

THE NEXT SOCIAL CONTRACT

An American Agenda for Reform

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NEXT SOCIAL CONTRACT INITIATIVE

NEW AMERICA FOUNDATION



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Next Social Contract Initiative

The Next Social Contract Initiative aims to fundamentally rethink our inherited social contract, the system of institutions and policies designed to empower and support citizens from childhood and work through retirement. Inspired by the premise that economic security and opportunity are mutually reinforcing, a new social contract should foster innovation and entrepreneurship, encourage long-term growth and broadly shared prosperity, and engage individuals and families not only as participants in the economy but also as citizens.

The Next Social Contract Initiative has produced papers, articles, slideshows, and events on America's adaptation to a changing economy, redesigning our key public social programs, and policy ideas to better achieve outcomes based on foundational principles of our democratic republic.

This paper is the culmination of the ideas and themes of the Next Social Contract Initiative and aims to reframe the current debate on American economic security and opportunity toward a new social contract that will allow widely shared prosperity and security for all Americans.

<http://nsc.newamerica.net>

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PART ONE

The Crisis of America's Social Contract

The American social contract is in crisis. Even before the Great Recession exposed its inadequacy, it was clear that the existing American social contract — the system of policies and institutions designed to provide adequate incomes and economic security for all Americans — needed to be reformed to meet the challenges of the twenty-first century. What is needed is not mere incremental tinkering, but rather rethinking and reconstruction. Policies that have worked should be expanded, while others that have failed should be replaced. The result should not be just a modification of today's partly failed economic security system, but a substantially reformed system incorporating the soundest elements of the old — a new social contract for a new America.

The American Social Contract: From the Industrial Era to the Information Age

The social contract can be thought of as a system of economic security and adequacy based on three elements: wages, income maintenance programs and “merit goods,” or goods which all citizens should have but which are undersupplied by the private sector.

Modern social contracts or compacts have been a response to the challenges of industrialization and urbanization. In one country after another, as soon as the majority of farmers was replaced by a majority of urban workers selling their labor in manufacturing or service industries, older systems of means-tested “poor relief” and rural family support networks were overwhelmed. In the industrial economies, mass unemployment caused by business cycles, financial crises and depressions could not be blamed on the moral failings of individuals, and inadequate response by government led to widespread hardship and threatened unrest or revolution.

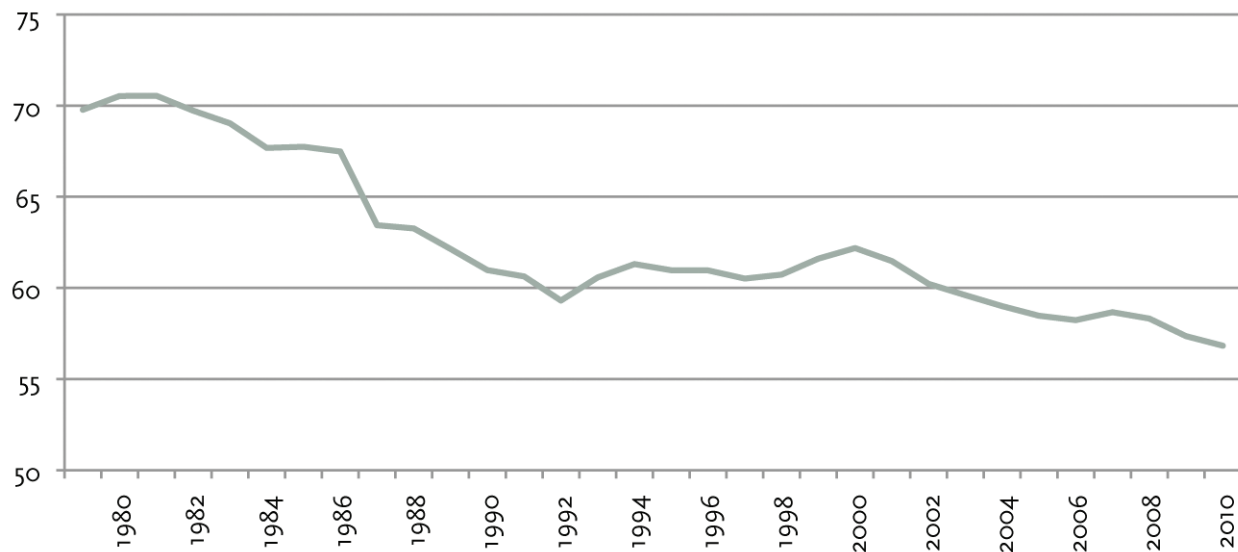
For these reasons, every modern society has some kind of social contract designed to cushion the majority of its people against the blows of economic forces. Industrialized nations have experimented with different methods of providing the wage-earning majority with a minimum of economic security.

One approach in the U.S. was sponsored by elements of the business community in the early twentieth century and is sometimes known as “welfare capitalism.” As an alternative to government benefits and minimum wages, American business leaders including the conservative Henry Ford and the progressive Gerard Swope of General Electric favored paternalism by companies that would not only pay decent wages but also provide health insurance, pensions and in some cases child care.

Franklin Roosevelt's National Industrial Recovery Act (NIRA) encouraged each industry to create its own industry-wide minimum wages and benefits so that generous, paternalistic companies would not be undercut by rivals that paid low wages and provided no benefits. Although the NIRA did not survive, elements of welfare capitalism like tax-favored employer-based health insurance remain important to this day.

After the Supreme Court ruled the NIRA unconstitutional in 1935, Congress tried another approach: public social insurance. The Social Security Act (SSA), passed in 1935, created systems of unemployment insurance, means-tested federal assistance to the poor, and a universal public pension, called Old-Age, Survivors, and Disability Insurance or OASDI, which came to be known as “Social Security.” Later expansions of social insurance include Medicare, Medicaid and SCHIP.

Figure 1: Share of Workers with Employer-Provided Health Insurance, 1979-2010



Source: John Schmitt and Janelle Jones, Center for Economic and Policy Research, from Current Population Survey, March 2012.

In the last decades of the twentieth century, economic and demographic changes eroded the employer-based and family-based elements of the mid-century social contract. Pressured by growing global competition and deregulation, employers retreated from providing health insurance and pensions. At the same time, the entry of most mothers into the workforce created the need for more child care and elder care. Meanwhile, the public social insurance component of the American social contract proved to be the most stable and efficient element.

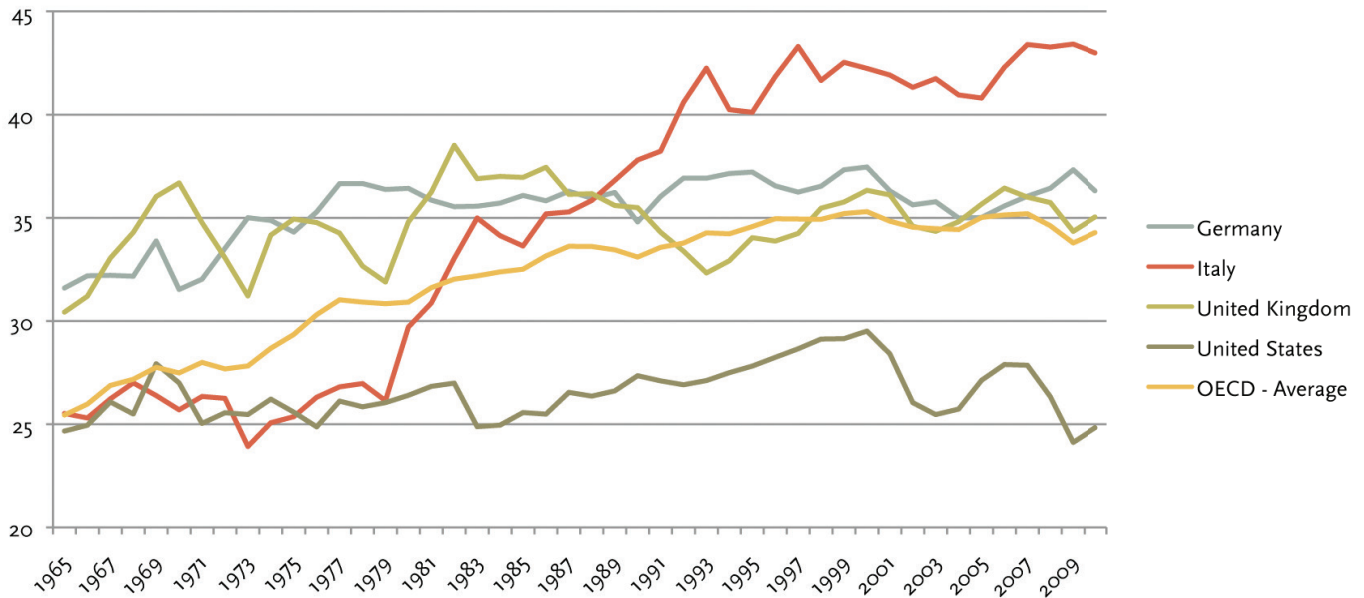
Instead of compensating for the decline of employer-based benefits and family-based care by an expansion of social insurance, however, Congress adopted a third approach to the provision of income maintenance and merit goods: individual tax expenditures. Influenced by neoliberal economic theory, a bipartisan consensus held that the best way to provide merit goods to Americans was not the direct public provision of income maintenance and merit goods by public agencies, but rather their indirect provision by means of voucher-like tax credits and tax-favored private savings accounts. According to the theory, the creation of artificial markets in these areas would combine universal access with cost restraint, as competition among providers for vouchers would drive costs down.

Policymakers in both parties relied heavily on tax expenditures to strengthen all three parts of the social contract:

wages, through wage subsidies (the Earned Income Tax Credit); social insurance, through subsidies to individuals for health insurance and retirement savings (employer-based health insurance, 401(k)s and IRAs); and merit goods, through tax subsidies for the private purchase of higher education, housing and child care. Although President George W. Bush's push for partial privatization of Social Security failed, the neoliberal approach prevailed in the design of the Affordable Care Act of 2010, better known as "Obamacare." Combining an individual mandate to buy private health insurance with means-tested subsidies delivered through the tax code, the ACA rejected the alternative of universal public social insurance or public health care provision and replaced one private welfare state approach — employer-based benefits — with another private welfare state approach — tax-credit vouchers.

The extreme reliance on tax-favored private spending in order to provide social goods makes the U.S. an outlier among advanced industrial democracies. Between 1965 and 2010, tax revenues in other developed countries as a share of GDP have risen from an average of 25 percent in 1965 to 34 percent in 2010. In the same period, however, combined federal-state-local tax revenues in the United States have stayed flat: they were 24.7 percent of GDP in 1965 and 24.8 percent in 2010. Of industrial nations, only Mexico and Chile have lower shares of GDP going to government.¹

Figure 2: Total Tax Revenue as a Percentage of GDP



Source: OECD Revenue Statistics.

The United States collects substantially less tax revenue than other advanced economies and the OECD as a whole.

As this history shows, the American social contract does not reflect a single public philosophy. Instead, it is the result of contests among conflicting approaches, favored at different times from the 1930s to the early twenty-first century. The economic security system for Americans is partly public, consisting of purely federal social insurance (Social Security and Medicare) and federal-state hybrid social insurance (Medicaid, unemployment insurance, SCHIP). And it is partly private, including what Christopher Howard has called a “hidden welfare state” that uses the tax code to subsidize purchases of privately-provided health insurance and retirement assets.

The structure of the American social contract must be reviewed and evaluated in light of a number of trends that are transforming the economy and society of the twenty-first century United States:

The service sector workforce. More than eight in ten American workers is employed in the service sector,² and the proportion is likely to grow further as a result of automation in goods-producing industries. While professional service jobs are often well-remunerated, much of the service sector workforce labors in menial jobs for low wages and no benefits.

An aging population. The aging of the population is not a demographic disaster, but something to be welcomed. However, a lower worker-retiree ratio will require adjustments to be made in America’s system of providing for workers and retirees alike.

Working parents. While the mid-twentieth century American social contract was based on the assumption that home-makers would be responsible for child care, today over 70% of mothers of children are in the workforce.³ Arrangements for child care and family work policies have not caught up with this social trend.

Uneven sharing of the gains from growth. In the last quarter century, many of the gains from economic growth have gone to a tiny number of individuals, while incomes and total wealth for many Americans have stagnated or declined. This represents a dramatic change from the mid-twentieth century, when all classes in the U.S. shared the benefits of economic growth.⁴

The United States is a rich country that will steadily grow richer as a result of productivity growth, notwithstanding the crisis of the Great Recession and its aftermath.

America can afford decent wages and an adequate safety net for all of its citizens. The question is how to provide these necessities to citizens in ways that are fair, efficient and economically sustainable.

The American Social Contract: Failures and Successes

The existing social contract in the U.S. is an incoherent and inefficient blend of inherited programs and policies that reflect six major approaches to providing adequate wages, economic security or merit goods: labor market regulation, federal social insurance, public provision, means-tested in-kind benefits, federal-state social insurance, and tax expenditures for employer and individual benefits.

Existing Methods of Providing the Social Contract

Labor market regulation (minimum wages and maximum hours laws, immigration quotas)

Federal social insurance (Social Security, Medicare)

Public provision (public K-12 schools, public colleges and universities)

Means-tested, in-kind benefits (food stamps)

Federal-state social insurance (unemployment insurance, Medicaid, SCHIP)

Tax expenditures for employer benefits (employer-provided health care, pensions), for individual benefits (individual health insurance tax credits, the child tax credit, the earned income tax credit, IRAs and 401(k)s) and for lending programs (home loans, student loans)

Of these six methods of providing adequate income, economic security and merit goods, the first three — labor market regulation, public provision, and universal federal social insurance — are the simplest, fairest and most efficient. All of the other approaches create inefficiencies, perverse incentives and sometimes uncontrollable costs. Many of these design defects have been exposed by the Great Recession.

Inefficient Approaches

Means-Tested Programs

Of the various methods of providing for economic security, means-tested programs, often known as “public assistance” or “poor relief,” are the oldest, antedating the Industrial Revolution. For centuries in Western Europe and its colonial offshoots, local governments as well as religious and secular charities provided safety nets for the poor.

Means-tested poor relief has usually been controversial and unpopular. Members of the working class and middle class who have been ineligible for poor relief have resented the resources going to the poor. Because of their political unpopularity, means-tested programs have typically been inadequately funded. As the saying goes, “Programs for the poor are poor programs.”

In addition to suffering from insufficient funding, means-tested programs tend to be intrusive and paternalistic. Eligibility for public assistance is often determined by humiliating investigations into personal and family wealth and work history, designed to deter free riding at the expense of taxpayers. When means-tested poor relief takes the form of cash grants, they are often conditioned on certain kinds of behavior, on the theory that the poor lack discipline and need to be compelled to change their lifestyles. And when means-tested programs take the form of public employment or “workfare,” the wages are often sub-par and the work unattractive in order to encourage the poor to find jobs in the private sector.

In many democratic countries, the general public has preferred that means-tested benefits for the poor take the form of in-kind benefits, like food-stamps and public housing, which only provide funding for specific items. In-kind benefits are yet another kind of behavioral policing, ensuring that the poor will have access only to socially-approved goods.

In short, means-tested economic security programs, if they are to obtain the support of the majority in democratic countries, are almost always designed to be humiliating, intrusive, punitive and manipulative, in order to reassure taxpayers that the poor are being disciplined and that the taxes of the majority are not being wasted on the undeserving. The result can be a vicious circle, in which a system designed for stigmatization and punishment alienates the poor, whose alienation in turn creates contempt toward them by the majority.

Federal-State Social Insurance

“Cooperative federalism” is the term for programs that are administered concurrently among different levels of government. Examples of cooperative federalism include hybrid federal-state social insurance programs like Medicaid, SCHIP and unemployment insurance. Often these federal-state partnerships operate by encouraging states to spend money on particular social purposes in order to obtain federal matching grants.

In prosperous times, this system generally works. During economic downturns, however, states face an impossible dilemma. As tax revenues dry up, the demand for welfare benefits from these programs increases. Worse, while the federal government can run deficits, 49 out of 50 states have “balanced budget agreements” that force them by law to balance the budget every year.⁵ This is the situation today: in the wake of the Great Recession, state governments are still looking at more than a \$55 billion shortfall in FY2013 (up from more than a hundred billion in preceding years) and are being forced to lay off teachers and other employees, cut benefits, and raise taxes in an effort to balance their budgets.⁶

The federal government can help out when times are hard, and it has assisted states and local governments in paying

for Medicaid and unemployment in the last few years. But federal support for state programs can often be too small, meaning that America’s system of social welfare is not the automatic stabilizing mechanism it ought to be.

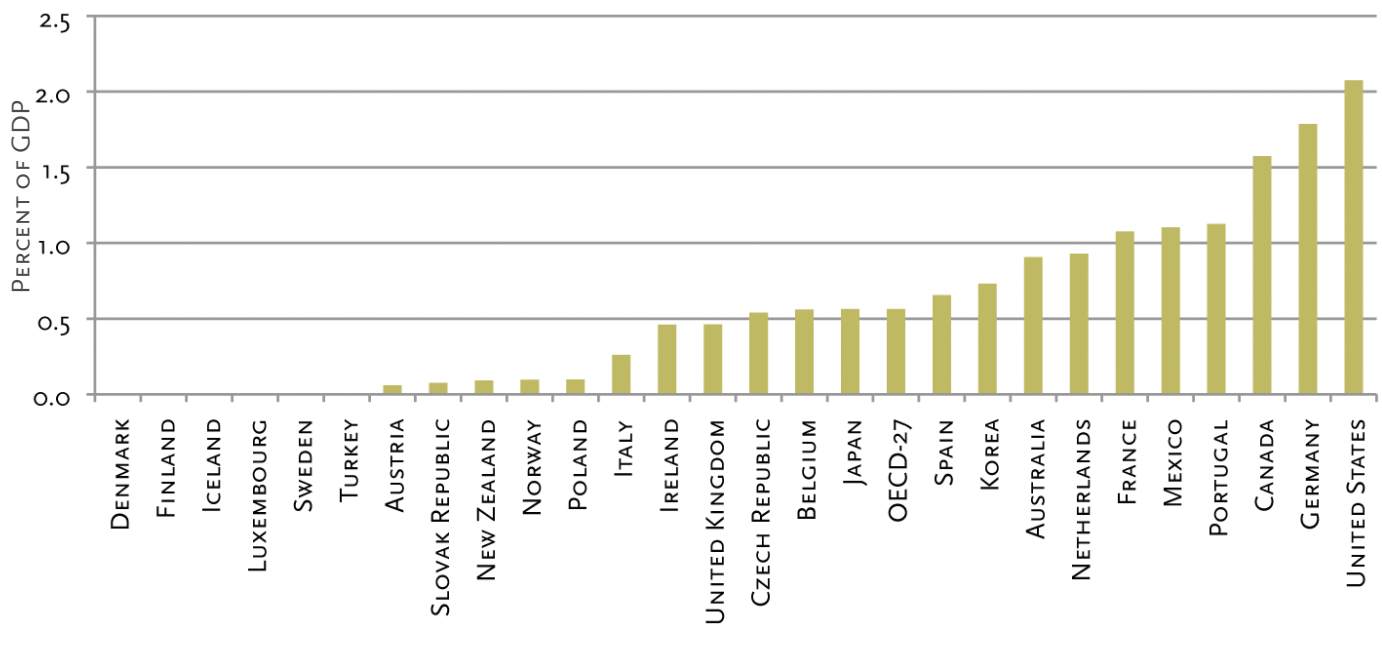
Federal-state insurance programs are also flawed in other ways. Increasingly, Congress has relied on “unfunded mandates”: it has used federal mandates to require states to provide benefits, but not given states enough funding to meet those mandates. And federal-state hybrids weaken oversight and cost control by dividing responsibility among federal and state governments while producing unfair variations in benefits among different jurisdictions.

A 2005 OECD report based on cross-national comparisons shows that matching programs with concurrent contributions by central and state or provincial governments tend to have problems. Even if lower-income regions get better matching rates in an attempt to minimize regional disparities, these regions are still less likely to spend their own funds and the resulting equalization effect is, at best, weak.⁷

Tax Expenditures

A tax expenditure is a substitute for government spending that takes the form of eliminating tax liability for money that is spent for a particular designated purpose. Tax

Figure 3: Tax Expenditures to Provide Social Benefits, OECD Countries 2007 (Excluding Pensions)



Source: OECD Social Expenditure Database.

expenditures have the same effect on budgets as spending does because they reduce government revenue. In the last quarter century, Congress has used tax expenditures to subsidize low wages (the earned income tax credit or EITC), income maintenance (tax-favored retirement savings accounts such as 401(k)s and IRAs), families with children (the child tax credit) and merit goods (employer-provided health insurance, the home mortgage interest deduction, tax-favored lending to homeowners and college students).

The heavy reliance of the U.S. government on tax expenditures in social policy has appealed to conservatives because tax expenditures can be portrayed as tax cuts (although the revenue must be made up by higher taxes elsewhere, if the tax expenditures are to be revenue-neutral). Tax expenditures have also appealed to progressives as an alternative to direct spending programs that might draw opposition.

But while tax expenditures may make good politics, they do not make good policy. The excessive reliance on tax expenditures to achieve social welfare goals has produced what Christopher Howard calls “the hidden welfare state” and Suzanne Mettler “the submerged state.”⁸ The use of

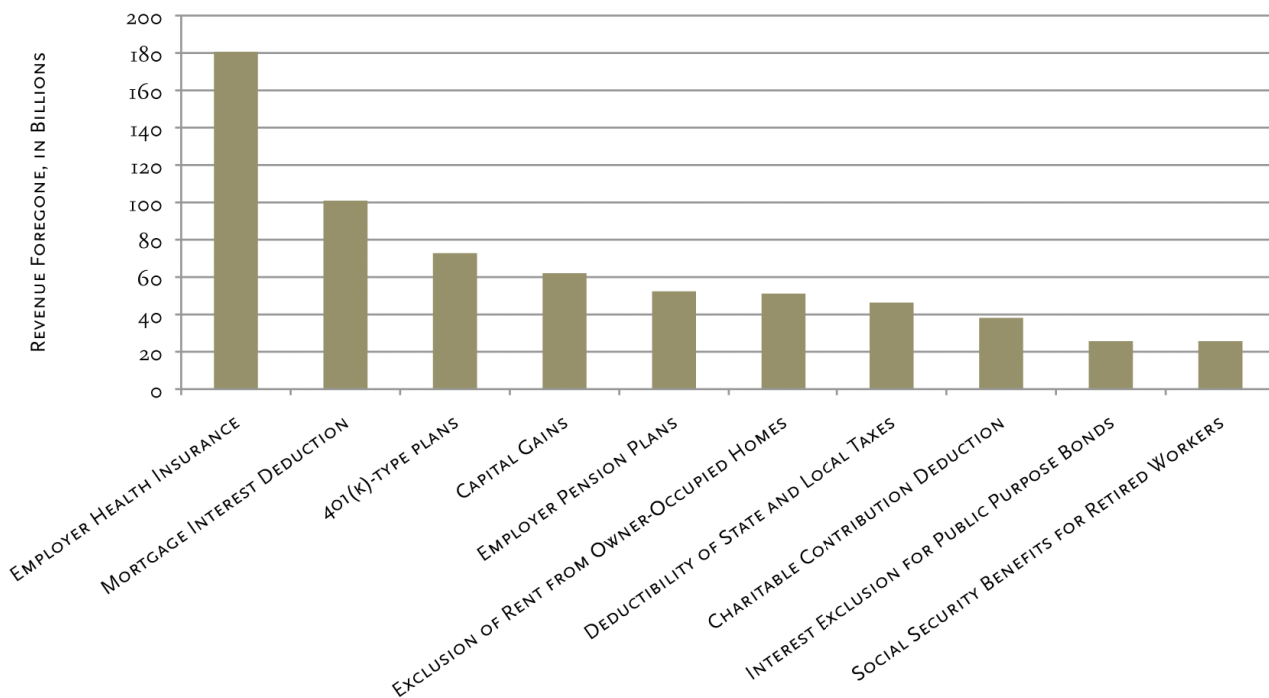
tax expenditures as the tool of choice in American public policy has been misguided because it has been invisible, inequitable, inefficient and inflationary.

The fact that tax expenditures are invisible distorts public policy, leading to an undersupply of government programs. As Suzanne Mettler found through her research on the submerged state, many of those who benefit from tax expenditures do not realize the support comes from the government. For example, 60 percent of people who used the home mortgage interest deduction did not think they had ever used a government social program.⁹ As a result, there is an unwillingness to adequately fund public programs, even those that are broadly popular.

Tax expenditures are inequitable because many of them, like the home mortgage interest deduction, disproportionately benefit the affluent. Tax-based spending by nature is more likely to help those who have more money because they pay higher taxes.

Tax expenditures are inefficient, because of the costs imposed by for-profit middlemen in many indirectly-provided goods and services, including student loans and

Figure 4: Largest Personal Tax Expenditures, FY 2013



Source: Office of Management and Budget. Note: Only includes “personal” expenditures, distinct from “corporate” expenditures. Distinction made by OMB.

home loans and tax-favored, privately-managed retirement savings accounts.

Finally, tax expenditures tend to be inflationary. The flood of subsidies for the private purchase of merit goods has been associated with levels of cost inflation in health care, higher education and housing of a kind unknown in other, similar nations that do not rely on this tool of public policy. In theory, providing tax credits or tax-favored loans for the private purchase of merit goods is supposed to lead to lower prices through competition for the vouchers. In practice, however, health care, higher education and housing are imperfectly competitive markets in which subsidies to purchasers may allow producers to raise their prices in order to extract rents from the taxpayers rather than lower costs through competition. Even worse, some of those rents can become tools to entrench the system, as powerful producer interests deploy some of their profits in the form of campaign donations, to pressure Congress to increase subsidies and reject regulation.

During the business cycle, tax expenditures tend to be harmful because they are pro-cyclical rather than counter-cyclical. Because they vary with income, government subsidies in the form of tax expenditures swell during booms and shrink during economic busts. In contrast, social insurance programs like unemployment insurance act as “automatic stabilizers,” replacing demand during downturns and shrinking during economic upturns. Replacing individual tax expenditures with social insurance transfer payments would help cushion Americans from economic fluctuations, as well as potentially help to moderate cycles of boom and bust in the economy as a whole.

Efficient Approaches

Unlike means-tested programs, federal-state social insurance and tax expenditures that subsidize the private purchase of merit goods, the other three major approaches to building a social contract — labor market regulation, federal social insurance, and the public provision of merit goods — tend to be more efficient and politically sustainable.

The minimum wage, as a labor market regulation, is simple and straightforward, unlike the complex earned income tax credit (EITC). It helps low-income Americans without requiring intrusive means-testing and bureaucratic supervision. It is impossible for employers or individuals to game. It is politically sustainable as well

because higher minimum wages enjoy strong public support. A recent survey found that 73% of likely voters support increasing the minimum wage to \$10 an hour and indexing it to inflation.¹⁰

Universal, purely federal social insurance programs like Social Security and Medicare are strong elements of the social contract as well. Unlike means-tested programs, these universal programs enjoy broad public support and do not have humiliating eligibility requirements. Unlike federal-state hybrid programs, their solvency is not dependent on the condition of finances in particular states. And unlike tax expenditures, they link highly visible benefits with highly visible taxes, in the form of payroll taxes.

America’s own recent history makes it clear that the most solvent, efficient, and equitable social contract is one based on a few simple, universal programs of social insurance.

As an approach to merit goods, public provision is often preferable to the use of tax expenditures to subsidize private purchases of those goods. Public education, provided directly as a public service by state and local governments with some federal help, has not been plagued by the cost inflation and abuses of student loans that have accompanied the channeling of subsidies through the tax code to university students. Similarly, the public provision of health care via the Veterans Administration to eligible military veterans and their families has avoided the cost inflation and inefficiency characteristic of the taxpayer-subsidized private insurance and health care industries. As in the case of social insurance, the transparency of costs of universal, in-kind public services sustains political support even as it ensures fiscal accountability.

The crisis of the American social contract is also an opportunity. Americans can now draw from more than a century of experience, in the United States and other countries, to evaluate what works and what doesn’t when it comes to providing economic security and equity for a modern industrialized nation with a majority of wage-earners. America’s own recent history makes it clear that the most solvent, efficient, and equitable social contract is one based

on a few simple, universal programs of social insurance.¹¹

The American social contract cannot be renegotiated overnight. But the broad outlines of a more solvent, efficient and fair social contract are clear. As a bold framework that can guide long-term reform, we propose an alternative social contract to be built almost exclusively on three approaches: labor market regulation, federal social insurance, and public provision.

A Living Wage. Adequate income for all Americans who work full-time would be achieved by a labor market regulation: a minimum wage that is also a living wage, indexed for inflation.

Expanded Social Insurance. Economic security for all Americans would be guaranteed by an expanded, streamlined system of purely federal social insurance, from paid family leave to a more adequate and solvent Social Security system.

Expanded State and Local Public Services. Finally, public provision would be the preferred approach to ensuring access to merit goods like education for all Americans. Public provision for

the most part would take the form of expanded state and local public services, funded by a new system of federal revenue sharing that would partly replace more regressive state and local taxes.

The three elements of the next social contract — a living wage, expanded federal social insurance and increased state and local public service provision — would be mutually-reinforcing. A higher minimum wage would result in higher payroll tax revenues, benefiting federal social insurance. The complete assumption of responsibility for all social insurance by the federal government would liberate state and local governments to concentrate on providing public services like education. At the same time, increased hiring by state and local governments, paid for by federal revenue-sharing, would create a tighter labor market in the private service sector, reducing the danger that a high minimum wage would produce a large gray market in labor.

The next social contract that we propose would ensure that a virtuous circle would replace today's vicious circle of low wages, inefficient and out-of-control private welfare spending and wasteful subsidies to for-profit middlemen to provide what ought to be public goods and services. 📌

PART TWO

A Living Wage

The original purpose of the minimum wage was to promote economic independence on the part of American workers, whose incomes would be sufficient to keep them out of poverty without the need for public welfare or private charity. The failure of Congress to provide for the automatic adjustment of the minimum wage for inflation led to a steep reduction in its real value, notwithstanding periodic increases, from the 1970s to the present. While the earned income tax credit (EITC) has reduced poverty, as a form of means-tested welfare it has increased the dependence of a new underclass of “the working poor” on government for survival. It is time to return to the original vision of the minimum wage — a wage sufficiently high that a full-time worker need not be dependent either on public welfare or private charity.

The Case for a Living Wage

From the late twentieth century until the present, a bipartisan consensus has supported the earned income tax credit (EITC) over the minimum wage as a method of helping low-income Americans. Conservatives approve of the EITC because it takes the form of a tax break rather than a direct spending program and subsidizes workers in the private sector. Many progressives favor enlarging the EITC to raising the minimum wage because the benefits of the EITC are more narrowly targeted and there are fears of the minimum wage causing job loss due to adverse effects on employment.

But the debate over the EITC versus the minimum wage has been fundamentally misconceived. The minimum wage was never intended to be a targeted “poor relief” program. Instead, it was originally justified by two purposes: first, promoting the independence of mainstream American workers from welfare, including welfare taking the form of wage subsidies; and second, discouraging “low-road” economic strategies by employers, industries and states in the American federal system. Each of these objectives is better achieved by a high minimum wage than by the EITC, which makes workers dependent on government and subsidizes inefficient, low-wage employers and industries.

Campaigns for a “living wage” in the U.S. began in the nineteenth century. Often they were justified by the claim that a democratic republic like the United States requires

a middle class majority whose members have a degree of economic independence not only from employers but also from government and private charity. In the early twentieth century, some champions of the minimum wage supported it because it discouraged “low-road” economic strategies. Companies in industries whose executives feared competition from rivals using low wages and other exploitative labor practices became advocates for a minimum wage. And some corporate leaders and union leaders alike viewed national minimum wages as methods of preventing low-wage, low-tax, anti-union Southern states from luring industries away from the more industrialized Northeast and Midwest.

The first attempt to create a federal minimum wage system was the National Industrial Recovery Act of 1933. Its purpose was not merely to combat the Great Depression but also to create a new, permanent system of industrial relations. Instead of a single federal minimum wage, the NIRA sought to create different minimum wages for different industries. In return for being granted relief from some antitrust regulations, the firms in each industry, acting through trade associations, would be required to negotiate with organized labor to write “codes” that would create, at the very least, an industry-wide minimum wage and an industry-wide employer-based pension system. The role of the federal government was to approve the arrangements negotiated by business and labor in each sector.

Similar systems of tripartite government-business-labor “corporatism” have been used successfully by many other democracies from the early twentieth century to this day. In Britain, Germany, and other advanced industrial nations, statutory minimum wages were confined to so-called “sweated industries” like home production in which unionization was difficult. Most workers were covered by particular minimum wages agreed upon by business and labor in their industries, with government supervision. Only countries with relatively weak labor movements, like France, relied heavily on statutory minimum wages.

After the Supreme Court struck down the NIRA in 1935 on grounds that had to do with federalism, Congress created a single statutory federal minimum wage in the Fair Labor Standards Act (FLSA) of 1938. In addition to creating a federal minimum wage of 25 cents per hour, the FLSA limited the workweek to a maximum of 44 hours.¹²

The earned income tax credit originated in a completely separate sphere of public policy that had nothing to do with minimum wage policy: targeted antipoverty policy. The Social Security Act of 1935, which also created a purely federal public pension for the elderly and federal-state unemployment insurance, established a means-tested federal antipoverty program, Aid to Dependent Children (later changed to Aid to Families with Dependent Children, or AFDC). Intended originally for widows and orphans, AFDC became controversial because many of its beneficiaries were single women with children out of wedlock, many of them poor and black.

By the early 1970s, the search for alternatives to AFDC led many conservatives and liberals to favor a negative income tax (NIT) — a basic income provided through the federal tax code. But as in other democracies, including the Nordic welfare states, the idea of a basic income proved to be unpopular with voters, who dislike welfare programs with no connection to individual work effort.

An alternative to the NIT, championed by Louisiana Senator Russell Long of the Senate Finance Committee, was the use of a refundable tax credit to supplement low wages. The purpose was to encourage the entry of welfare recipients into the workforce, a goal that enjoyed strong public support. To reduce the number of non-working poor receiving government benefits, both parties supported the enactment of the EITC in 1975 and subsequent expansions in 1986 and 1993.

Although the EITC was advertised as replacing “welfare” with “work,” it simply replaced welfare for the poor without work requirements with welfare that came with a work requirement. A means-tested wage subsidy like the EITC is a form of “welfare.” The EITC reduced the welfare caseload, but it did nothing to reduce the dependency of the working poor on government, because without wage subsidies their market wages were too low to allow them to escape destitution.

It was during the 1980s and 1990s that the minimum wage and the EITC collided. Originally created as an alternative to non-work-based welfare, the EITC was used as an excuse by conservatives and neoliberals to avoid raising the minimum wage.

“No man can be a good citizen unless he has a wage more than sufficient to cover the bare cost of living, and hours of labor short enough so that after his day’s work is done he will have time and energy to bear his share in the management of the community, to help in carrying the general load.”

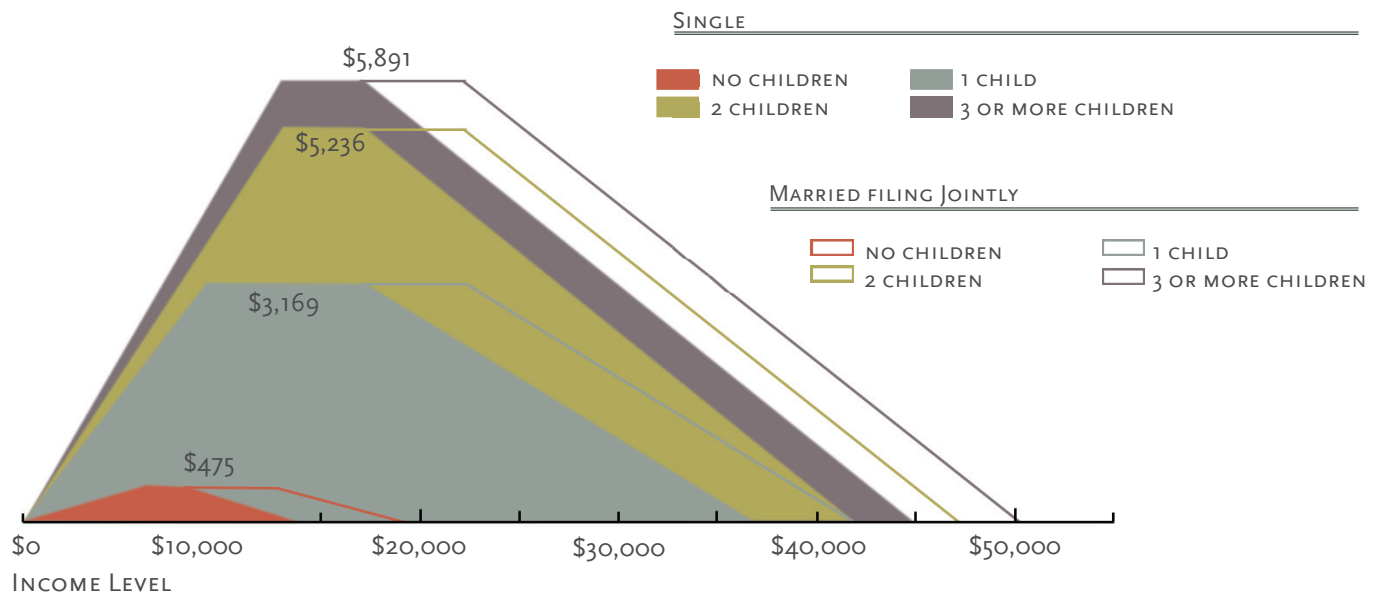
— THEODORE ROOSEVELT, SPEECH AT OSAWATOMIE, KANSAS, “THE NEW NATIONALISM” (AUGUST 31, 1910)

From its origins in 1938, the minimum wage had never been indexed to inflation. Instead, Congress had to restore its value periodically by legislation, to prevent it from being eroded by inflation. The value of the minimum in inflation-adjusted constant dollars plunged between 1978 and 1989, thanks to high inflation and the failure of Congress to act. The real minimum wage dropped from almost 8 dollars an hour in the 1950s and 1960s to less than 5 dollars an hour in 2006.

The case for the EITC rather than the minimum wage relies on two major arguments: that a higher minimum

Figure 5: The Complexity of the EITC

Value of Federal Earned Income Tax Credit, 2012



Source: Center on Budget and Policy Priorities. The Earned Income Tax Credit, <http://www.cbpp.org/cms/index.cfm?fa=view&id=2505>.

wage would increase unemployment, and that the EITC targets the poor more effectively than the minimum wage.

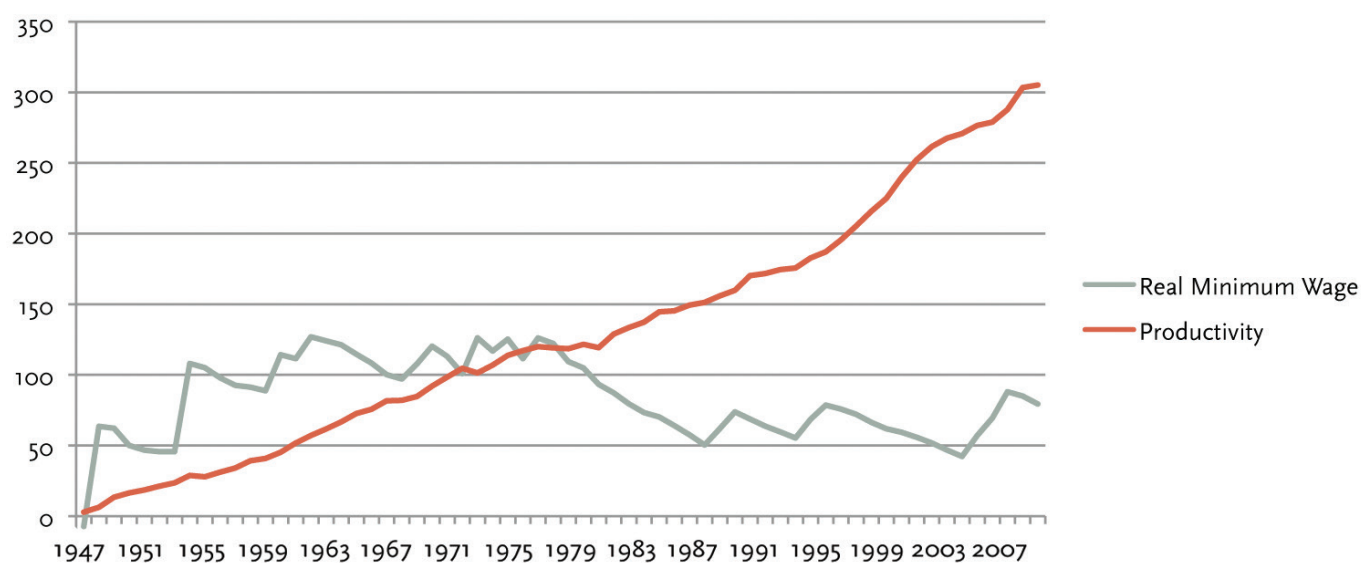
Would increasing the minimum wage increase unemployment? Despite the insistence from conservative politicians that the minimum wage is a “job destruction program,” there is no consensus among academic economists on this issue, in part because economists tend to divide along partisan lines. The argument that increases in the minimum wage automatically lead to higher unemployment tends to be based on a priori deductions from axioms of neoclassical economics, not empirical studies of particular cases in which minimum wages have been increased in the U.S. and abroad. They also tend to ignore the role of a higher minimum wage in creating at least some jobs as better-paid workers at the bottom of the wage distribution spend more money.

The most widely-cited work on the effect of the minimum wage on employment is the 1994 study by David Card and Alan Krueger of fast-food restaurants in the mid-Atlantic following the New Jersey state-level minimum wage increase in 1992.¹³ Card and Krueger did not find that an increase in the minimum wage led to job losses, and a wide range of other studies show similar results.¹⁴

Undoubtedly there is a point at which too great an increase in the minimum wage would create large-scale unemployment. The question is whether a minimum wage adequate to keep a full-time worker out of poverty would have that effect. If the answer were yes, that is still not a damning indictment of a higher minimum wage. There are other methods to address unemployment, and society might decide that, as a matter of principle, it is preferable to respond to the incidental unemployment caused by a living wage by other measures, like public employment, rather than to deliberately create and maintain an underclass of workers paid too little by their private sector employers to survive without assistance from welfare.

The argument that globalization means that high wages prevent the U.S. from competing with foreign economic rivals is unpersuasive. To begin with, low labor costs are only a small part of the advantage of low-cost producer nations like China, less important than undervalued currencies, subsidized or free land, energy and infrastructure for businesses and state-directed credit. In any event, the U.S. is competing, not with low-wage developing nations, but with high-wage countries like Germany, Japan and South Korea, which have been far more successful than the United States in expanding their global market shares in

Figure 6: Cumulative Annual Percent Change, Productivity and Real Minimum Wage



Source: Bureau of Labor Statistics (CPI and Nominal Minimum Wage and Productivity).

high-value-added industries even though their wages are equivalent to or higher than American wages.

While conservatives tend to argue that a higher minimum wage would cause unemployment and reduce America's international competitiveness, many progressives prefer an expanded EITC to a higher minimum wage because the former is a narrower program targeting the poor more effectively. While this is true, a means-tested program like the EITC risks lacking the broad political support that could sustain a universal program like the minimum wage that can benefit middle-class teenagers and part-time workers as well as the poor.

The case for the EITC instead of the minimum wage depends on effacing any moral or political difference between a minimum market wage and a minimum income consisting of a below-poverty market wage and a government subsidy. But while the two approaches may produce identical incomes, the adequate market wage frees the worker from dependence on government. The EITC and similar wage subsidy schemes divide the single U.S. labor market into two castes: ordinary workers, who live on their market wages alone, and a dependent underclass of the "working poor" who cannot escape poverty with the help of market wages alone, no matter how hard they work.

The EITC does not reduce welfare dependency. It is a form of welfare dependency. The EITC has merely replaced one form of highly visible welfare to which voters object with another form of welfare that is invisible to voters because it is hidden in the tax system. The proposal to make the working class and the middle class, as well as the new underclass of the "working poor," dependent on government wage subsidies should be treated as what it is – an admission of defeat in the project of creating an independent middle-class citizenry in the United States. In addition, EITC benefits are greater for workers with children than for single workers or childless couples, adding additional complexity and further segmenting the labor market by discriminating against some categories of workers rather than others.

The original rationale for the minimum wage as a living wage remains compelling: nobody who works a reasonable number of hours per week in any job in the United States should be poor and dependent for survival upon government agencies at any level of government. Nor should any full-time worker be unable to make ends meet, in the absence of additional paternalistic support from employers or dependence on private religious or secular charity. The goal of the living wage is to provide both dignity and the minimum of self-reliance that is necessary for citizens of a democratic republic.

Another traditional rationale for the minimum wage, the “high-road” case for discouraging employers and industries that rely on low wages, also remains persuasive. An adequate federal minimum wage provides a floor that limits a “race to the bottom” by firms within particular industries and by individual states and localities within the U.S.

Indeed, a number of studies suggest that high wages provide incentives for employers to invest in new technology or more efficient organization in order to use costly labor more effectively.¹⁵ After reviewing cross-country inequality trends, Daren Acemoglu of MIT concluded that “there may be greater incentives to invest in technologies complementing workers whose wages are being pushed up by labour market institutions.”¹⁶

While a moderate increase in the minimum wage need not necessarily increase overall unemployment, it might very well hurt some businesses and industries that depend on paying below-poverty wages to their workers. This is a virtue of the minimum wage, not a vice. U.S. employers are not permitted by law to employ child labor, or to force workers to work 18 hour days, or to endanger the safety of their workers. Why should they be allowed to pay their workers below-poverty wages?

Perhaps the single greatest advantage of a living wage over a system of wage subsidies is the fact that a living wage is simple and easy to enforce. Relying on wage subsidies like the EITC to compensate for inadequate market wages is highly inefficient. To begin with, any means-tested program

Consumers and the Minimum Wage

Another argument against raising the minimum wage is that an increase would hurt the consumers of goods and services produced by low-wage labor. As we have seen, substituting technology for low-wage labor might allow many of the same goods to be produced at the same or lower cost, even if the lowest wages in a particular industry were higher.

Furthermore, the consumers of luxury services provided by low-income workers are disproportionately affluent or rich. There is no reason why the costs of subsistence of a low-income worker should be partly socialized by American taxpayers, so that worker can provide menial services as a maid, or gardener, or pool cleaner, to upper-income Americans who could afford either to pay more for the same services or live without them, as working-class and middle-class Americans are compelled to do.

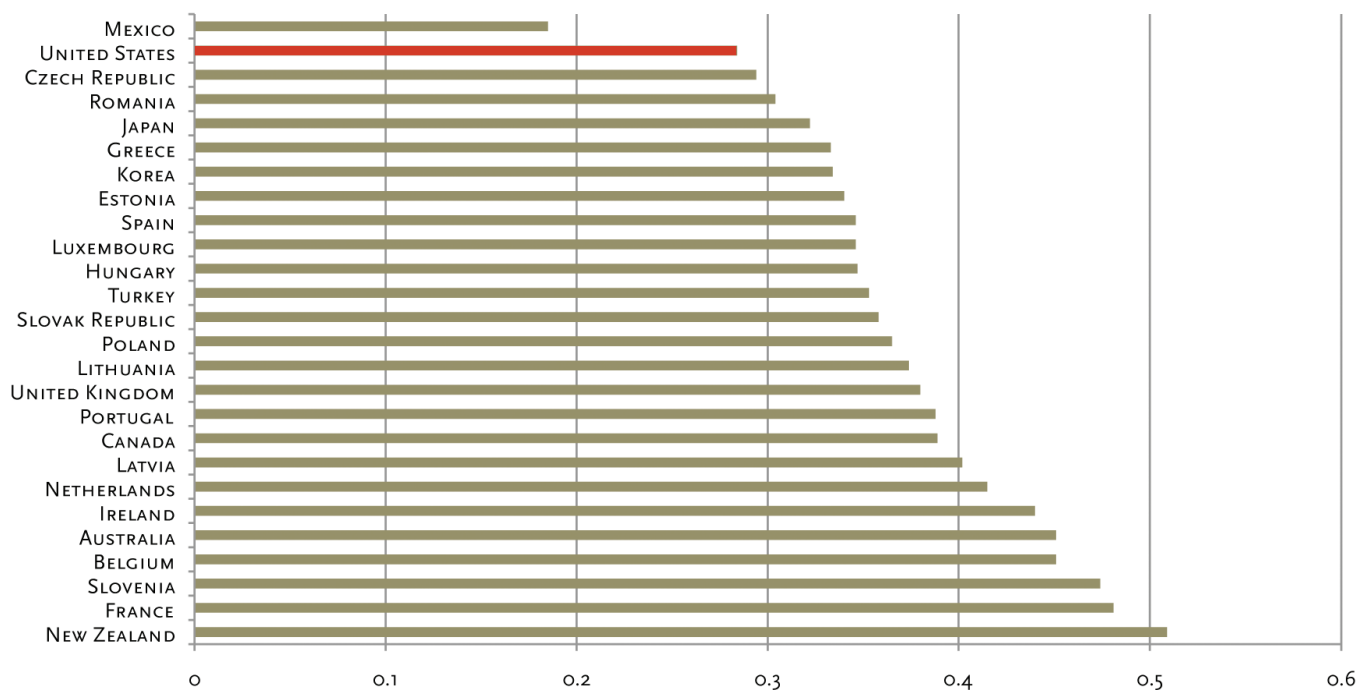
What about merit good services for low-income Americans, like health care or shopping for the home-bound elderly? If turning the minimum wage into a living wage threatened the ability of low-income Americans to purchase any necessary services, then the appropriate response would be to increase the provision of those services by the public sector, the nonprofit sector, or both.

One method for the provision of necessary services for low-income Americans who could not otherwise afford them might be the adoption, in the U.S., of “service vouchers,” a program used in many European countries.¹ Service vouchers subsidize the wages of workers who perform in-home services like cleaning and yard work for eligible citizens, such as elderly people with modest incomes. Service vouchers are wage subsidies, just like the EITC. But because they are targeted wage subsidies, the public, through its elected representatives, can make sure that wage subsidies go only to certain socially-desirable occupations, like help for the elderly, instead of being showered indiscriminately on all low-wage workers, including low-wage factory workers and the menial servants of the rich.

¹ Michael Lind and Lauren Damme, “A Subsidy for Dignity,” *Democracy: A Journal of Ideas*, Spring 2012, <http://www.democracyjournal.org/24/a-subsidy-for-dignity.php>; Michael Lind and Lauren Damme, “The Dignity Voucher Program,” New America Foundation, July 15, 2010, http://newamerica.net/publications/policy/the_dignity_voucher_program.

Figure 7: Minimum Wage Relative to Mean National Wages

The United States has the lowest ratio of minimum wage to mean wage of any OECD country besides Mexico.



Source: OECD.

requires an intrusive bureaucracy to ensure that the recipients meet eligibility requirements and are not cheating. To make matters worse, in the case of the EITC that agency is the Internal Revenue Service (IRS). As it is, the enforcement capacity of the IRS is extremely limited. It is perverse to require the IRS to spend its limited enforcement budget, not on identifying and punishing wealthy scofflaws, but on supervising and policing millions of the working poor.

Our argument is not that the EITC should be completely rejected. The argument, rather, is that in the last generation two programs with completely different rationales – the minimum wage and the EITC – have been treated mistakenly as competing substitutes for means-tested welfare without work requirements. In a new system based on an inflation-adjusted living wage, there might be room for a modest EITC tailored to workers who are unable to work full-time jobs. But no American citizen

or legal immigrant who works a full 40-hour week at any occupation should require government welfare in the form of a wage subsidy.

Turning the minimum wage into a living wage would not, by itself, increase wages for most Americans or ensure that workers share in the gains from economic growth. And in the absence of a tight labor market, produced by factors including full employment macroeconomic policies and limits on unskilled legal and illegal immigration, a higher minimum wage might expand black and gray markets in off-the-books labor. One method of creating tight labor markets that would reinforce the minimum wage and also increase the bargaining power of workers paid more than the minimum wage would be a permanent expansion of public employment in the provision of necessary public services, a proposal that will be defended in Part Four of this essay. 🇺🇸

PART THREE

Expanding Social Insurance

If producing adequate jobs and income for working-age adults is the first goal of the social contract, ensuring adequate income for non-workers — the elderly, children, the unemployed and disabled — is the second objective. In the area of income maintenance for non-workers, the existing American social contract is a mixture of successful approaches that should be emulated and failed methods that should be abandoned.

Social Security and Medicare have succeeded because they are universal programs that include all Americans regardless of class and do not require humiliating eligibility tests; they are based on individuals and thus not dependent on an employer; and they are efficient in that they minimize government overhead or the investment of personal time. They can serve as models for an expanded system of social insurance to provide economic security for all Americans. The U.S. should move away from a tax-code based hidden welfare state that is invisible, inequitable, inefficient and inflationary and toward universal social insurance programs like Social Security and Medicare.

Expanding Social Security

Nowhere is the contrast between the inefficient tax expenditure system of the hidden welfare state and the efficiency of social insurance more visible than in the area of retirement security. America's retirement system combines inefficient and inadequate programs of subsidized private retirement savings with a simple and successful public pension.

The public component of retirement security, Social Security, is the most important and successful part of America's system of economic security. Its benefits to American society go beyond those to individual retirees. As President Franklin D. Roosevelt declared when he signed the Social Security Act in 1935, the Social Security system "is a structure intended to lessen the force of possible future depressions. It will act as a protection to future Administrations against the necessity of going deeply into debt to furnish relief to the needy. The law will flatten out the peaks and valleys of deflation and of inflation. It is, in short, a law that will take care of human needs and at the same time provide for the United States an economic structure of vastly greater soundness."¹⁷

When Social Security was created in 1935, business opposition was limited because the pay-out was so low that it did not conflict with existing employer pensions. In the spirit of welfare capitalism, many employers offered defined benefit pensions to workers that guaranteed a specific pay-out to employees for their retirement. The result was an informal two-tier system, which benefited workers with employer pensions.

Over the past two decades, American companies have steadily shrunk their private pension contributions and have put more of the risk onto employees. They have done so in two ways: either by eliminating company retirement plans altogether or by shifting from a defined benefit to a defined contribution pension program.¹⁸ In a defined benefit system, a retired worker knows exactly how much he or she will receive each month; in a defined contribution system, the employee makes a contribution into a retirement account such as a 401(k) or IRA, which is then invested in the bond and equity markets with attendant risks. The experience of the past decade shows that this shift in the nature of U.S. retirement

policy has worked to the disadvantage of American workers while creating more vulnerability and uncertainty.

The flaws of tax-favored private retirement savings accounts were painfully exposed at the beginning of the twenty-first century by two stock market crashes in less than a decade. Unlike Social Security or a traditional private defined benefit pension, a 401(k) or IRA account can lose much of its value as a result of volatility in the stock market or inflation. Those who retire during a stock market downturn find that their private savings are far smaller than they had planned.

Low interest rates have also devastated retirement savings since the beginning of the Great Recession. Between 2008 and 2011, the money earned by Americans from interest payments dropped by roughly 27 percent, from \$1.4 trillion to \$1 trillion.¹⁹

Although it is not an imminent danger, inflation, too, can wreak havoc with plans for a secure retirement. While Social Security is adjusted for inflation, tax-favored private retirement savings plans are not. Investors with 401(k)s or IRAs must hope that the gains from their investments are not erased by inflation.

Volatility and vulnerability to inflation are not the only flaws of tax-favored private savings accounts. Only some American workers have access to 401(k)s through their employers, and of these, many contribute nothing or far too little to take advantage of the tax break. Those who do take advantage of tax-favored retirement savings plans often lose vast amounts of money because of bad decisions and hidden fees by money managers.²⁰

In the late twentieth century, proponents of voucher-like schemes for the private delivery of economic security and merit goods emphasized the importance of “choice.” But there is no evidence that the American public was clamoring for replacing employer pensions or Social Security, to name only two examples, with complicated, difficult-to-understand choices advertised by for-profit companies.

In any event, history has proven that most individuals do poorly when left to make their own investment choices. According to one study, from 1991 to 2001 investors in stock mutual funds earned an average annual return of 3.8 percent, well below the S&P 500 annual return of 9.1 percent. The study attributes this miserable performance to a combi-

nation of irrationality on the part of investors (buying when stocks are high and selling in a panic when they are low) and excessive broker fees generated through too much trading.²¹

Social Security has grown in importance because of the decline in defined benefit pensions provided by employers and the shift toward defined contribution savings accounts like 401(k)s. Social Security and Medicare have played key roles in reducing elderly poverty: in 1959 (the first year poverty was measured for the elderly) elderly poverty was at 35.2 percent; in 2010, it was 9.0 percent.²²

Rather than cutting Social Security, a better approach to the deficit would be reducing or eliminating tax expenditures for private retirement savings.

Many Americans depend on Social Security for their livelihood. For those currently 65 and older, Social Security is the largest single source of income, accounting for 37 percent on average. By contrast, private pensions and annuities income account for only 9 percent.²³ The numbers are even starker for low-income Americans. For the bottom 20 percent of Americans ages 65 or older, Social Security accounts for 84.3 percent of their income, and private pensions and annuities only 1.8 percent.²⁴ Social Security is the largest source of income for more than half of America’s elderly.²⁵

In spite of this success, Social Security is under attack in the name of deficit reduction. But rather than cutting Social Security, a better approach to the deficit would be reducing or eliminating tax expenditures for private retirement savings and to strengthen Social Security to cement its role as an essential pillar of stable retirement income for workers.

As another alternative to today’s failed retirement security system, with its mix of sound Social Security payments and volatile tax-favored private savings, some have proposed creating a new category of universal defined benefit pensions to replace employer-based defined contribution plans like 401(k)s and traditional employer-based defined benefit pensions. For example, Theresa Ghilarducci has proposed a mandatory plan for all workers in which employers and

employees would have to contribute up to 5 percent of earnings with a guaranteed annual rate of return adjusted for inflation.²⁶

While such a reform would be an improvement over the present inadequate retirement system in the U.S., the

weakness of such proposals lies in the fact that a universal, defined benefit public pension plan already exists – Social Security. These proposals would create two defined benefit pensions: a new one, in which pooled money was invested by the federal government in the stock market, atop the older Social Security system, based on payroll taxes.

Does the Aging of America Doom Social Security?

The relationship between Social Security and demography is usually discussed in the context of rising ratios of retirees to workers by those claiming that social insurance systems are doomed to bankruptcy. These alarmists, however, are frequently guilty of factual and logical mistakes.

While it is important to understand that the aging of the population will lead to more seniors using Social Security, many commentators neglect to take into account rising productivity, which permits both workers and retirees to enjoy higher living standards even as the number of retirees per worker increases. The increase in labor productivity in the last half-century has allowed three of today's workers to support the same number of retirees that five workers were required to support 40 years ago. To maintain living standards with projected dependency ratios, labor productivity growth in the U.S. would have to increase by 40 percent by the 2030s. This is quite possible, given the levels at which labor productivity increased between 1960 and 2000.¹ Although Americans should not be forced to work longer, better health may enable many to do so voluntarily in the future.

Ignoring the fact that productivity growth can increase the incomes of both workers and retirees in spite of lower worker-retiree ratios leads some to propose that a fixed worker-retiree ratio be maintained by increasing the admission of working-age immigrants to pay payroll taxes. But in order to keep the present worker-retiree age ratio the same, the U.S. would have to import truly mind-boggling numbers of immigrants. In 2000, the U.N. Population Division calculated that maintaining the worker-retiree ratio in the U.S. between 2000 and 2050 would require the U.S., which admits roughly 1 million immigrants a year, to let in an average of 12 million immigrants per year. According to the U.N., to maintain a stable worker-retiree ratio, the U.S. would have to admit nearly 600 million additional immigrants in the next 40 years.²

The U.S. Census Bureau's Population Projection Branch has dismissed the idea that immigration can play a significant role in the solvency of Social Security and other social insurance programs: "International migration may address a high dependency ratio decisively in the short term, yet is highly inefficient in reducing it over the longer term — especially if considerations of population scale, as well as age composition, are taken into account."³

The U.S. can afford to maintain a decent standard of living for its retirees. The only question is whether to pay for Social Security benefits solely on the basis of payroll taxes, or to supplement payroll revenues with other revenues that can tap into non-wage income, as we propose elsewhere in this report.

¹ Jane Sneddon Little and Robert K. Triest, "The Impact of Demographic Change on U.S. Labor Markets," *New England Economic Review*, Federal Reserve Bank of Boston, 2002, <http://www.bos.frb.org/economic/conf/conf46/conf46e1.pdf>.

² "Replacement Migration: Is it a Solution to Declining and Ageing Populations?" United Nations Department of Economic and Social Affairs, Population Division, 2001, <http://www.un.org/esa/population/publications/migration/migration.htm>.

³ Frederick W. Hollmann, Tammany J. Mulder, and Jeffrey E. Kallan, "Methodology and Assumptions for the Population Projections of the United States: 1999 to 2100," U.S. Bureau of the Census: Population Division Working Paper no. 38 (Washington, D.C.: U.S. Department of Commerce, January 2000).

If it were desirable to invest part of individual retirement savings in the stock market, then it would be easier for the government to invest some Social Security payroll taxes in the stock market. But why invest Social Security revenues in the stock market at all? The suggestion is an anachronistic legacy of the bubble economy, when unsustainable stock market returns were outpacing the growth of the real economy. The great advantage of the Social Security system is that its payroll tax base is more stable than the stock market. It is true that payroll revenues can collapse during periods of mass unemployment, like the Great Recession, and payroll revenues can suffer if the gains of economic growth are not adequately shared in the wages of American workers, as has been the case for a generation. But the solution should be to augment, or replace, narrow payroll taxes with taxes with a broader base, like a national consumption tax — not to make Social Security, the program on which most retired Americans rely, dependent on the success of the federal government as a stock market speculator.

In retirement security, as in other parts of the American economic security system for individuals, complexity is linked to vulnerability, not stability. In the late twentieth century, the conventional wisdom, reflected by the World Bank and other agencies, held that governments should diversify their retirement systems. In many official reports, retirement security policy was compared to a stool with multiple legs. The flaw in this metaphor should have been obvious: a stool with two wobbly or disintegrating legs is less stable than a single, solid column.

The design defect of America's retirement security system from 1935 to the present is clear: from the beginning, Social Security has been too small a part of the overall retirement security system. Each of the tax-favored private systems that were intended to supplement Social Security pay-outs — tax-favored employer pensions and tax-favored individual savings accounts — have been failures. The prudent way forward is to expand Social Security, the successful, efficient social insurance component of the system, while phasing out tax-favored private pensions and individual savings accounts.

The first step toward a sounder American retirement security system should be to increase Social Security's replacement rate — the percentage of pre-retirement income that is replaced by Social Security. As Steven Hill has pointed out, in other, similar countries public pensions tend

to replace a much higher percentage of pre-retirement income than in the U.S., where first employer pensions and more recently, 401(k)s and IRAs, were supposed to supplement relatively low Social Security payments.²⁷

A case can be made for restructuring Social Security, while expanding it. Many other democracies have a two-tier or “double decker” system of public retirement security, consisting of a universal, flat benefit to keep the elderly out of poverty that is the same for everyone and a public defined benefit program that varies among citizens on the basis of their lifetime incomes. In this way, two goals — redistribution and insurance — are performed by two different programs. In contrast, in the current American Social Security system both functions are performed by a single program, on the basis of a complex formula that is partly redistributive and partly determined by variations in earnings among individuals.

*“Accident, illness, old age, loss of a job.
These are the Four Horsemen that ride
roughshod over lives and fortunes of
millions of wage workers of every modern
industrial community...”*

— I.M. RUBINOW, *THE QUEST FOR SECURITY*
(NEW YORK: HENRY HOLT AND COMPANY, 1934), PP. 20-21.

From the late 1930s to the present, there have been many proposals to turn Social Security into a two-tier system. The projected exhaustion of the Social Security Trust Fund may provide an occasion to do so. Absent other changes, Social Security will be able to fulfill only about three-quarters of its obligations to retirees at some point in the 2030s (the precise date depends on prior rates of economic growth and revenue collection).²⁸

One option for dealing with the projected Social Security shortfall would be to maintain the existing one-tier formula and raise the revenues needed by increasing the payroll tax. Other methods include lifting the “cap” on

earnings subject to payroll taxation, infusing non-payroll tax revenues, or a combination of those. But a case can be made that payroll taxes should be reduced, not increased, for lower-income workers and perhaps all workers, permanently. From this it follows that the Social Security system would need an infusion of revenues other than payroll taxes — all the more so, if Social Security's average pay-out were expanded, as we propose.

Unlike Social Security, Medicare is funded by multiple sources of revenue. Significantly, the streams of revenue in Medicare are not promiscuously intermingled, but fund distinct programs. Medicare Part A, which pays for hospitalization, is financed almost entirely by the Medicare portion of the payroll tax (2.9 percent). Medicare Part B, which pays for doctors' visits, is financed by general revenues (75 percent) and patient premiums (25 percent). In addition, there is Medicare Part C, which allows individuals to obtain health care services through a provider plan, (funded by Medicare parts A and B) and Medicare Part D, a voluntary plan which provides prescription drug coverage and is paid for by Medicare plus individual premiums.²⁹

If Medicare can have parts A, B, C and D, with distinct funding streams, then why can't Social Security also have distinct components with distinct funding streams? This would be preferable to the politically-likely alternative of repeated bail-outs of Social Security in its present form with the aid of general revenues, perhaps in multi-year "patches," once revenues fall short of promised benefits a generation from now.

We propose replacing the present incoherent mix of Social Security, tax-favored employer pensions (including state and local public employee pensions) and tax-favored retirement savings accounts with a single, purely public two-tier Expanded Social Security system.

The first tier of Expanded Social Security would be a universal, flat benefit, indexed to inflation and equivalent to the minimum wage, once the minimum wage has become an above-poverty living wage. It would be funded by general revenues or a dedicated tax, such as a portion of a VAT. This new, universal first tier of the new American retirement security system could be created by the universalization and expansion of the present Supplemental Security Income (SSI) program for the poor and disabled, which is funded out of general revenues.

The second tier of Expanded Social Security would be

a public defined benefit pension, reflecting variations in lifetime earning among individuals through higher benefits, within limits. It would be paid for solely by the payroll tax. This public pension would be a version of today's "Social Security" or OASDI. Because most or all Americans would receive both the universal, flat Social Security benefit and the earnings-dependent Social Security benefit, the latter might be reduced, to permit a corresponding reduction of payroll taxes, without reducing the overall income of most American retirees from the new Social Security system as a whole.

Along with the new two-tier public retirement security system, tax breaks for private retirement saving would be eliminated. The increase in the Social Security replacement rate, by the combination of the first and second tiers of the new system, would greatly reduce the need for most Americans to put aside additional money for retirement. Those who chose to do so nevertheless should be taxed at a capital gains rate equal to the rate of taxation imposed on income earned by wage labor.

The U.S. economy might benefit from an end to the misallocation of resources produced by an inadequate public social insurance sector and a bloated tax-favored private savings sector. At the same time, an expansion of Social Security pay-outs would have a permanent positive effect on the real, productive economy. Lower-income people are more likely to spend an extra dollar on goods and services, and decreasing the amount of retirement income that comes from tax-favored private savings accounts may also discourage asset bubbles from developing in the future.

Proposals to increase retirement security by expanding Social Security are likely to find widespread public support. By large majorities, Americans support raising taxes for Social Security over cutting benefits. An August 2012 Associated Press poll found that 53 percent of adults said they would rather raise taxes to pay for Social Security for future generations than cut benefits, while only 36 percent said they would cut benefits.³⁰ And according to a 2009 poll, three times as many Americans said that too little rather than too much is spent on Social Security (45% to 15%). 66% agreed with the statement that "with the economic crisis and the stock market crash, it's more important than ever to strengthen Social Security to make sure that retirees and the disabled can count on secure benefits for generations to come."³¹

Medicaid and Unemployment Insurance: From Federal-State Hybrids to Federal Social Insurance

Most American social insurance programs are not purely federal, like Medicare and Medicaid, but partly federal and partly state programs, like Medicaid, SCHIP, and unemployment insurance.

Medicaid is administered by states with federal matching funds that vary inversely with a state's per capita income. The most important issue facing Medicaid – along with health care in general in the United States – is controlling the rapidly increasing costs. While the Affordable Care Act will increase the number of people who will have some form of health insurance and eliminate some cost inefficiencies in the system, it did not address much of the underlying and unsustainable cost structure.

The federal-state funding combination exacerbates the cost issue for Medicaid. As noted, state governments struggle to meet their financial obligations during downturns, and thus important social programs end up being pro-cyclical drags on state budgets. It is not sensible to have states be responsible for social programs that are central to the lives and well-being of many Americans when they cannot undertake countercyclical spending by running deficits when necessary. Freeing states from these debilitating funding issues would also give them more flexibility and ability to pay for other important programs that are being squeezed out by Medicaid costs at the state level.

States have had to cope by cutting reimbursement rates or freezing payments to hospitals. As a result, patient access to quality care is in jeopardy. Converting Medicaid into a federally-run program similar to Medicare would allow the government to set a federal reimbursement level that would likely lead to higher participation from providers.

Moving toward Medicaid as a federal program should have two primary elements, according to a proposal by Greg Anrig. First, the federal government should assume all costs of “dual-eligible” Medicaid and Medicare patients, removing the onus of dual-eligible Medicare premiums and long-term care away from the states. Second, the federal matching rates for Medicaid should be gradually ratcheted up until the federal government assumes all costs. The Medicaid provisions in the Affordable Care Act set the stage for this approach to work successfully.³²

Like Medicaid, Unemployment Insurance (UI) is a hybrid program in which states operate their own systems and set their own eligibility standards, tax rates, and benefit amounts. The federal government covers administrative cost and extended UI benefits.

This funding system, however, creates incentives for states to underfund their unemployment insurance reserves and minimize eligibility and payout levels. The need for unemployment insurance is countercyclical: when the economy is poor, more money will need to be spent on unemployment insurance while at the same time less money will be coming into the state from revenues. Approximately 2/3 of states

The Case for Federalizing Medicaid

One basic reality is quite simple: the central fiscal problem confronting both the federal government and the states is the prospect of a continuation of rapidly rising health care costs. For the states, relieving them of the number one obligation causing their financial distress would enable them to regain the capacity to function much more effectively. For the federal government, taking over Medicaid would entail large new outlays, but it would also create much greater leverage in directly confronting the underlying problem of soaring medical inflation.

Logistically, there are two primary approaches that should be pursued to phase in federalization of Medicaid. One entails federal assumption of the full cost of dual-eligible Medicaid and Medicare beneficiaries, and the other involves ratcheting up federal matching payments for Medicaid and CHIP until the 100 percent threshold is reached. If Medicaid were to be federalized, that would create new possibilities for later merging it with Medicare, or a new public insurance plan that would be made available to everyone on the state insurance exchanges, which in turn could become federalized as well.

— Greg Anrig, *The Next Priority for Health Care: Federalize Medicaid*, Next Social Contract Initiative, September 2010, http://www.newamerica.net/publications/policy/the_next_priority_for_health_care_federalize_medicaid

have had their UI reserves run dry in the Great Recession or tepid recovery, leading to further pressure to limit unemployment insurance and putting more hardship on families who are already under-consuming.³³

These state-imposed limitations on UI come in the form of both eligibility barriers and decreased benefits. States have limited eligibility by increasing the requirements for base periods of previous work experience and preventing temporary or contract workers from coverage. The latter provision is particularly problematic as the economy shifts away from an earlier “career” model of employment that put a greater emphasis on full-time long-term employment for a single employer. And benefits are so low that the average unemployment insurance benefit in 49 out of the 50 states is below the poverty line for a family of four.³⁴

An unemployment insurance system that protects workers and provides a sufficient base in periods of unemployment is most sensible and efficient at a federal level. This system should include all hourly workers as potential recipients and replace the mix of federal and state funds with a single federal program. Like Medicaid, the current hybrid structure of unemployment insurance is unstable, tough on state budgets, and often fails to meet an important minimum baseline of benefits — all problems that would be easier to tackle at the federal level.

Adding Family Leave to the American Social Insurance System

The new social contract that we propose would add a new universal federal entitlement for all citizens to the existing federal programs for retirement security and unemployment insurance: paid family leave for parents of newborns or caregivers for ailing relatives.

The American social contract has failed to adjust to social change between the New Deal era, when most mothers were home-makers supported by a husband who earned a breadwinner wage, and the present, in which both parents in the typical family are in the workforce. In the absence of a coherent public policy, families struggle to provide child care by relying on private or non-profit daycare centers, public schools, relatives or paid domestic workers.

The need for a coherent program to help Americans with child care and related care-giving is a key element of a new social contract with American workers. As Lauren Damme argues, expanding access to paid family leave programs across the country can be done either through unfunded employer mandates, federal-state hybrids, or a federal program. Of these three, a federal program is the most efficient and most equitable option. Placing the cost on the employers directly means added pressure on businesses. Federal-state hybrids struggle with cost control and stability during economic downturns, as conflicts over Medicaid funding demonstrate.

Fixing the Broken Unemployment Insurance System

The last three years have taught us many lessons to the contrary. One of the things we have learned from the Great Recession is that America’s hybrid state/federal unemployment insurance (UI) system is essentially broken. Most workers are not eligible, and many of those who are eligible do not get enough to keep themselves and their families out of poverty. States routinely exclude millions of workers from coverage and deliberately underfund UI systems that they are structurally incapable of operating in the midst of a recession.

Our reconstruction of the unemployment insurance system should start from three basic principles. First, unemployment is a national problem for our single, national economy, and requires a nation-wide system to respond to it. Second, in order to protect the entire workforce from the sudden shock of wage loss and the economy from the sudden shock of consumer spending collapse, all workers need to be inside the system, contributing and protected. Third, unemployment benefits should be set at a sufficient level to keep individuals and families from falling into poverty and should be automatically extended in periods of economic decline and job losses, when normal expectations that people can find new jobs no longer apply.

— Steven Attewell, *Front Line of Defense: Building a New Unemployment Insurance System*

Next Social Contract Initiative, June 2010, http://www.newamerica.net/publications/policy/front_line_of_defense

Federal social insurance programs like Social Security and Medicare, on the other hand, have been more successful.³⁵

The United States is now one of only six countries in the world without a policy of statutory paid leave for new mothers, putting us in a group alongside Samoa, Sierra Leone, Liberia, Papua New Guinea, and Swaziland.³⁶ And the United States is the only OECD country without a mandated amount of minimum paid yearly leave from work.³⁷

Until 1993, American workers had no protection against losing their job if they had to take time off for personal or family illness or if they needed to care for a new child. The 1993 Family and Medical Leave Act (FMLA) changed this, allowing for workers to take up to 12 weeks of unpaid, job-protected leave for certain medical and family care needs.³⁸ While the FMLA was a step forward, it still falls far short of a just family leave policy, particularly in a changing economy.

For example, exclusions to eligibility under FMLA restrict the policy to approximately half of the workforce, and a disproportionate number of those left uncovered by FMLA are low-income workers. And because it only covers unpaid leave, FMLA does not help those low-income workers who are eligible but cannot afford to take off time from work.

A handful of states have supplemented the federal FMLA policy with policies to decrease exclusion and thus make more workers eligible for family leave benefits. In addition, California, New Jersey and Washington have implemented full paid family leave programs. The California program provides up to six weeks per year of partially-paid leave (up to 55 percent of earnings up to a maximum cap of around \$1000 per week) for caring for a new child or a sick family member. Early results from the California program showed that nearly all employers thought the program had positive or neutral effects, but that many low-income workers were either unaware of the program or unable to afford even partial wages for a period of time.³⁹

These state programs should be models for a new federal family leave system, which, once implemented, should replace them. Structuring paid family leave as a federal social insurance program, funded by a small federal payroll tax in addition to other payroll taxes, is by far the best approach to guaranteeing family leave for all Americans.

While paid family leave would provide paid time for indi-

viduals to devote to newborn infants or other purposes, the problem of day care for the children of working parents would remain. One solution would be state and local systems of public nursery schools and preschools, which might be created through an expansion of the existing public K-12 system. Many social conservatives, however, would object that this discriminates against home-makers.

A possible compromise would be an enlargement of the social insurance system to fund child care for infants and preschoolers in a way that allows parents to use the money to purchase tuition at public or private or nonprofit institutions or to enable one parent to stay at home. The child tax credit, a refundable federal income tax credit of \$1000 per dependent child, might be replaced with a refundable payroll tax credit. Because it costs lower-income families nearly \$10,000 a year to pay for a child,⁴⁰ permitting each parent a \$2000 tax credit for each child, or \$4000 per child per year, would effectively socialize nearly half the cost of raising children for families of moderate means. In order not to punish the children of divorced or unmarried parents, the tax credit should not depend on the marital status of the parents.

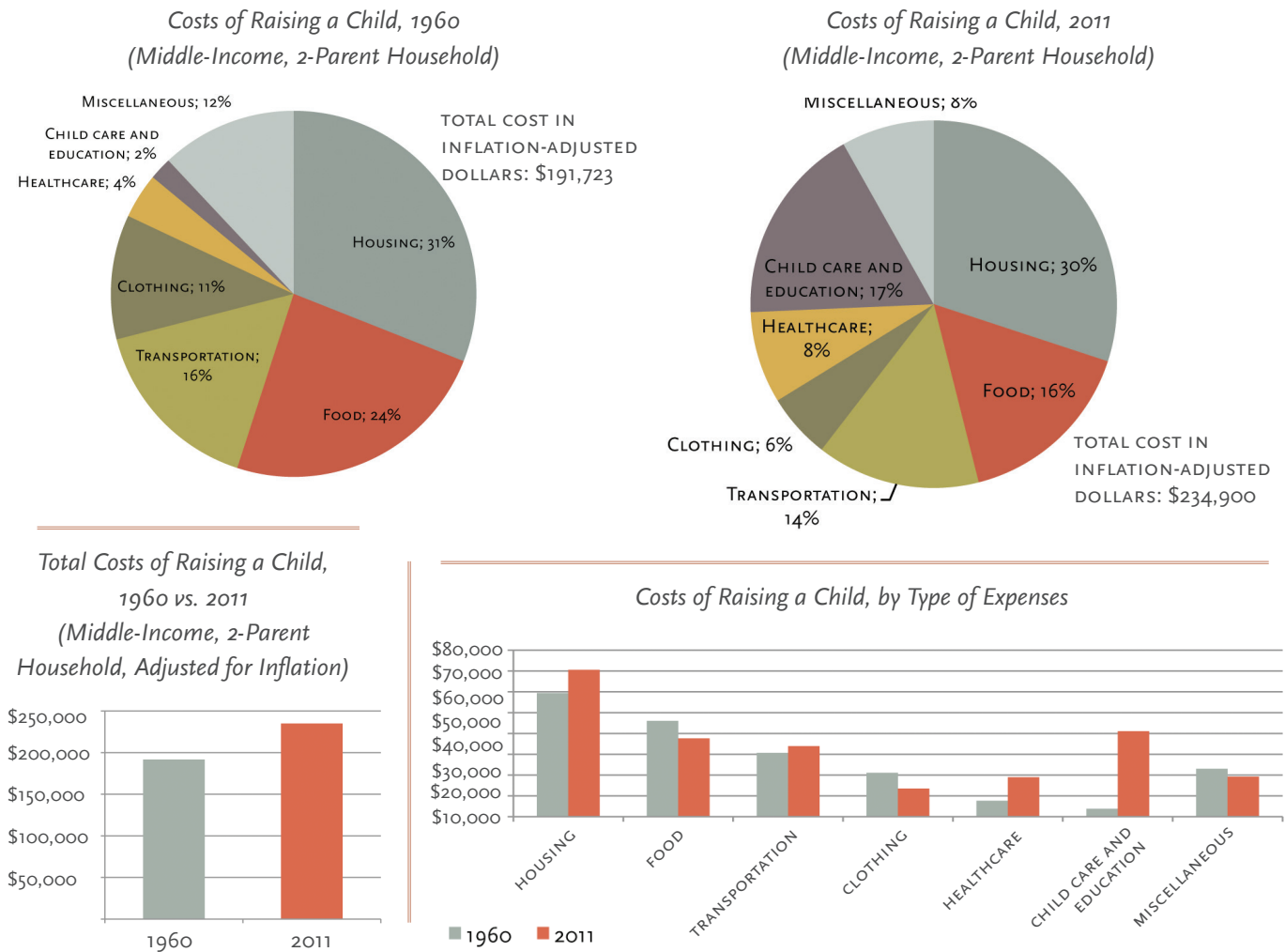
Administering an expanded child care tax credit through the payroll tax system, rather than the income tax system, would be efficient, politically sustainable, and fair. It would be efficient because far more Americans pay payroll taxes than pay federal income taxes. It would be politically popular because the child tax credit, like family leave, would be linked to work effort, through the payroll tax. And it would be fair, because single, childless Americans, through the payroll tax system, would help to subsidize the next generation of American workers, who in turn will subsidize them in retirement through their own payroll taxes. It is fitting that the parents of future citizens and workers should be granted payroll tax relief that helps to defray the costs.

Integrating Health Insurance into Social Insurance

The final missing ingredient from a comprehensive, universal social insurance program is health insurance. No matter of public policy is more contested than health care, because of its importance both for individuals and the economy.

President Franklin Roosevelt left health care out of the 1935 Social Security Act because it was too controversial. His successor, Harry Truman, pushed for universal, single-payer health care but could not get Congress to pass it.

Figure 8: Costs of Raising a Child



Source: United States Department of Agriculture, Center for Nutrition Policy and Promotion, *Expenditures on Children by Families*, 2011.

President Lyndon Johnson was able to shepherd Medicare through Congress in 1965 only because it was limited to the retired, who did not have access to the tax-favored, employer-provided health insurance system that became entrenched after World War II with encouragement from the Eisenhower administration. President Nixon's proposal for universal employer mandates went nowhere.

By the 1990s, when the Clinton administration proposed its ill-fated health care reform, the U.S. health care system was plagued by two problems: inadequate coverage and excessive costs. The Affordable Care Act, backed by President Barack Obama, focused on the problem of coverage rather than costs. The ACA rejected the New Deal/Great Society tradition of universal, taxpayer-based social insurance for the conservative alternative of tax expendi-

tures and individual mandates to purchase private health insurance. This model had been proposed by the conservative Heritage Foundation in the 1990s and was adopted in Massachusetts under Governor Mitt Romney.

While some elements of the law are laudable, as a whole the ACA combines all of the faults of the bad approaches to public policy, while rejecting the sound approach of universal federal social insurance. Means-tested subsidies, tax expenditures, and elaborate federal-state hybrid systems (in this case, health care exchanges) are all united in an overly-complicated system. For working-age, non-poor Americans, the Affordable Care Act (ACA) envisions a transition from system of tax expenditures based on employers to another indirect system based on tax subsidies to individuals purchasing insurance in state-created exchanges.

Even if it succeeds in expanding coverage, the ACA is unlikely to contain costs.

Other countries use a variety of methods to ensure universal coverage, from individual mandates to purchase private (nonprofit) insurance in Switzerland to the other extreme of single-payer/single-provider in the British National Health Service. But all countries that provide similar medical services for much lower costs than the U.S. use “all-payer regulation” — utility-style price regulation of medical goods and services, negotiated periodically by the central government and the nation’s medical providers. All-payer regulation would eliminate the threat to future federal budgets posed by Medicare and Medicaid. In the absence of all-payer regulation, Americans are likely to be given a false choice between government insolvency, because of the effect of health care cost growth on Medicare and Medicaid, and rationing, so that Americans are forced to

consume less health care than Europeans and Asians at much higher prices.

In the long run, the health insurance system should be integrated into a single, life-long, comprehensive social insurance program. As a step in that direction, Medicaid and SCHIP, two inefficient and unfair federal-state hybrid programs, should be completely federalized and merged with Medicare.

The U.S. health insurance system is likely to move either toward efficient social insurance or toward inefficient and costly voucherization of the social insurance elements like Medicare and Medicaid, combined with rationing of health care of a kind unknown in other advanced industrial democracies. For reasons of solvency and fairness alike, health insurance needs to be absorbed into an expanded, comprehensive American social insurance system. ■

All-Payer Regulation

Most developed nations determine prices in the health care sector by a method called “all-payer regulation.” Here is how it works: the government negotiates with representatives of medical service providers, like hospitals and pharmaceutical companies, to set standard prices for medical goods and services. These include operations, drugs and hospital stays. The prices are then renegotiated in a few years.

This kind of government-industry price negotiation is not unknown in the United States. It is used in the public utility sector, in which rates are set as a result of bargaining among providers and public utility commissions. And Medicare and Medicaid set fee schedules for the goods and services for which they pay. Maryland has long used an all-payer system for hospitals that has kept hospital costs under control.

Because of the political power of America’s medical industry, all-payer regulation is almost never discussed as a method of reducing exorbitant health care costs in the U.S. But without all-payer regulation, excessive prices for medical goods and services are likely to continue to be paid both by Medicare and Medicaid and by private insurers, including those provided with new customers by the Affordable Care Act.

In the words of Uwe Reinhardt, one of America’s leading health care economists:

At this time, the U.S. health system appears to stand at a clearly defined crossroads. On one road, Americans would seek better control over national health spending through an all-payer system, such as the one operated by Maryland for the hospital sector. On the other road, Americans would seek better control of health-care prices and national health spending through greater reliance on market forces for most of the health system. Depending on how that road is traveled, *it could entail more pronounced rationing of health care by income class, meaning less health care for those who cannot afford it.*¹ (emphasis added).

¹ Uwe E. Reinhardt, “The Many Different Prices Paid to Providers and the Flawed Theory of Cost Shifting: Is It Time For A More Rational All-Payer System?”, *Health Affairs*, 30, no. 11 (2011), p. 2129. See also Joseph White, “Cost Control and Health Care Reform: The Case for All-Payer Regulation” (May 2009), <http://www.ourfuture.org/files/JWhiteAllPayerCostControl.pdf>.

PART FOUR

Expanding Public Provision

The third major element of the social contract, after income and economic security programs, is made up of merit goods. Merit goods are goods or services to which the American people believe that everyone should have access, even though the market does not supply them in adequate quantities or at acceptable prices. In recent decades Congress has relied heavily on tax credits and tax-favored lending for individuals to increase access to merit goods like housing, higher education, and child care. As we have seen, tax subsidies for the private purchase of specific kinds of goods and services tend to be inequitable and can lead to cost inflation and the misallocation of resources from unsubsidized to subsidized sectors of the economy.

If all Americans are paid a living wage and have adequate social insurance, then it might not be necessary to subsidize some particular merit goods like housing at all. Other merit goods, like higher education and child care, might be best provided as public services by state and local governments.

Public Provision — The Role of State and Local Governments

The expansion of reliable and solvent social insurance would eliminate the rationale for subsidies for merit goods like housing and savings accounts, to the extent that they are valued chiefly as emergency economic assets. While public support for housing and savings should be phased out, support for the merit goods of education, including preschool and higher education, and medical facilities should be increased. Because schools and hospitals are “club goods” in particular localities, the best way to increase access to these is not to create pseudo-markets for vouchers but to expand public health care and public education at the state and local level, financed by federal “fiscal equalization” or revenue sharing.

In the case of assets, most tax expenditures to encourage purchase of particular assets should be eliminated. The expansion of social insurance we propose would allow the elimination of most tax-favored retirement and health care accounts. The experience of other countries like Canada with home ownership rates comparable to that of the U.S. proves that

tax expenditures for home ownership are not needed to ensure a home-owning middle class. Tax subsidies for housing should be capped at a low level or eliminated.

While subsidies for some merit goods like savings and housing should be reduced or abolished, other merit goods might be provided most efficiently by direct public provision rather than by subsidies for private purchase. Many of the amenity services on which increasingly-rich societies, like increasingly-rich individuals, can be expected to spend a growing share of their incomes are also “club goods” — goods which are most efficiently provided if people pool their resources. For merit goods like these, the most efficient and fair form of provision would be a major expansion of both public employment and public services, rather than an expansion of wage subsidies and subsidized purchases of private services.

The case for the permanent expansion of public services is strengthened by the striking fact that most employment growth in the past decade has been concentrated in three sectors which provide merit goods that are also club goods:

healthcare, education and government, mostly state and local public services.

The growth of these sectors refutes fashionable predictions about “the jobs of the future.” In the 1990s, advocates of the new economy argued that we would increasingly depend on what Robert Reich called “symbolic analyst” jobs.⁴¹ But the vision of a nation of tech workers was oversold. A world-class technology sector will transform the economy and generate tax revenue but will create relatively few jobs. And graduate and professional schools are turning out too many lawyers, professors and other professionals for the limited number of available jobs — jobs which may diminish further in number as IT substitutes technology for labor in the professional services sector.

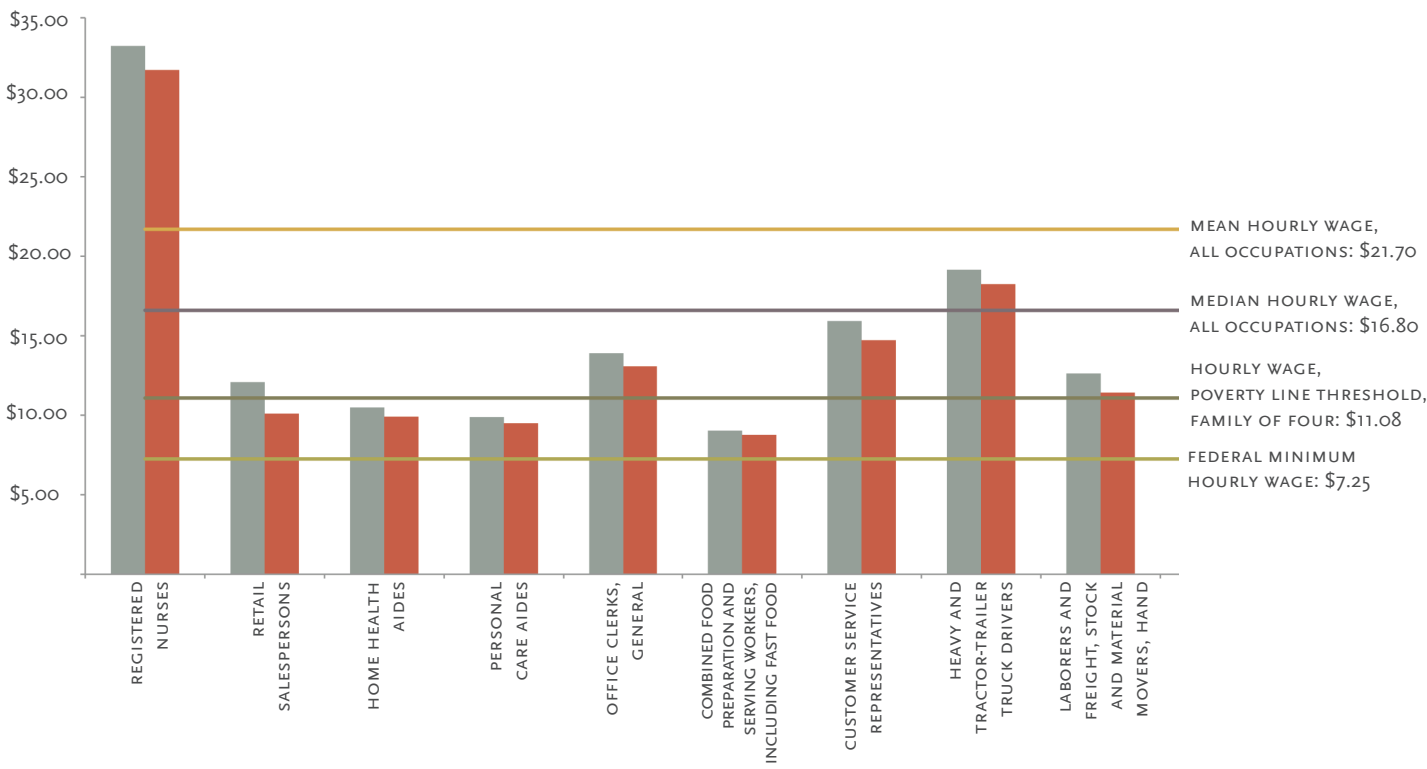
For the real jobs of the future, look to healthcare, education and local public services.

What is driving this growth? One reason is the aging of the population. Another is the fact that societies, like individu-

als, choose to purchase more healthcare as they grow more affluent. According to the logic of “Engel’s Law,” much of the disposable income freed by productivity-lowered prices in appliances, transportation, energy and perhaps housing may be spent on quality of life goods like health, education, and recreation. There is every reason to believe that there is vast untapped demand among ordinary Americans for many quality of life services that only the affluent minority can afford today. While some of these, like recreation and restaurant dining, can best be provided by the private sector, others like education, health and recreational facilities like parks can be provided most efficiently by government.

Of these, the most important is health, the good that makes possible all other goods. According to the Bureau of Labor Statistics, healthcare accounts for seven out of the 20 fastest-growing occupations, more than any other category. Home health aides and personal and home-care aides are found both among the fastest-growing job categories and among the occupations with the largest overall job openings in the years ahead.⁴²

Figure 9: Mean and Median Hourly Wages, Occupations with Largest Projected Employment Growth, 2010-2020



Source: Authors’ Analysis of Bureau of Labor Statistics data. Note: the 10th largest growth occupation, postsecondary teachers, does not have income data due to discrepancies within the field.

Only one of the nine occupations with the largest projected growth in the next decade has above-average wages, and 8 out of 9 are below twenty dollars an hour.

While employment in manufacturing is declining overall, employment in pharmaceutical and medicine manufacturing in the US is expected to expand. Better yet, the growing healthcare sector is creating jobs for workers at all educational levels, from the highest — physicians and surgeons who need professional degrees — to the lowest — health aides who need only high school qualifications plus brief on-the-job training. The medical-industrial complex is unique among industries in combining the potential for greater research and development, more manufacturing and a growing number of labor-intensive jobs that cannot be offshored.

Far from being a problem, then, the steady and sustainable growth of employment in the healthcare sector, along with jobs providing care for the elderly and children, education and the provision of public goods, may be the next stage in the evolution of advanced economies.

The increasing supply of service sector workers interacts with an increasing demand for certain services as populations grow more affluent. While the service sector as a whole will continue to grow, public policy will play a role in determining both the allocation of service jobs between the private and the public sector and the labor market conditions in both.

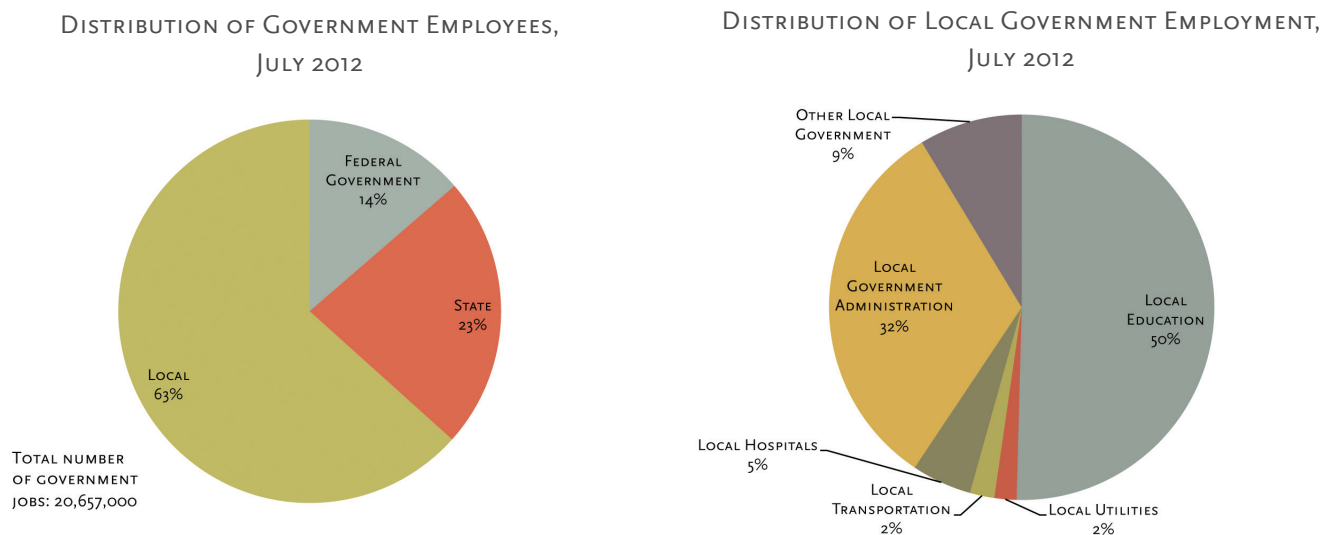
Public provision of some essential goods and services can benefit workers directly, in the case of government employ-

ees, and indirectly, in the case of private sector workers.

In the mid-twentieth century, the generous paychecks of unionized industrial workers in Detroit and other manufacturing centers, when spent on goods and services, employed many other Americans and acted as a private, informal method of redistribution of the gains from economic growth. But twenty-first century countries cannot rely on well-paid production workers as the heart of the middle class. As a result of productivity growth, even in the absence of offshoring, there simply will not be enough of them. The next American middle class must be based on service sector workers with generous paychecks.

Many of the best-paid service sector workers will necessarily be found in the public sector. Unlike the oligopolies that dominated U.S. and global manufacturing in the post-World War II era, today's American service sector employers — nursing homes, for example — are “price takers,” not “price makers.” Many of them are low-profit businesses in competitive markets. They lack the power of monopolies and oligopolies to raise wages for their workers and pass on the costs to consumers. And any idealistic service sector employer that did so unilaterally would be in danger of going out of business. Unlike private employers, government can tap into the gains generated in the low-employment, high-productivity sectors and redistribute some of those gains to workers in less productive sectors.

Figure 10: Most Public Sector Employment is State and Local, Not Federal



Source: Bureau of Labor Statistics, CES Employment Data, Not Seasonally Adjusted.

Expanding the government's share of low- and medium-skilled workers can also raise the wages of similar workers in the private service sector indirectly, by creating a tighter private labor market and forcing private employers to compete for workers with generous public employers. In addition to these direct and indirect effects, the public sector can influence wages in the private sector in its roles as a major consumer and a major contractor.

Raising private sector wages indirectly, by expanding public employment, would also have the benefit of encouraging greater productivity growth in the private service sector. If private health care, leisure and hospitality had to compete for low-wage workers, they would be forced to make better use of productivity-enhancing technology to compensate for higher labor costs. The promise of the neoliberal hidden welfare state is that competition for voucher-like tax subsidies among producers will lead to price-reducing innovation. But as we have seen, in the imperfect markets for health care and education, the infusion of public tax expenditure subsidies without government price controls tends to merely create monopoly and oligopoly rents for producers, inflation and pressures for rationing.

The experience of other countries, as well as the experience of the U.S. utility sector, proves that government provision of services or government regulation of prices does not prevent the introduction of new technology or block productivity gains. Indeed, a public provider can pioneer and adopt new best practices before those practices diffuse among private providers. As Phillip Longman has pointed out, the Veterans Administration led the way in adopting information technology in hospital practice, saving money as well as lives.⁴³ The public sector can also play a role in promoting industry-wide efficiency by forcing contractors to pool patents and adopt common standards, something the federal government has done in sectors as different as penicillin

research and aerospace. The contrast of private sector efficiency and public sector inefficiency is an ideological myth.

It may sound heretical to propose expanding public employment at a time when state and local governments are being forced to cut jobs and services. Nevertheless, the fact remains that in a high-productivity economy more of the middle-class jobs in the future will need to be located in the public sector, chiefly at the state and local level. In practice, advocates of wage subsidies like the EITC and subsidies for the private purchase of insurance and merit goods concede this point. The real debate is not about redistribution, but about the form that such redistribution should take.

The fact remains that in a high-productivity economy more of the middle-class jobs in the future will need to be located in the public sector, chiefly at the state and local levels.

The alternative of expanding wage subsidies for private sector employment should be rejected. The provision of public services directly rather than relying on tax expenditures is superior in terms of fairness and fiscal soundness. Direct provision of merit goods and services is fairer because most tax expenditures disproportionately benefit affluent Americans, often increasing as incomes increase.⁴⁴ And direct provision of merit good services encourages public sector solvency. It is easier to keep the costs of visible programs funded by legislative appropriations under control than it is to control the costs of tax expenditures, which are largely invisible and to which individuals have a right by law, no matter how much the total may be. ❏

PART FIVE

How to Pay for the Next Social Contract

Is the next social contract that we propose affordable? We have already addressed the issue of incidental unemployment that might be caused by a higher minimum wage, so we will focus here on the cost of our proposals to expand social insurance and state and local public services. Because we seek to replace partly-public and partly-private systems of income maintenance and merit goods with purely public alternatives, the cost of the alternatives must be measured against the cost of the existing systems as a whole, not merely existing public programs.

In 2007, before the Great Recession, net formal public spending on social expenditures in the U.S. was 18.6 percent of GDP. This was far below the level in the United Kingdom (22.0), Germany (26.5), and France (29.6).⁴⁵ Japan had a relatively low level of public social spending, as well, at 19.7 percent of GDP. But Japan's undeveloped welfare state exists in the context of institutions like employer paternalism and heavy reliance on unpaid female household labor.

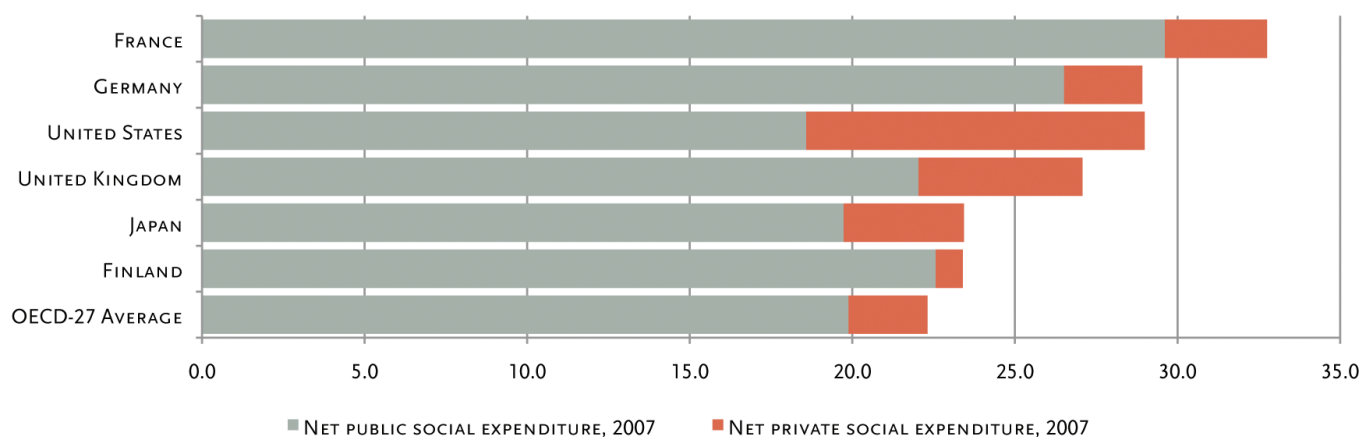
While public expenditures in the U.S. are low compared to those of similar countries, private social expenditures are much higher, largely because of the heavy reliance in the U.S. on the delivery of benefits by means of tax expenditures for individuals, employers and lenders. In 2007, the U.S.

was an outlier, spending 10.4 percent of GDP on private social expenditures, far more than the UK (5.0), Germany (2.4) or France (3.1).

When net public and net private social expenditures (many of which are publicly-subsidized) are added together, America's "exceptionalism" disappears. The total for the U.S. in 2007 was 27.5 percent of GDP, higher than the level in the UK (26.9 percent) and comparable to that of Germany (28.4) and France (32.7).⁴⁶ The legitimate comparison of the costs of social expenditures under the proposed next social contract would be combined public and private social expenditures, rather than just the formal government share. In our vision of the next social contract, the resulting expansion of the visible government would be much more dramatic than the actual expansion of government as a whole.

The United States currently spends more than a trillion dollars per year on tax expenditures in total, much of which is for social purposes. Reducing or eliminating tax expenditures would add that amount to the budget, which would partly offset the cost of increasing more visible, direct spending. As liberals and conservative alike have noted, "broadening the base" through limiting tax expenditures would increase revenue — either to pay for the strengthen-

Figure 11: Net Public and Net Private Social Expenditures, Selected OECD Countries 2007



Source: OECD Social Expenditures Database, 2007. The United States is above average in terms of overall social spending, but has some of the lowest public social spending. Instead, the United States has a much larger amount of private social expenditures, like tax-favored retirement, employer health insurance, and the Earned Income Tax Credit.

ing of social programs, as we propose, or to cut taxes, as many others have suggested.

But revenue neutrality for its own sake should not be a goal in reforming the American social contract. For one thing, even under the existing social contract, the aging of the population will lead to increases in spending on Social Security and Medicare and Medicaid, absent painful and politically unrealistic cuts in spending on the elderly. We propose expansions of social insurance, like family leave and a generous child care payroll tax credit, and of public services, including public day-care and public higher education. Some of the costs could be offset by the elimination of federal income tax expenditures. Undoubtedly, however, additional revenue would need to be raised both for expanded social insurance and for expanded state and local public services.

As we argued in Part Three, the expansion of universal federal social insurance should be funded, at least in part, by new federal revenues other than the payroll tax. In order to establish a right to social insurance based on effort, part of every social insurance program, be it an existing and reformed program like Social Security or a completely new federal entitlement like paid family leave, should be funded by a payroll tax.

But payroll taxes can and should be supplemented by other

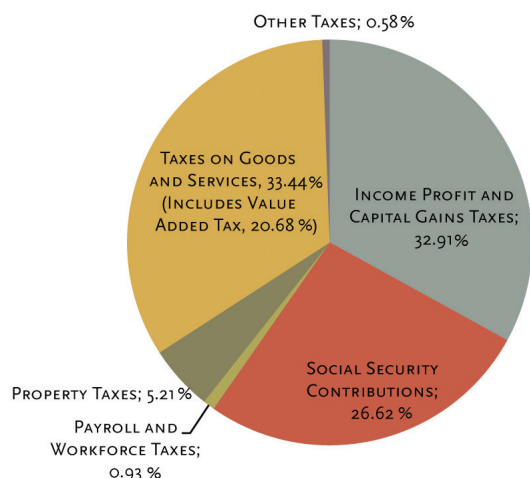
taxes that help to pay for social insurance. A large body of economic scholarship holds that taxes on consumption, rents and unproductive speculation are less harmful to economic growth than other kinds of taxes. In order to minimize the distortion of economic decision-making as well as to avoid shortfalls as a result of economic fluctuations, additional taxes for social insurance should be broad like a value-added tax (VAT), rather than narrow “sin” taxes, like a carbon tax, which have sometimes been suggested as partial or complete replacements for payroll taxes.

The United States is the only developed nation without a value-added tax, and on average the VAT accounts for more than 20% of total tax revenue in OECD countries.⁴⁷ A value-added tax is a consumption tax, like a sales tax. But because a VAT is collected at each stage of the production of a product, it avoids the problem of “cascading” sales taxes on top of sales taxes. Even a narrow-based VAT that exempts necessities like food or children’s clothing can collect large amounts of revenue with relatively low rates, and it is harder to “game” or evade than an income tax.⁴⁸

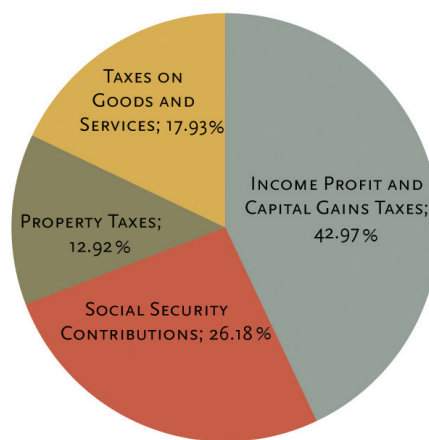
In the U.S., a VAT could be used to reduce the federal deficit, fund an expansion of social insurance and serve as the basis for a revived system of revenue sharing in the U.S. A VAT can also be used to reduce other taxes that tend to distort corporate decision-making and labor markets. A joint study by the

Figure 12: Value Added Tax

OECD AVERAGE (EXCLUDING U.S.) TAX REVENUES BY SECTOR AS SHARE OF TOTAL TAX REVENUE, 2010



UNITED STATES TAX REVENUES BY SECTOR AS SHARE OF TOTAL TAX REVENUE, 2010



Source: OECD Revenue Statistics.

New America Foundation's Economic Growth Program and the Urban Institute found that a narrow-based 5% VAT could be used to significantly cut the corporate income tax from 35% to 25.6%, while at the same time slashing the employer portion of the payroll tax from 6.2% to 4.5%.⁴⁹ As we noted in our discussion of Expanded Social Security, the regressive effect of such broad-based taxes can be mitigated by the overall progressivity of social insurance as a whole or by rebates administered through the Social Security system, like a payroll tax rebate.

A VAT could be supplemented by taxes on resource rents, of the kinds already used by Canada and Australia.⁵⁰ A finan-

cial transaction tax or "Tobin tax" (named after the economist James Tobin) should also be considered. A miniscule tax on all financial transactions would not affect most individuals or businesses, but it would fall heavily on high-volume transactions, including high-speed, computer-driven stock market and currency exchange trading that is a form of casino speculation rather than socially-useful investment.⁵¹ Capital gains taxes should equal taxes on wage income, and might be supplemented by wealth taxes on large holdings which could raise significant revenue even if their rates were very low.⁵² Finally, inherited wealth should be taxed, as a kind of rent. Taxes on inheritances by individuals might be easier to col-

Fiscal Equalization Around the World

In a system of government that includes any level of decentralized authority, systems of fiscal equalization — partial redistribution of funds to particular regions or states — often exist to help equalize inherent intraregional differences. Fiscal equalization can ensure that people across regions can have access to similar public services at similar tax rates, and it can also insure regions against economic shocks that they may not be able to cope with themselves.

Equalization exists in two forms: vertical or horizontal. Vertical equalization is a redistribution of funds from the federal government to regional governments, while horizontal equalization is a redistribution of funds between regional governments. Equalization can also target either revenues or costs: revenue equalization targets the differences in regional capacity to raise revenues, and cost equalization redistributes based on regional costs of providing a given level of public services.¹

The Canadian program of vertical revenue equalization was written into the country's constitution in 1982. The level of redistribution is based on each province's ability to raise revenues, the funds can be spent in any way, and the amount is adjusted based on a three-year moving average of GDP growth.² Australia has a similar vertical system of disbursing equalizing block grants derived from funds raised by the Goods and Services Tax (GST). The goal is to give each state "the same per capita fiscal capacity," which is its ability to provide average services by raising revenue at average rates.³

Via a different mechanism, federal states in Germany are constitutionally required to share state revenues horizontally, rather than receive portions of federal revenues. For example, of the VAT revenues that are dedicated to states, three quarters is distributed by population and one quarter is distributed to states that have weaker finances.⁴

Although the U.S. abolished its own system of vertical federal revenue sharing in 1987, forms of less overt fiscal equalization still exist in the United States. Medicaid, the health insurance program for low-income Americans, is funded as an open-ended earmarked matching grant with a varying rate inversely related to income and tax-based funding capacity; as such, it does redistribute some federal funds to states.

1 Blochliger, Hansjorg and Charbit, Claire, "Fiscal Equalisation," OECD Economic Studies, 2008, no. 44.

2 "Equalization," Department of Finance Canada, Web site, visited July 27, 2012. <http://www.fin.gc.ca/fedprov/eqp-eng.asp>.

3 "Report on GST Revenue Sharing Relativities – 2010 Review" Commonwealth of Australia, 2010. http://www.cgc.gov.au/__data/assets/file/0007/18349/2010_Review_final_report_vol1.pdf.

4 Werner, Jan and Shah, Anwar, "Fiscal Equalisation in Germany," November 2005. <http://info.worldbank.org/etools/docs/library/24116/FiscalEqualisationInGermany.pdf>.

lect than taxes on estates. Taxes like these would partly shift the burden of paying for government from individual wage earners, entrepreneurs and investors in productive enterprises to the undeserving beneficiaries of unearned income.

Revenue Sharing

The strategy that we propose of replacing most subsidies for private purchases of merit goods with direct provision of some but not all of the same merit goods by state and local governments can only succeed if state and local governments have adequate revenue. But there are profound inequalities in the abilities of different states to pay for similar public goods. For example, a tiny property tax allocated to education in rich Connecticut might raise far more money than a high property tax in poor Mississippi or New Mexico.

Most other democracies in the world use “fiscal equalization” policies to reduce the inability of poor states or provinces to fund adequate levels of public services at reasonable tax rates.⁵³

The United States had its own system of fiscal equalization in the form of federal revenue sharing between 1972 and 1987. On October 20, 1972 President Richard Nixon signed the State and Local Fiscal Assistance Act that instituted a system of revenue sharing. Nixon called general revenue sharing “a new American revolution — a peaceful revolution in which power [is] turned back to the people...a revolution as profound, as far-reaching, as exciting as that first revolution almost 200 years ago” and described among its benefits lower taxes, better schools and hospitals, more police, and whatever local officials determine based on local needs.

The U.S. general revenue sharing program distributed a portion of federal income tax receipts to states and cities but lasted only 15 years. While critics of the program argued that affluent municipalities should not receive federal aid, most spending was on essential or desirable public services. Small, low-income towns and poor urban communities were able to pay for police salaries, health care, and public transportation. At its peak, revenue sharing provided American municipalities with a total of \$6.8 billion — the equivalent of almost \$20 billion today.⁵⁴ Revenue sharing provided more than half of the annual budget for some towns and counties.

Broad but shallow bipartisan support was not enough to protect the program from a coalition of anti-government conservatives and liberals who preferred narrowly targeted federal spending programs. The end of revenue sharing was

a disaster for many American municipalities, particularly for rural and poor cities and towns. Many were forced to engage in cut-backs of essential public services, including La Mirada, California, which according to the *New York Times* “reduced its government to a shell, contracting out anything from police protection to public works.”⁵⁵ The end of revenue sharing also forced state and local governments to raise taxes; the poorer the region, the higher the taxes had to be to support comparable levels of public service. Since state and local taxes are more regressive, the abolition of revenue sharing shifted the overall American tax system at all levels in a regressive direction.

Revenue sharing can help State and local government deliver again, closing the gap between promise and performance.

Revenue sharing will give these hard-pressed governments the dollars they need so badly. But just as importantly, it will give them the freedom they need to use those dollars as effectively as possible.

— PRESIDENT RICHARD NIXON, STATEMENT ABOUT THE
GENERAL REVENUE SHARING BILL, OCTOBER 20, 1972

It is time to revive an idea that has worked successfully, both in the U.S. until 1987 and in other federal democracies. The expansion of state and local public services that we propose should be paid for in part by a new system of federal revenue sharing or “vertical fiscal equalization.” In the case of one or more taxes, the federal government would collect the tax and distribute part or all of it to state governments on the basis of population.

Revenue sharing could be “general,” with no strings attached, or it could be restricted in purpose, taking the form of “block grants” for particular activities like public education and public health care. To succeed, limited-purpose revenue sharing would have to avoid being used as a tool of

centralized micromanagement by Congress.

Among other benefits of the restoration of revenue sharing in the U.S. would be a limit to the destructive “race to the bottom” among states. In the absence of fiscal equalization, some American states can lure firms and industries from others by lowering or abolishing corporate or income taxes and by using selective tax expenditures to subsidize firms. While this strategy may succeed in bringing business to the state, it often comes at a high price in terms of reduced public services or the shifting of taxation from progressive personal and corporate income taxes to regressive sales and property taxes. By providing much state and local spending with a national revenue base, revenue sharing reduces the incentive of state and local governments to sacrifice public services to economic development strategies. Instead of a race to the bottom among states competing on tax rates, there can be a race to the top among states competing for business on the basis of quality public education, infrastructure and other services that benefit the private sector.

It might be objected that “rich states” would be subsidizing “poor states.” But states do not pay taxes, only individuals

do, directly or indirectly (as through the corporate income tax). In the United States, there are more rich Americans in states like New York and Connecticut than in states like Mississippi and New Mexico. But any taxes used for federal revenue sharing would fall on the rich in Mississippi and New Mexico, and would fund public services to the benefit of the non-rich in New York and Connecticut. Privileged Americans should not be allowed to use sub-national jurisdictions as excuses for shirking their responsibility to contribute to minimum levels of public services throughout the United States as a whole.

In addition to other benefits, revenue sharing would be good for the U.S. economy as a whole. Booming regions can help other parts of the nation that are suffering from regional downturns. And during national or global economic crises, the greater capacity of the federal government to borrow money for emergency deficit spending could prevent the kind of the kind of disastrous layoffs of teachers, police officers and firefighters which, during the Great Recession, did much to neutralize federal stimulus policy. Revenue sharing is, among other things, an effective “automatic stabilizer” in a modern national economy. ■

Learning from the Great Recession

Our experience under the Great Recession has underscored the enduring value of the core pillars of a social contract that President Franklin Roosevelt first laid out in his address to Congress in January 1944: the right to a job, the right to adequate compensation, the right to a secure retirement and affordable health care, and the right to improve one’s position in life through access to quality public education.

We need a new strategy for maintaining full employment even as we reform our benefits system to be less dependent on formal full-time employment. Our basic strategy for maintaining high levels of employment over the past two decades was essentially reliant on an expansive monetary policy with minimal intervention in the labor market. But this strategy won’t work in a world in which consumer demand is constrained by high debt levels, businesses are either facing overcapacity or can meet demand with fewer workers, and much of the demand provided by macroeconomic policy leaks out of the United States to stimulate job creation in other economies.

In particular, we need to explore ways to expand public and public-generated employment to make up for shortfalls in private sector job creation. The best way to create jobs and make the economy more productive over the long term is by increasing public infrastructure investment, some of which can be targeted to communities with particularly high rates of unemployment. Studies estimate that every \$1 billion of infrastructure spending creates on average 18,000 jobs and has a 1.57 multiplier effect on GDP. The United States has an enormous backlog of unmet public infrastructure needs, and it would make sense to address them over the next five years in order to help return the economy to full employment.

— Sherle R. Schwenninger, *The American Social Contract: Lessons from the Great Recession*

Next Social Contract Initiative, September 2010; http://newamerica.net/publications/policy/the_american_social_contract

PART SIX

Toward the Next Social Contract

The next American social contract that we propose would build upon what works today while rejecting what has failed. As an alternative to wage subsidies that create a class of workers dependent on federal checks and reward low-wage, inefficient employers, we propose raising the minimum wage until it is a living wage and indexing it to inflation. As an alternative to achieving income security through individual tax expenditures and hybrid federal-state social insurance programs, we propose creating a comprehensive, expanded system of purely federal social insurance. Finally, as an alternative to tax expenditures that subsidize the private purchases by individuals of particular merit goods, we propose to eliminate subsidies for some (housing) while relying on expanded public provision of others, like education, including public higher education, by state and local governments.

The logic in each case is the same: direct government action is more efficient than indirect subsidies of the private sector which, while helping individuals, funnel money to some private employers and for-profit, private service providers. A living wage can increase incomes at the bottom for employees without subsidizing employers who pay their workers too little to live on. Expanding social insurance in the form of transfer payments based on taxation can increase the security of retirees, parents of newborn children, and the unemployed and disabled, without subsidizing money managers and other intermediaries, as tax-favored private savings programs do. And expanded public provision of higher education and other merit goods can be done at cost, unlike indirect federal subsidies, some of which are siphoned off into salaries and perks for the shareholders and managers of for-profit providers.

The next American social contract that we propose would be radical in the original sense of the word: it would get to the root of the dangers posed by low wages and an inadequate economic security system.

The reforms that we propose would produce a radical alteration of responsibilities among individuals, employers and government at different levels. In return for being

freed from the burden of providing benefits to employees, employers would be expected to pay more in wages.

In the next social contract, the division of labor among federal, state and local governments would be transformed for the better as well. The federal government would specialize in the public provision of benefits in the form of social insurance, which would be expanded as tax-based subsidies for retirement savings, health care, and higher education are gradually phased out. All hybrid federal-state social insurance programs, such as unemployment insurance and Medicaid, would be replaced by purely federal programs. Freed from any burdensome role in providing social insurance, state and local governments, with the help of federal funds via revenue sharing, would specialize in the direct public provision of merit goods such as public education at all levels.

The next social contract that we propose breaks with the orthodoxies of today's conventional left, right and center.

The next social contract that we propose breaks with the orthodoxies of today's conventional left, right and center. The replacement of the hidden welfare state that is made up of the indirect, tax-subsidized private provision of goods and services by direct public provision might be thought of as a progressive proposal. But many centrist Democrats have championed the failed neoliberal strategy of inefficient, indirect tax expenditures in the areas of wages, benefits and merit goods — a strategy that we reject. Likewise, many progressives favor expanding the means-tested programs that we propose to eliminate or convert into universal social insurance.

Each of the elements of the next American social contract described here has also been favored by prominent conservatives. President Ronald Reagan and former Federal

Reserve chairman Paul Volcker have called for the complete nationalization of Medicaid. Ron Unz, the publisher of *The American Conservative*, has argued that conservatives should favor a higher minimum wage,⁵⁶ while Republican presidential candidate Mitt Romney has called for indexing the minimum wage to inflation. The economist Henry Simons, a founder of Chicago School of economics and a critic of the New Deal, argued that direct public provision of some goods was more efficient than indirect provision subsidized by loans or tax credits.⁵⁷ And President Richard Nixon, a Republican, championed fiscal equalization in the form of general revenue sharing.

The goal is to consolidate and streamline the economic safety net into a few big, simple, efficient programs that are difficult for special interests to game and easy for citizens and their elected representatives to understand and evaluate.

Almost all of the reforms here involve expansions or reductions of existing programs — the minimum wage, Social Security, Medicare and public schools — rather than the creation of new programs. Indeed, the goal is to consolidate and streamline the economic safety net into a few big, simple, efficient programs that are difficult for special interests to game and easy for citizens and their elected representatives to understand and evaluate. Large, simple, and visible programs are the most direct way to use the strengths of a democratic system and fight regulatory capture and the imbalanced influence of specific interests.

Our program would also promote genuine fiscal responsibility — defined as paying for legitimate commitments, not merely shrinking the size of government, reneging on historic commitments or making ordinary Americans less secure. Direct spending for social insurance and publicly provided goods and services would replace the invisible spending of the hidden welfare state. The replacement

of tax expenditures, whose total amounts are determined by individuals rather than Congress, with direct spending programs would permit overall limits to be set on spending for social purposes in a transparent way.

The reforms that we propose would benefit employers and the economy as a whole as well as individual Americans. Businesses would benefit from the complete replacement of employer benefits with universal public benefits, so that companies would no longer need to serve as miniature welfare states. The playing field among big businesses that offer benefits and small businesses that cannot afford to do so would be leveled. The economy would be helped by an end to the misallocation of resources in the form of tax subsidies going to inefficient, for-profit middle-men in health care, housing, higher education and retirement savings. And the U.S. financial industry would be dramatically downsized, as the flood of tax-favored private savings flowing from the American middle class into the hands of Wall Street money managers shrinks to a trickle.

Most important of all, the next social contract would reflect core American values. Influenced by the democratic republican tradition, most Americans have believed in “equal rights for all, special privileges for none.” This principle would be reflected in a move toward more universal social insurance and away from unpopular, means-tested programs for the poor that are resented by the working class and middle class. A minimum wage that is a living wage would resonate with the conviction that workers should earn enough to live without reliance on charity or welfare, while a two-tier Social Security program based in part on payroll taxes would make personal effort the basis of earned benefits while also keeping the elderly out of poverty.

Like the American republic, the American social contract is a work in progress. As the economy and the world change, each generation faces the need to rebuild our system of shared economic security, which benefits the larger economy and country by cushioning economic volatility, restoring a sense of fairness, and helping keep alive the American dream. To bequeath greater opportunity and greater security to the next generation should be the priority for this generation of Americans. ♦

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