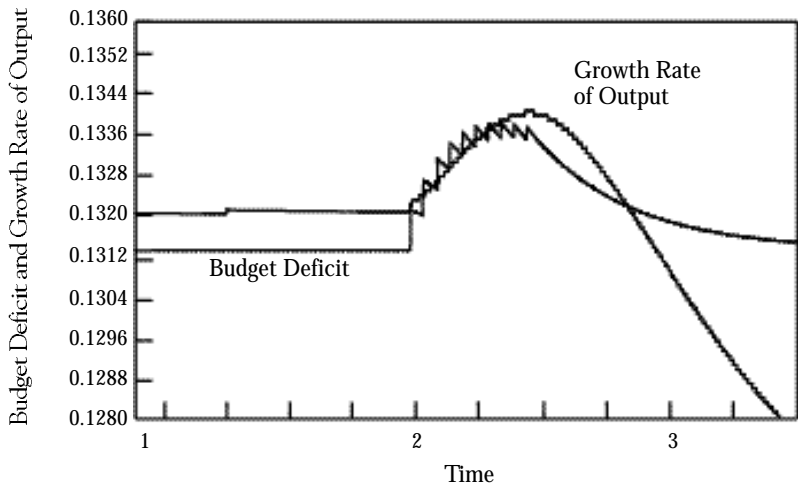
Crucial to our argument is the distinction between the level of government spending (the dollar value of spending) and the share of government spending in total output. If total output is fixed at a certain level, a permanent rise in the level of government spending implies a permanent rise in its share of output. With continuously growing output, however, the level of government spending must increase at the same rate as output in order to keep constant the share of government spending in output.

One important implication of this distinction is that a one-time rise in government spending does not per se tell us whether the investable surplus has been affected over the long run. This is because with growing output, the share of government spending in total output will fall back to its initial level. Other things being equal, the share of the investable surplus in total output will thus remain unchanged in the long run. In contrast, the mainstream perspective holds that a rise in the level of government spending necessarily implies a rise in its share in output because output is continuously at the full employment level.⁴ Hence, in the mainstream perspective, a rise in the level of government spending lowers output growth in the long run (Moudud 1998, 1999a).

It is quite curious that this distinction between the level of government spending and its share in growing output is completely missing from the mainstream fiscal policy literature that uses a growth framework (Lucas 1990). It is even more curious that Atkinson (1999) recognizes that such a distinction needs to be made, yet does not deal with its implications.

What is at stake is not a mere mathematical relationship. If the private saving rate is given, a rise in the share of government (consumption)

Figure 1 The Effect of an Increase in the Level of Government Spending on Short-Run Growth

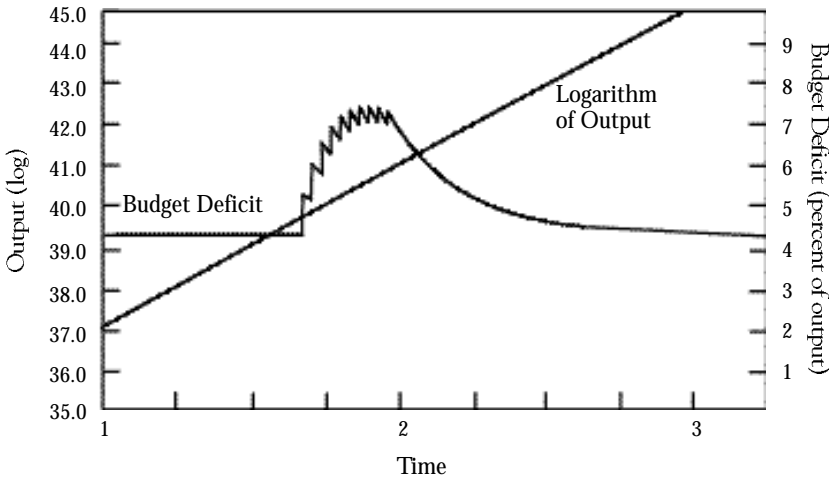


Note: Simulation is based on hypothetical data. The budget deficit is expressed as a share of output.

expenditures results in a decrease in the share of the surplus product that is available to finance private investment (Shaikh and Tonak 1994). The fall in the investable surplus lowers long-run output growth, although there is a short-run boost to output. This result, however, is not inevitable in our view.

Figures 1 to 3 simulate the effects of an increase in government spending on the level of output (Y) and its rate of growth (Y/Y). Figures 1 and 2 show the effect of an increase in the level of government spending. Because output grows continuously, an increase in the share of government spending in national output will be only temporary. Thus, the budget deficit as a share of national output ($g - t$, where g = share of government spending in output and t = taxation rate) will increase for a span of time. Because of underutilized capacity in the short run, there will be a temporary acceleration of output relative to its trend. The long-run effect will be nil, however, because the jump in government spending will die out, since output grows continuously. In other words, if social spending is increased in steps that are spaced by appropriate intervals, all of its benefits can be captured without any negative long-run consequences.

Figure 2 The Effect of an Increase in the Level of Government Spending on Long-Run Growth



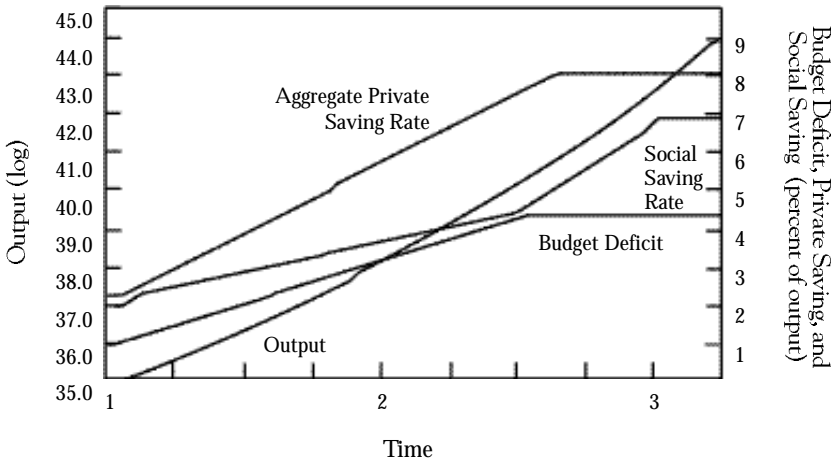
Note: Simulation is based on hypothetical data. The budget deficit is expressed as a share of output.

The simulations in Figures 1 and 2 were done by holding the private saving rate constant. Suppose, however, that appropriate policies are implemented to stimulate the growth of business retained earnings. This policy would allow the budget deficit to rise while the investable surplus remained constant or increased (see Figure 3). The rise in the aggregate private saving rate, s , would allow the budget deficit, $(g - t)$, to rise at a slower rate, thereby allowing the investable surplus, $s - (g - t)$, to rise. An increase in the investable surplus will, over the long run, entail an injection of cash into the business sector and will, other things being equal, stimulate investment. Output growth will therefore increase.

Policies to raise business retained earnings include measures to lower the tax burden on corporations, such as investment tax credits, lower rates of corporate taxation, and accelerated deductions for capital depreciation (Fazzari 1993), and higher taxes on other kinds of capital income, such as capital gains taxes and STETs (securities transactions excise taxes).⁵

Would an increase in capital gains taxes have a negative effect on private investment? Careful empirical studies on the determinants of investment seem to suggest that it would not (Fazzari 1993, Fazzari and

Figure 3 The Effect of an Increase in the Social Saving Rate on Long-Run Growth



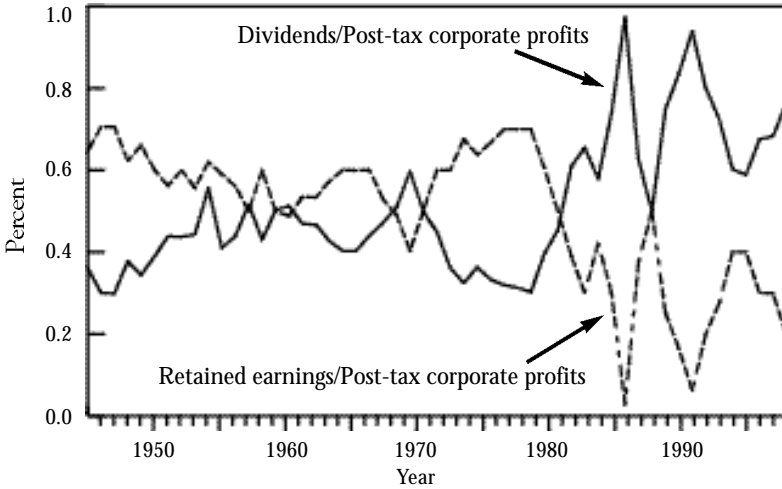
Note: Simulation is based on hypothetical data.

Herzon 1996). The studies show that the growth of demand and profitability (retained earnings) is the most powerful determinant of investment. The effects of cost of capital changes, such as those from a capital gains tax, are weak. One would similarly expect the effects of a STET to be weak; first, because a low tax on securities transactions will have only a small effect on the cost of capital, and second, because the cost of capital effects on investment are minor.

Finally, Feldstein (1974) reports that since the introduction of Social Security in 1937, rising marginal personal income tax rates have induced companies to reduce dividend payments and increase retained earnings. Feldstein (1970) finds similar evidence for British firms. Pechman (1987) shows that for the period 1929 to 1986, high taxes on regular personal income stimulated lower dividend payout rates.⁶

Figure 4 plots retained earnings and dividends as shares of the taxable profits of nonfinancial corporate businesses for the period 1946 to 1998. One important pattern stands out. For the period 1946 to 1980, the retained earnings share was around 60 percent, and the dividends share was around 40 percent. By the middle of the 1980s, a dramatic shift had

Figure 4 Retained Earnings and Dividends (Percentage of Post-Tax Profits of Nonfinancial Corporate Businesses)



Source: Haver Analytics.

occurred: the dividends share rose to around 80 percent, and the retained earnings share fell to around 20 percent. One important reason for the shift may have been the dramatic tax cuts received by wealthy households during the first Reagan administration (as Feldstein and Pechman argue). Put differently, firms retained a greater proportion of their profits when tax policy was more progressive, that is, when upper-income households paid higher tax rates. Significantly, since 1995 there has been a reduction in the retained earnings share and a rise in the dividends share.

The shift in the share of retained earnings points to the sensitivity of the dividend payout rate to household taxes. It suggests that if the dividend payout rate does indeed fall as a consequence of higher taxes on households receiving dividends, then such a taxation policy is a powerful lever that can be used to raise the growth rate of investment. This line of argument suggests that the portion of the surplus product that flows into wealthy households as dividends and net interest earnings and into the financial sector should be partly redirected to the productive sector of the economy that is the source of the surplus product.⁷ Thus, our tax policy proposal (for example, to increase capital gains taxes and institute STETs) would reduce to some degree luxury consumption by wealthy

households and speculative activities in the financial sector. Such a policy would have the effect of increasing the total amount of saving available to firms to devote to investment.⁸

Our proposal that certain kinds of taxes could support government spending without hampering investment is hardly novel (Gramlich 1992; Pechman 1989; Pechman and McPherson 1992; Peterson 1991). Among other measures, Gramlich (1992) suggests raising revenues by levying energy taxes and taxes on externalities and by closing tax loopholes (for example, eliminating the deduction of mortgage interest on the personal income taxes of wealthy households and deductions on fringe benefits).⁹ He quotes a Congressional Budget Office study that estimated that the complete removal of 14 such loopholes in 1993 would have increased government revenues by \$137 billion, or 2.1 percent of the GNP.

Pechman's seminal work on tax policy is particularly interesting, as his concern is with a tax structure that would support government social policy and also raise the social saving rate. Pechman uses a definition of income that includes nonwage income (such as capital gains and gratuitous receipts such as transfer payments, gifts, and inheritances). He recognizes that special provisions such as "tax expenditures" and other loopholes lead to a considerable loss of government revenue and shows that the tax base could be widened in a number of ways. A tax levied on a more comprehensive definition of income would be progressive and would raise additional revenues so as to lower the budget deficit.

To summarize, our perspective suggests that the long-run rate of growth can be raised even if the government budget deficit is growing, provided the social saving rate rises. Such a policy strategy will be successful only if the profit rate is either steady or increasing, however. Had it been implemented, it could have been successful in the post-Reagan era, during which the profit rate rose. The limitation of this policy is that its success appears to depend on the extent to which the underlying profitability of the economy is healthy.

How would our policy proposals change if the economy were to enter a recession that coincided with the collapse of the long-run profit rate and the level of profits? Efforts to raise the social saving rate will be of limited

use; indeed, with the appearance of underutilized capacity, such policies would probably do more harm than good. In these circumstances, expansionary fiscal policies are called for in order to stimulate effective demand. As Post Keynesian authors have argued, a growing welfare state will also stimulate consumer spending and thereby sustain demand.

Further, such expansionary measures should be accompanied by higher levels of spending on public investment on infrastructure as well as a greater degree of spending by the public sector on goods and services. By exploiting the links between public and private investment (Erenburg 1993; Dalenberg and Eberts 1992; Morrison and Schwartz 1992; Nadiri and Mamuneas 1991), such measures might act as complements to the private sector's endogenous attempts to raise the profit rate.

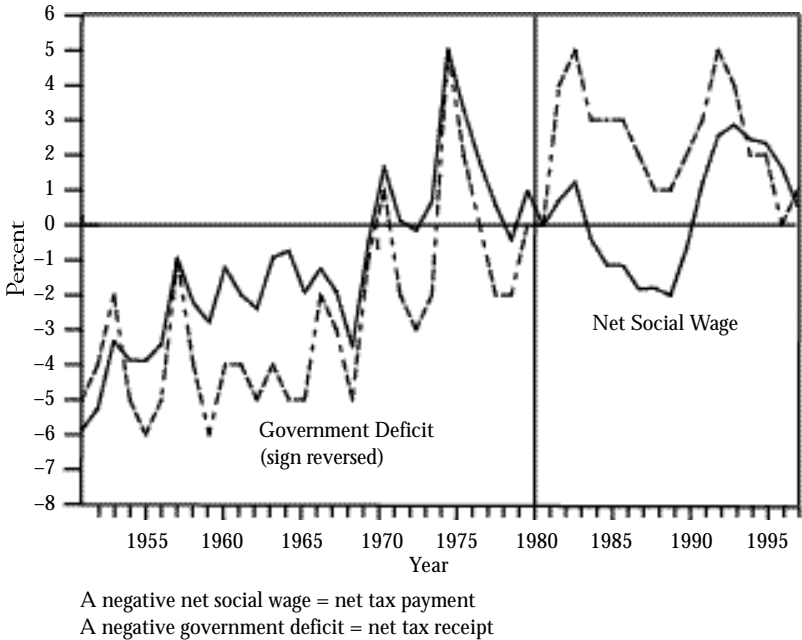
Recent Social Policy: Rhetoric and Reality

Our framework suggests the rationale for active public policies during economic upturns *and* downturns in order to stimulate growth and provide a social safety net for the unemployed and the poor. In recent years, however, the trend in the United States has been toward regressive social policies favoring a pattern of private sector capital accumulation that has produced rising inequality along with growth.

We have pointed out that most conventional analyses argue that increases in social spending have negative effects on long-run growth: Social expenditures lower government saving and thus lower households' saving. Since private investment is primarily financed by household saving, increased social expenditure will have a negative effect on private capital accumulation and growth.

Is this argument supported by the macroeconomic experience of the United States in the last 20 or so years? We think not. In this section we attempt to show that rolling back the welfare state has not stimulated household saving. The main effect of rolling back, we argue, has been to contribute to a weakening of labor's bargaining strength and thus to a lowering of the share of wages in national income.

Figure 5 Net Social Wage and Government Deficit: 1952–1997
(Percentages of Employee Compensation)



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

As a first step in examining the conventional position, let us note that the relevant quantity here is the amount of social expenditure less the amount of taxes that may be considered as supporting such expenditures (Shaikh and Tonak 1987).¹⁰ The portion of total government expenditure received by labor can be estimated by summing all government transfer payments and other social expenditures directed toward labor. The tax base for these expenditures can be estimated as the sum of payroll taxes and other tax payments that originate from employee compensation. Since the second component on the expenditure side and the second on the tax side cannot be observed directly, Shaikh and Tonak estimate them by assuming that the share of labor in both is the same as the share of employee compensation in total personal income. The difference between the benefits received by labor and the taxes extracted from labor by the state is called the *net social wage* (Shaikh and Tonak 2000). If the net social wage is positive, then labor is receiving more in government

benefits than what it is paying in taxes; if the net social wage is negative, then labor is paying more in taxes than it is receiving in benefits.

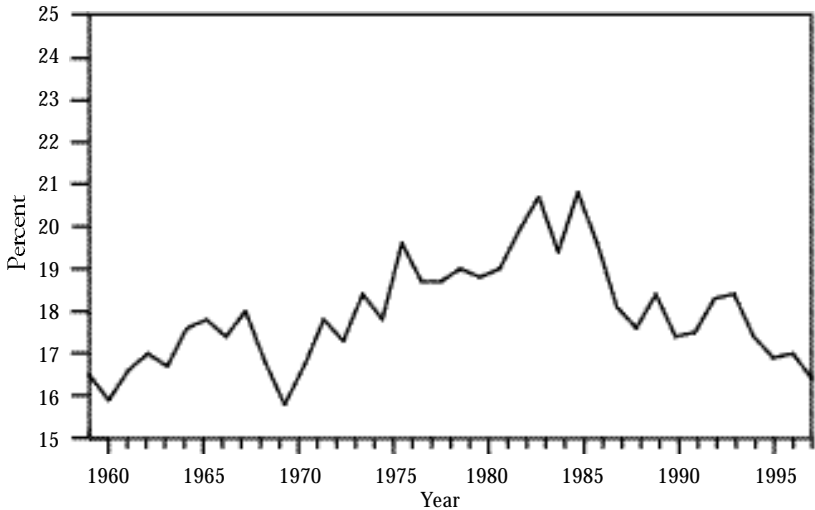
Figure 5 shows movements in the net social wage and the government budget deficit, as percentages of employee compensation. (The government deficit is shown with the sign reversed, so as to make it consistent with the sign convention for the net social wage. Therefore, budget surpluses lie below the zero line and budget deficits lie above it.)¹¹

Several things in this figure stand out. First, the net social wage was negative during the 1950s and 1960s, suggesting that the rapid expansion of benefits that took place then was financed solely by taxes on labor income rather than on property-type income. In fact, wage and salary earners, by virtue of their status as net tax payers, contributed substantially to the government surplus during this period.

Second, the slowdown in growth and rising inflation of the 1970s presented a severe test for the expansion of government social programs as the social wage turned generally positive. The maintenance of the social safety net via a net transfer from the government to wage and salary earners and those without jobs was at least partly responsible for the reduction in government surpluses and the expansion of deficits in 1971 and between 1975 and 1976.

Third, the popular and academic rhetoric surrounding reductions in social spending during the Reagan-Bush years was based on the premise that dangerous runaway deficits and mounting public debt were being caused by rises in such spending. In reality, government deficits soared as a result of increased military spending and tax breaks to the affluent. The cuts in social spending resulted instead in keeping the net social wage negative during much of the 1980s, implying that the deficit spending of those years was partly subsidized by wage and salary workers. The net social wage became positive again in 1991, but the current cyclical expansion, which began in 1992, and “welfare reform” are driving it, along with the government deficit, down to zero.

According to the mainstream macroeconomic perspective, limiting the growth of social expenditures is bound to have a beneficial impact on private saving, thereby contributing to higher long-run rates of investment

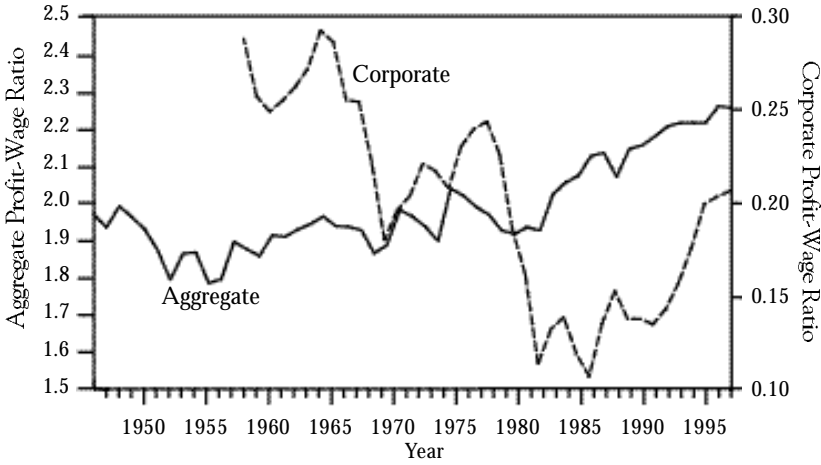
Figure 6 Private Saving: 1959–1997 (Percentage of GNP)

Source: Haver Analytics.

and growth. But, as Figure 6 shows, the private saving rate was rising during the period in which the net social wage was rising rapidly. On the other hand, the growth of the net social wage during the last 20 or so years has been virtually zero (though with cyclical variations), despite this being roughly the period in which there has been a dramatic decline in the private saving rate. These facts immediately raise a key question regarding the effects of dismantling the social safety net: If this dismantling has not succeeded in promoting the virtue of thrift, what has it done?

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

Figure 7 Aggregate and Corporate Profit-Wage Ratios: 1947–1997

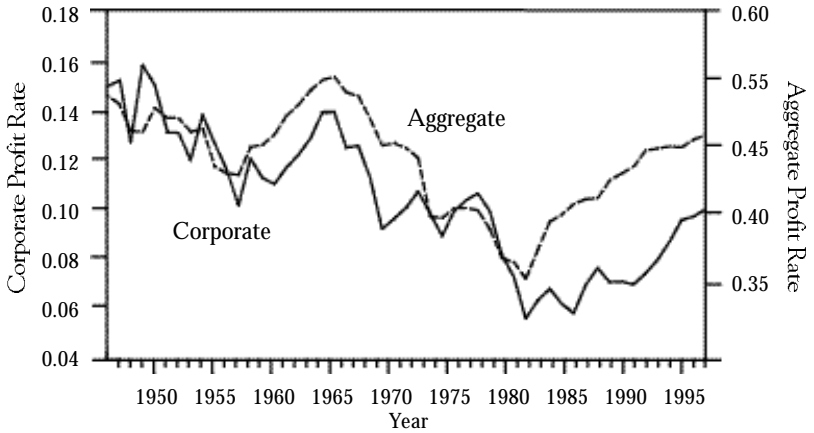


Source: Authors' calculations based on data from the Bureau of Economic Analysis. The data are available at <http://www.bea.doc.gov/>

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

game” has been a general weakening of the bargaining power of labor (Moody 1988; Harrison and Bluestone 1988).

A manifestation of the general weakening has been a pronounced change in the distribution of income between capital and labor in favor of capital. From our perspective, the appropriate way to assess the distributional change is to examine how the aggregate surplus product produced by labor engaged in surplus-producing, production activities has changed relative to the total compensation received by labor in the same activities. Since data on these variables for the recent years are not yet available, we approximate the ratio of the surplus product to employee compensation of productive labor using a well-known method (Shaikh and Tonak 1994, 144–146). The result of our computations is shown in Figure 7, labeled as aggregate profit-wage ratio. For comparative purposes,

Figure 8 Aggregate and Corporate Profit Rates: 1947–1997

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

Note: (1) Aggregate profit rate is the ratio of aggregate profits (as defined in the note to Figure 7) to the current-dollar value of the net fixed capital stock in the entire economy. (2) Corporate profit rate is the ratio of corporate profits before taxes to the current-dollar value of the net fixed capital stock in the corporate sector.

Figure 7 also shows the ratio of pretax profits to employee compensation in the corporate sector, labeled as corporate profit-wage ratio.

The change in the ratios over time is striking. From the early 1980s the aggregate profit-wage ratio shows a substantial acceleration, and the corporate profit-wage ratio moves steadily upward. As is to be expected, the rise in the profit-wage ratios has contributed to a dramatic rise in profitability for the overall economy as well as for the corporate sector (see Figure 8). Using a familiar technique of decomposition (for example, Wolff 2000, 12), we have estimated the contribution of the share of profits in output and of the output-to-capital ratio to the rise in profit rates since 1982. We found that the rise in profits share was the dominant factor in raising the profit rates, accounting for 55 to 57 percent of their increase. The increase in the output-to-capital ratio, reflecting both a rising capacity utilization rate and technological change, accounts for the remaining portion of the change in profit rates.

To summarize, the recovery and expansion in the United States in the Reagan-Bush-Clinton era has been accomplished mainly by the rise in

profitability. Limiting the growth of social expenditures since the early 1980s has not contributed to the economic expansion through the channels indicated by the mainstream perspective (that is, by raising the private saving rate). The rollback of the welfare state has contributed decisively, however, to transforming the institutional environment in which capital and labor interact. The strengthening of the relative position of capital has been accompanied by a steady decline in the share of labor in net output, and this decline accounts for a large portion of the rise in profitability. Social policy pursued through the 1980s and 1990s is thus a reversal of the social policy of the 1950s and the 1960s, which was oriented toward building a set of rules and institutions that provided protections for labor and stood against the socially undesirable consequences of the capital accumulation process.

The framework of today's social and fiscal policies also poses worrisome implications for the downswing that is bound to follow the current expansion. The dismantling of the social safety net implies that during the downswing, government social expenditures are likely to expand more slowly than they have during prior downturns, with a correspondingly smaller (percentage) decline in the budget surplus. The countercyclical effects of the government budget will therefore also be weaker than they have been in the past. If this is accompanied by other policies aimed at fiscal austerity, the net effect of the budget will be to allow for a deeper recession.

Such policies will do harm in the short run without remedying the long-run structural causes of the downswing. They will deepen the recession by slashing aggregate demand. Cuts in public investment may reduce future private investment and thereby lower long-run growth. Cutting the budget deficit will not raise the long-run rate of profit, which regulates the long-run growth rate, but it will exacerbate poverty and inequality in both the short and the long run.

Conclusions

Perhaps the main lacuna in the debate between the Keynesian and the mainstream camps about fiscal policy in general and welfare spending in particular is that each side emphasizes the importance of one arm of the

process of accumulation. For the Keynesian camp, short-run or cyclical demand factors are crucial, whereas for the mainstream camp, supply-side factors are. Thus, the Keynesian camp emphasizes the negative effects on demand that result from cutbacks to social programs, whereas the mainstream camp emphasizes the positive effects on growth that result from an increase in saving.

Our perspective recognizes the importance of *both* demand- and supply-related factors. As Minsky (1986) asserted, when the economy is in a downswing, increases in demand via government spending play a crucial role in providing a “floor” to recessions. When the economy is operating close to its trend growth rate (when there is no excess demand, and capacity utilization rate is at the normal level), the social saving rate is of central importance. Social spending policy should deal with both of these poles of the accumulation process.

Our view of the long run, however, differs from the mainstream perspective not only in terms of what the mainstream omits but also in fundamental ways. First, what matters for investment is not aggregate saving but investable surplus. In principle, both household and business portfolio decisions are of equal importance in determining the finance needed for investment. In practice, the saving needed to finance investment comes mainly from business retained earnings and not from household saving. Expansionary monetary policies, which lower the rates of return on bank deposits relative to the rate of profit on real investment, are likely to help increase the flow of investable finance to the business sector.

The flow of investable finance can also be increased by raising the proportion of retained earnings in total profits. The logic behind this is that if costs and the rate of profit are fixed in the long run, then higher growth rates of output can be obtained only by increasing firms’ retained earnings. The importance of businesses’ utilizing internal finance for investment (as opposed to their financing investment by borrowing) raises the possibility of using tax policies aimed at raising business retained earnings to stimulate long-run growth. Pechman’s (1989) comprehensive income tax proposals and Shaikh and Tonak’s (1994) analytical framework on the distribution of the surplus product provide the inspiration for policies to stabilize or increase the investable surplus. Our

point is that this variable can be kept constant or increased by raising taxes on upper-income households and certain financial market transactions and by closing tax loopholes. Such measures would also allow government spending to rise with higher taxation revenues or a growing rate of business retained earnings or both.

Alternatively, periodic increases in the *level* of government spending rather than its *share* in output would provide a demand stimulus and leave both the investable surplus and the long-run growth path unchanged. With no change in tax policy, such periodic increases in government spending would provide all the positive Keynesian benefits without any of the negative long-run effects predicted by the mainstream.

Stimulating the investable surplus might be of limited use when profitability has collapsed. The appearance of underutilized capacity under these circumstances would require expansionary fiscal policies, and efforts to stimulate long-run growth could include a higher degree of productive public investment.¹²

The second fundamental way in which our perspective differs from the mainstream is that we argue that the economy can be on or near its long-run growth path at normal capacity utilization and still experience unemployment. Thus, provided that wage growth does not exceed productivity growth, the long-run growth rate can be increased without any inflationary consequences.

We are critical of the welfare reform measures enacted in the 1990s, especially the Personal Responsibility and Work Opportunity Act. The long boom of the U.S. economy does not provide any economic justification for the social retrenchment measures enacted. In our opinion, budget surpluses should be used to finance public sector investment projects, increased public education, and a national health care program. Although government spending on welfare does constitute a deduction from the annual surplus product, public policy should take advantage of the current boom and budget surplus to help unemployed and underemployed people develop genuine and advanced skills that will assist them in finding good jobs in the private or public sector. Instead of the draconian measures currently employed, such alternative policies would not only “get people off welfare”

but would also lead to greater social equity. Equally important, if such labor market policies are accompanied by industrial policies to stimulate productive investment in *both* the private and public sectors, long-run macroeconomic gains will also result.

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

Appendix

Let f stand for firms and h for households. By considering the capital account of the business sector (Moudud 1999b), it can be shown that business investment, I , is financed by the sum of (a) business saving less money and bond holdings, (b) equity finance, and (c) bank credit.

$$(1) \quad I = [S_f - (\Delta M_d + \Delta BN_G)_f] + \Delta EQ + \Delta D_B$$

where S_f = business saving

M_d = money holdings

BN_G = government bonds

EQ = equity

D_B = bank credit

Δ indicates change.

Equity is related to household saving and money and bond holdings by

$$(2) \quad \Delta EQ = [S_h - (\Delta M_d + \Delta BN_G)_h]$$

Combining equations 1 and 2 we get

$$(3) \quad I = [S_f - (\Delta M_d + \Delta BN_G)_f] + [S_h - (\Delta M_d + \Delta BN_G)_h] + \Delta D_B$$

In a closed economy, when aggregate demand equals aggregate supply

$$(4) \quad S - (G - T) = I$$

where S = aggregate private saving = $S_h + S_f$

$(G - T)$ = budget deficit

Thus, combining equations 3 and 4, we get social saving

$$(5) \quad S - (G - T) = [S_f - (\Delta M_d + \Delta BN_G)_f] + [S_h - (\Delta M_d + \Delta BN_G)_h] + \Delta D_B$$

As shown in Moudud (1999b), the growth rate of output, Y , is given by

$$(6) \quad g_Y = \chi [s - (g - t) - a_f]$$

where g_Y = output growth

χ is a constant

$s - (g - t)$ = social saving rate = $[S - (G - T)]/Y$

a_f = the ratio of investment in fixed capital to output.

Now, dividing equation 5 by Y we get

$$(7) \quad s - (g - t) = [S_f - (\Delta M_d + \Delta BN_G)_f]/Y + [S_h - (\Delta M_d + \Delta BN_G)_h]/Y + \Delta D_B/Y$$

The expression $[S_f - (\Delta M_d + \Delta BN_G)_f]/Y + [S_h - (\Delta M_d + \Delta BN_G)_h]/Y$ is what we call the investable surplus, as it represents the amount of cash that firms have available to finance investment. Equations 6 and 7 show that, other things being equal, an increase in the investable surplus would raise the growth rate. Of course, an increase in the flow of credit, $\Delta D_B/Y$, would also do so; however, this would increase firms' burden of debt and financial fragility.

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Notes

1. We use the adjective "Keynesian" in the conventional sense throughout this paper. In recent years, a few authors have forcefully argued that Keynes's own views on macroeconomic policy had a decidedly long-run orientation and were not confined to short-run demand management issues. Our views on macroeconomic policy are closer to what we see as the original Keynes than to the Keynesians. See Kregel (1985), Brown-Collier and Collier (1995), and Crotty (1999).
2. The formal model underpinning our evaluation of social policy is the classical-Harrodian model of cyclical growth developed by Shaikh (1989) and extended by Moudud (1999b). This framework provides an alternative to mainstream analyses, which assume continuous full employment and make rational optimizing behavior by individuals and household saving the drivers of economic growth. Given that mass unemployment and excess capacity are recurrent features of the economy and that business retained earnings are the most important source of investment, the additional significance of the classical-Harrodian perspective is that it provides a rationale for Keynesian-type social policies.
3. In Keynes's view future economic events are uncertain in that "there is no scientific basis on which to form any calculable probability whatever" (cited in Rousseas 1986, 17). The representative agent methodology, which underpins neoclassical models, finesses "problems of coordination emphasized by Keynes and other macroeconomists—between investors

and savers, borrowers and lenders, capitalists and workers” (Haliassos and Tobin 1990, 909).

4. That is,

$$\frac{C}{Y_f} + \frac{I}{Y_f} + \frac{G}{Y_f} = 1$$

where C = consumption, I = investment, G = government spending, and Y_f = full employment level of output. Thus an increase in the proportion of government spending out of output, $g = G/Y_f$, is indistinguishable from an increase in the level of government spending, G .

5. These measures to raise taxes on capital income are fundamentally opposed by Lucas (1990), who argues that all forms of taxing capital income should be abolished to maximize growth.
6. Although these higher retention rates were given a further stimulus by investment tax credits and generous depreciation allowances.
7. Though the simulation involving a rise in the level of government spending does not necessitate any of the above taxation policies, since over the long run the social saving rate remains unchanged.
8. Equities channel a portion of personal saving to the business sector via the stock market, whereas a taxation policy that lowers dividend payout rates would bring about this allocation more directly.
9. Some of these tax shelters are quite remarkable. Pechman mentions two examples. One is the so-called Mayer amendment enacted in 1951. Its purpose was to provide capital gains benefits for a lump sum distribution to Louis B. Mayer after he retired from the movie industry. Since the amendment could not mention him by name, it was worded so as to apply to a movie executive who (a) had been employed for 20 years, (b) had held rights to future profits for 12 years, and (c) was entitled to receive a share of profits for life or for at least five years after the termination of his employment. The other example is an amendment submitted by Congressman James Burke of Massachusetts to provide a 7 percent tax credit for the purchase of garden implements so as to “encourage private production of food.” The garden tools amendment was removed, but the fate of the Mayer amendment is not clear.
10. The government expenditures and taxes referred to here are the combined federal, state, and local expenditures and taxes.
11. We wish to thank Anwar Shaikh and Ahmet Tonak for making their data available to us. The analysis in the following three paragraphs draws heavily from Shaikh and Tonak (2000).
12. We use the word “productive” in the sense that it is used in classical economics (Shaikh and Tonak 1994); that is, it describes all those activities that generate a surplus.

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