

The Haves and the Have-Lots

The American welfare state is bigger than you think, and more unfair than you would like.

A father goes grocery shopping for his family and returns with the basics—milk, bread, peanut butter, cereal, apple sauce, frozen pizzas. He also comes home with a large steak, which he alone plans to eat, and a bottle of good wine, which his pregnant wife cannot share. Money is a little tight, so he buys fewer vegetables and substitutes Kool-Aid for fresh juice. He uses a credit card, knowing they won't be able to pay off the full balance next month. No one in the house starves that week, and the father eats and drinks unusually well.

If this happened once, most of us would say the guy was being a little selfish. But if he acted this way year after year, we would be deeply troubled and tell him to get his priorities straight. And yet too many U.S. social programs operate exactly this way: While they serve many people, they often give the most help

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to those who need it the least. Classic social insurance programs like Social Security and Medicare do, indeed, distribute benefits widely and offer extra help to the poor and the very sick. And means-tested programs like Medicaid and Temporary Assistance for Needy Families (TANF, also known as “welfare”) are aimed exclusively at the disadvantaged. Nevertheless, the ability of these programs to fight poverty and inequality is substantially negated by other social programs—mainly tax expenditures like the home mortgage interest deduction and social regulations like the Family and Medical Leave Act (FMLA)—that benefit primarily the middle and upper-middle classes. While these latter policies may have their individual merits, in their current form they often widen the gap between haves and have-nots.

Economists criticize many of these policies for their inefficiency—noting, for example, that the mortgage deduction in the U.S. tax code encourages people to over-invest in large, luxury homes. But an equally powerful objection is rooted in fairness. A number of social policies make a mockery of the goal, enshrined in the Constitution, that government exists to “promote the general welfare.” Our long-standing commitment to equal opportunity rings hollow when certain programs help people with good jobs and incomes to get health insurance, housing, parental leave, and retirement pensions, but offer little help to the poor and near-poor. We may disagree over how hard government should try to reduce poverty and inequality. Surely, however, when millions of Americans live in poverty and inequality has reached record levels, we can agree that public policies should not make these problems worse.

Call it phony universalism, Robin Hood in reverse, or socialism for the rich—whatever the name, the U.S. government is effectively targeting tax subsidies and legal protections at the more advantaged members of American society. The level of support is enormous, amounting to hundreds of billions of dollars each year. For every dollar spent on traditional anti-poverty programs, the United States spends almost as much through the tax code helping individuals who are lucky enough to have health and pension benefits at work or rich enough to buy a nice home (these are often the same people). This is how the United States can spend a ton of money on its welfare system and yet make fewer inroads against poverty and inequality than other affluent nations. Imagine a campaign against child obesity that encouraged kids to exercise daily *and* eat more Cheetos: U.S. social policy is beset by the same kinds of contradictions.

Some policy-makers realize what’s going on. When the Bush Administration proposed new tax incentives for Health Savings Accounts, the Center on Budget and Policy Priorities quickly pointed out that most of these benefits would go to affluent taxpayers. The Democratic authors of the American Dream Initiative, a

set of policies designed to expand and strengthen the middle class, were careful last year to propose refundable tax credits for college tuition so that more people with below-average incomes could benefit. But it's not enough to oppose bad ideas, or layer potentially good new programs on top of dysfunctional old ones. We also need to scrutinize existing programs and figure out how they got started, whom they really help, and what we could do to change them. Otherwise, we may find ourselves repeating these same mistakes as we respond to persistent poverty and growing inequality today. Moreover, if we can find ways to spend less on some of these existing programs, we can free up monies to serve more pressing social needs. The goal should not be to exclude the middle class from these programs but to ensure that more governmental benefits are distributed to those who truly need help.

The Strange Shape of U.S. Social Policy

The programs in question are rarely mentioned in debates over social policy or in studies of the welfare state. The unstated assumption is that U.S. social programs should resemble those in Europe. From this perspective, social programs are supposed to take the form of social insurance and grants. The former is broadly inclusive, and the latter is usually aimed at the poor. Because the United States spends a relatively small share of its gross domestic product on these kinds of social programs, it is considered a laggard or a semi-welfare state by observers on both sides of the Atlantic.

But the big difference between the American welfare state and its European cousins is not so much the level of government involvement as it is the mix of policy tools. After all, social insurance and grants are not the only tools used to make social policy. Governments also employ tax expenditures, social regulations, and loan guarantees, among other mechanisms, and the American welfare state relies on these alternatives more than any other nation. Instead of national health insurance, for instance, we offer tax breaks to those who purchase private health insurance, usually employers. Instead of subsidizing the wages of disabled workers, we require companies to make the workplace accessible to the disabled (via the Americans with Disabilities Act). The historic G. I. Bill extended loan guarantees to help veterans become homeowners; it did not build them homes.

Turning our attention to these stealthy social policies, it becomes clear that the American welfare state has expanded substantially in recent decades. While we haven't witnessed a "big bang" of innovation comparable to the mid-1930s or mid-1960s, we have seen a steady stream of new social programs since the 1970s. You wouldn't notice this development, though, if you were looking only for European-style social programs. Notable additions include the far-reaching

Employee Retirement Income Security Act (ERISA) of 1974, which established detailed regulations governing the financing, eligibility, and benefits of company pension plans; created the Pension Benefit Guaranty Corporation (PBGC) to guard against the bankruptcy of those plans; and produced a new tax break that gave birth to individual retirement accounts. The Earned Income Tax Credit (EITC), designed to boost the incomes of low-wage workers, became law a year later. Regulations governing employer health benefits passed in 1985 and 1996. The Americans with Disabilities Act (ADA), which President George H. W. Bush has called one of the highlights of his presidency, became law in 1990. The FMLA, compelling many employers to offer parental leave, was one of the first legislative accomplishments of the Clinton Administration, while the Child Tax Credit (CTC) was one of the main domestic initiatives during Clinton's second term. Tax breaks to offset the costs of higher education emerged in 1997 and 2001. The Medicare prescription-drug benefit, added in 2003, includes tax breaks for employers who offer comparable drug benefits to their retired workers.

Some of these new programs grew quickly. Take the EITC and the CTC, which together function as the equiva-

lent of European-style family allowances. In 1986 and again in 1990 and 1993, officials expanded eligibility and increased benefits for the EITC; as a result, the EITC now costs more than TANF, food stamps, or unemployment benefits, making it the most important means-tested income transfer in the American welfare state. The CTC became just as large as the EITC in much less time. The congressional Joint Committee on Taxation estimates that these two provisions in the tax code cost almost \$90 billion combined in 2006.

Other, older tax expenditures have posted significant gains as well. Even adjusted for inflation, the cost of the largest tax expenditures has more than doubled. In most cases, growth has been due less to legislative changes than to demographic and economic forces (e. g., higher health care costs, an aging population). Tax breaks for company health and pension plans have been around for decades. In 1980, these provisions cost \$12 billion to \$15 billion each. This year, subsidizing corporate health benefits will cost an estimated \$100 billion in lost tax revenues (\$115 billion if one includes similar tax breaks for individuals and the self-employed). The cost of subsidizing private pensions is greater. And all the tax breaks for homeowners—deductions for mortgage interest, property taxes, and capital gains—now exceed \$100 billion, up from \$20 billion in 1980.

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These subsidies dwarf everything spent on rental housing for the poor (all these figures come from the Joint Committee on Taxation; other analysts and organizations, using different assumptions and techniques, put the cost of tax expenditures even higher).

To those on the political left, these developments might be cause for celebration, proof that the American welfare state can still expand to meet citizens' needs. But such celebration would likely be tempered once it became clear who is helped by these unconventional social programs. Several of these programs are designed to support employment-based benefits, but many American workers don't receive such benefits in the first place. When the U.S. government offers tax incentives for private retirement pensions, it is helping managers and professionals more than sales clerks or farm workers; full-time workers in large corporations more than those who work part-time or for a small business; and unionized more than nonunionized workers. According to the latest figures from the Congressional Budget Office, only one-third of all workers earning less than \$40,000 are actively participating in tax-favored retirement plans, compared with more than three-quarters of workers earning over \$120,000. Likewise, when the PBGC bails out failing pension plans, it's going to benefit airline pilots and steelworkers, not cab-drivers or child-care providers.

Health benefits are typically offered by the same kinds of firms that provide retirement pensions. John Sheils and Randall Haught, health care consultants at the Lewin Group, estimate that families earning less than \$30,000 receive only one-tenth of the value of all tax breaks for health care. Families earning over \$75,000, in contrast, receive almost half of the total benefits, and families earning more than \$100,000 receive one-quarter [see also Jason Furman, "Our Unhealthy Tax Code," Issue #1]. The so-called COBRA regulations, named after the budget act that created them, enable workers to continue using their health insurance after leaving their job. But that assumes, of course, that workers have health insurance to begin with and that they can afford to pay the entire monthly premium, since their employer no longer has to contribute. Considering that company-based health insurance costs about \$4,000 per year for a single worker and \$11,000 for a family, it is unlikely that COBRA helps many workers with below-average incomes.

Or take the FMLA, which liberals hailed as a breakthrough in family policy upon its passage in 1993. For the first time, workers could take time off to care for a newborn child or sick relative without worrying about losing their job. That is certainly progress. But not everyone can benefit from this piece of social regulation. Businesses with fewer than 50 employees are exempt, and that covers over half of all workers in the private sector. Recently hired workers

and many part-time workers are also ineligible. Moreover, because the FMLA guarantees only unpaid leave, more affluent workers are better able to take the full twelve weeks.

The Child Tax Credit would not appear to have these problems, as it is not tied to employment. But the CTC is definitely not targeted at the poor or near poor. Families earning less than \$30,000 saved a little over \$7 billion in income taxes in 2005; families earning over \$75,000 saved twice as much. Moreover, the CTC helps many families who earn too much to qualify for the EITC, and thus negates much of its redistributive effect.

Other tax expenditures tilt even further in favor of the haves and have-lots. The home mortgage interest deduction is almost exclusively a middle- and upper-middle-class social program; more than two-thirds of the money goes to taxpayers earning more than \$100,000. Taxpayers with incomes over \$200,000, who would qualify as rich almost anywhere in the country, benefited five times more than those earning less than \$50,000. Considering that homes are the single-most important asset for Americans, this tax break significantly aggravates inequalities of income and wealth. Tax deductions for charitable contributions (\$36 billion) and for property taxes on homes (\$22 billion) are similarly skewed toward the rich.

We have, then, two related problems. When tax expenditures and social regulations are routed through employers, they usually benefit middle- and upper-middle-class workers. When tax expenditures are directed at individual taxpayers, they usually offer larger benefits to the more affluent. A tax deduction is worth more to someone making \$200,000 and in the 33 percent tax bracket than someone making \$30,000 and in the 15 percent tax bracket. These kinds of tax breaks, in turn, erode the progressivity of the income tax.

Strange Bedfellows

In the textbook version of American politics, Democrats want more welfare state programs, while Republicans want less. The New Deal and Great Society happened because Democrats controlled the White House and enjoyed huge majorities in Congress. National health insurance came closest to enactment during the Truman and Clinton administrations. By contrast, many Republicans compare welfare recipients to alligators or wolves who became too dependent on humans for food. Welfare should be cut back, they say, and other programs privatized, to restore recipients' natural instinct for self-preservation.

But how can we explain the explosion of benefits during an era when Republicans gained power nationally at the expense of Democrats? Even as the two parties became more polarized, with congressional Democrats becoming more

liberal and congressional Republicans more conservative, elected officials found ways to expand the role of government. ERISA (1974), COBRA health regulations (1986), the ADA (1990), the Health Insurance Portability and Accountability Act (HIPAA, 1996), the HOPE and Lifelong Learning Tax Credits for higher education (1997), and the CTC (1997) all passed under divided government. Several of them originated during Republican administrations.

Understanding why Democrats have supported such programs is fairly easy. For the more liberal wing of the party, it is pragmatism. In an era of divided government, Republicans could block new spending initiatives, and thus liberals settled for the proverbial half a loaf, covering fewer people than they wanted and employing less traditional tools of social policy in the hope that they would somehow become genuinely inclusive over time. The more moderate wing of the party, the so-

called New Democrats, have embraced these programs more enthusiastically because they feel that the Democratic Party needs to do more to attract middle- and upper-middle-class voters. They are particularly drawn to tax expenditures as a way for government to influence individual and corporate behavior without creating new bureaucracies.

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The more interesting and salient question is why Republicans cooperate. Although Democrats have been instrumental in enacting these programs, they could not have succeeded without Republican support. Indeed, even as Republicans have fought to restrict traditional welfare programs, they have been strong supporters of less traditional tools of social policy. In several instances—Senator Jacob Javits and ERISA, President George H. W. Bush and the ADA, Senator Nancy Kassebaum and HIPAA—Republicans were committed, vocal advocates of these new programs. A child tax credit was part of the GOP's Contract with America. And Republicans during the last few decades have resisted efforts to curb the major tax breaks for homeowners and for health and pension benefits.

If we think of the American welfare state as a building under construction, then Republicans have been taking a sledgehammer to some rooms while simultaneously adding on a new wing. Why? Public opinion is an obvious factor. For years the General Social Survey, a wide-ranging and well-respected poll conducted by the National Opinion Research Center at the University of Chicago, has asked Americans what they think about different parts of government. Although they have serious concerns about welfare and mixed feelings about the unemployed, Americans definitely believe that government should

help care for the sick and the elderly. Few people want government to spend less on health, education, child care, Social Security, or the poor. More tellingly, individuals who consider themselves Republican are more likely than not to say that government should spend more rather than less when asked about health care, Social Security, child care, and aid to the poor. Conservatives have trouble getting health insurance, supporting a family, and saving for retirement, just like liberals do. Simply ignoring these needs would have been political folly. Instead, Republicans tried to address a number of social problems in ways that would shift some responsibility away from government and to individuals and corporations (it didn't hurt that Republicans could portray tax expenditures as tax cuts, either).

In fact, the particular shape of the American welfare state is the result of conscious GOP efforts to stave off the emergence of a more European-style system. For instance, comprehensive reform of company pensions had been kicking around Congress since the mid-1960s, and its prospects were not good. Business groups, labor unions, the Nixon Administration, and a number of legislators from both parties had serious reservations. The chances of passage increased, however, after Social Security expanded dramatically in the late 1960s and early 1970s. In his autobiography, Javits makes it clear that ERISA was designed in part to slow down the growth of Social Security—if more workers could rely on company pensions, they wouldn't have as much need for public pensions. Congressional Republicans have defended tax expenditures for health benefits in similar terms, arguing that they represent an important line of protection against national health insurance.

Likewise, in the early 1980s, Reagan officials cut back on disability benefits and inadvertently triggered a firestorm of protests. Congress held numerous hearings featuring individuals who had been unfairly purged from the disability rolls, and the courts started ruling in favor of those individuals. Reagan officials soon backed off. In this context, the ADA seemed like a smart move: If more handicapped people could find and keep a job, they wouldn't need as much financial support from government. And in the late 1980s and 1990s, a number of Republicans objected to how much the government spent on families who paid for child care. What the government should do, they thought, was help families (and especially mothers) afford to stay home with their kids. Unable to terminate existing programs, they added on the CTC, which can be claimed by families whether or not they pay for child care. In short, Republicans have been adding a new wing to the American welfare state in order to move some people out of the old rooms and keep Democrats from building upon the old foundation. The kicker is that those new rooms aren't available to all.

The Future of the American Welfare State

Looking ahead, we are facing divided government for at least the next two years. If history is any guide, there will be a real temptation to make social policy through the tax code or regulations rather than through social-insurance programs or grants. But the current structure of the American welfare state should convince public officials and advocacy groups to proceed with caution. To be sure, while many tax expenditures and social regulations have little positive impact on poverty and inequality, some do. Plans to increase the minimum wage, expand the EITC, and create refundable tax credits for education and housing could do a lot to help the poor and near-poor and to expand the middle class. But we have inherited a number of tax expenditures and social regulations that need fixing. Programs such as ERISA, the FMLA, and the CTC are far less inclusive in practice than they are on paper. In this respect, they resemble older social programs that promote homeownership, health insurance, and retirement pensions through the tax code—all these programs help the haves and the have-lots more than the have-nots.

There are two paths toward a resolution of this dilemma. The first is simply to wait and see in the hope that these programs will expand as a matter of course. This is not as far-fetched as it seems. Social Security, for example, did not start out as a universal program. It originally covered about half of the labor force; domestic and agricultural workers, the self-employed, and a number of professions (e. g., doctors, lawyers, engineers) were excluded. Thus, in its original form Social Security served the broad middle of American society but did not benefit many of the poor or the more affluent, and it stayed that way for 15 years. Policy-makers started expanding coverage in 1950, and by the end of the decade Social Security could legitimately be called universal. Broader coverage in turn increased the demand for higher benefits, and by the mid-1970s Social Security had helped cut the poverty rate among the elderly in half.

The history of the minimum wage, one of the oldest pieces of social regulation, might offer added inspiration. The original Fair Labor Standards Act (1938), which established the national minimum wage, was riddled with exemptions for different industries and occupations. It covered a smaller fraction of the labor force than the original Social Security program. Liberal Democrats tried and failed several times in the 1940s and 1950s to expand the scope of the minimum wage. Their first major success occurred in 1961, when an additional two million workers in the retail trades gained coverage. The single-largest expansion came in 1966, as officials extended the minimum wage to workers in construction, agriculture, and several other industries. These amendments also covered public schools and hospitals for the first time, and narrowed the exemption for small business.

These historical analogies start to break down, however, once we look more closely at how their expansion actually took place. For Social Security, a small number of advocates in the Social Security Administration and on key congressional committees were instrumental in winning broader coverage. These individuals were unusually skilled and dedicated to expansion, their work was widely respected, and they operated at a time in U.S. history when “iron triangles” of committees, agencies, and interest groups controlled many public policies. But these conditions don’t exist for most parts of the contemporary welfare state. Social regulations are administered by the Department of Labor, which has long been a second-tier agency with limited influence on policy. Tax expenditures are administered by the Internal Revenue Service, whose main mission is collecting revenue, not making social policy. As a result, iron triangles largely have been replaced by more fluid issue networks, which in the case of labor policies include a large number of business lobbies (e.g., the National Federation of Independent Business) that are strongly opposed to government-mandated benefits for their employees. Economic forces won’t help, either. Employers are cutting back on their health and pension benefits, not expanding them. Rates of homeownership have increased very slowly. This problem will not fix itself.

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The second path is to deliberately change the distribution of benefits. Technically, it is not hard to imagine how existing tax expenditures and social regulations could be modified to help more Americans. Many Americans with below-average incomes cannot take advantage of tax deductions and tax credits because they pay little or no income tax. Officials could convert more tax expenditures into refundable tax credits, like the EITC. Or policy makers could cap the value of tax breaks so the affluent couldn’t deduct the full amount of mortgage interest and companies couldn’t deduct the full costs of unusually generous health plans. The money saved could be used to help lower-income families buy a home and decent health insurance. In order to continue deducting the cost of fringe benefits from their taxes, we could also require employers to offer those benefits to a larger share of their workforce. The FMLA could be extended to every firm covered by minimum-wage laws; this would cover the vast majority of workers.

Designing remedies is not terribly difficult. The hard part is generating support for reform. The people who benefit most from America’s tax expenditures and social regulations have considerable political power. They vote more often,

give more money to campaigns, and belong to more interest groups than people who benefit a little or not at all from these programs. A number of influential third-party providers—pension funds, home-builders, health insurers—also have a vested interest in the status quo. The same is true of organized labor, since unionized workers tend to have good health and pension benefits.

Given these constraints, someone in power will need to become a policy entrepreneur, a crusader. She or he will need to ask such pointed questions as, Should the government really be subsidizing the purchase of \$500,000 homes more than \$100,000 homes? Is it fair to spend lots of money on health insurance for the poor (Medicaid) and the affluent (tax expenditures) without helping millions of people in between? Should *any* social program make inequality worse? The basic idea is to make the status quo as morally indefensible as possible—to say, in effect, we need to get our priorities straight. Although it is unusual for large numbers of unorganized, less affluent people to triumph over powerful interests in American politics, it does happen sometimes. Such moments should inspire progressives again. ▀