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Do Welfare State Liberals Also Love Regulation?

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LINK TO ABSTRACT

One can infer that supporters of major welfare state programs like Social Security and Medicare are not necessarily enamored of market outcomes. From this perspective, it may be expected that they would also favor government regulations like minimum wages and strict rules on consumer protection. This is a simple story, but it is wrong.

First, it is a serious oversimplification to treat supporters of Social Security and Medicare in their current form as simply lovers of big government. There are strong efficiency arguments for the public provision of these forms of insurance. Second, only a very selective view of the economy would find that supporters of welfare state programs are more pro-regulation than opponents.

Rules and regulation: Those who set the rules don't need regulation

Starting with the second point, the perceived need for regulation depends on how the rules are drawn. Suppose we take the case of the Consumer Financial Protection Bureau (CFPB). The rationale for this protective agency comes from the belief that the financial industry will structure its products and contracts in ways that disadvantage consumers. The presumption is that consumers may not fully understand the terms to which they are agreeing; therefore they need a government agency to protect them.

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It is possible to disagree over the extent to which consumers misunderstanding contracts is actually a problem, but suppose that we step back and change the rules on financial contracts. Suppose that in order for a financial contract to be considered valid it must be written in the simplest possible way, with unnecessary complexity being a basis for voiding the contract. If this were the standard for enforcing financial contracts, then it is likely that fewer people would see any need for an agency like the CFPB to intervene in markets.

If having a legal standard that makes simplicity a basis for having an enforceable financial contract seems like a stretch, then we need look no further than the treatment of insurance contracts to find a comparable standard. The norm in enforcing insurance contracts is that the insuree has an obligation to disclose information that can be reasonably expected to affect the risk against which they are being insured. This is true even if the specific activity in question is not explicitly prohibited in the contract.

There is a sound economic argument for this treatment of insurance contracts. The person getting insurance is, compared to the insurer, in a better position to know the risks they face, and also to take precautions against these risks. This means that we would want them to bear the full cost of properly insuring against the risks they are taking or imposing on others. This would give them the incentive to reduce risk to the extent risk reduction is economically efficient.

It is possible to make a similar argument with reference to a rule requiring simplicity for a financial contract to be enforceable. Professionals in finance can easily write complex financial contracts that will be difficult for most customers to understand. They can also take advantage of research in psychology that will show them how to adjust contracts so that consumers will be most likely to pay the most money for the least expected value.

If we allow all financial contracts to be fully enforced, and do not have any regulatory mechanism to prohibit deliberately deceptive contracts, then we can expect the financial industry to devote considerable resources to finding ways to deceive consumers. This would be a major waste of economic resources on both the part of the industry and the part of consumers, who would now need to spend large amounts of time going over contracts to be sure there were no hidden clauses that would lead to substantial costs.

To avoid this waste of resources, it is desirable to put a check on the ability of the industry to deliberately issue contracts that are difficult for consumers to understand. The need for a regulatory path is the result of the way in which the rules are set. The vast majority of supporters of the CFPB would probably be content with closing the Bureau tomorrow, if the law was structured so that any unnecessarily complex contract was simply treated as being unenforceable.

There is a similar story with the minimum wage. Supporters of minimum wage legislation want to ensure that workers have a decent standard of living in a context where the labor market may not achieve this outcome. However the labor market outcome is very far from a natural result. It is affected by a wide variety of macro and micro policies.

The most obvious policy on the macro side is the Federal Reserve Board's decision to target low rates of inflation with its monetary policy. When it raises interest rates to slow the economy and to ensure that the inflation rate doesn't rise above its target levels, it is deliberately keeping workers from getting jobs and putting downward pressure on the wages of workers at the middle and bottom of the wage distribution.[2]

The priority that the Fed places on low inflation is not a given. It could pursue a policy that focuses on keeping the unemployment rate low, with the understanding that this could imply a somewhat higher rate of inflation. In that case, there might be less interest in or need for a minimum wage, since the labor market might then sustain wages at a level that would meet or exceed the targets for a minimum wage.

Of course many would argue that central bank policy cannot have an enduring impact on the unemployment rate and that the most useful economic path is therefore pursuing price stability. However, this objection implies differences in our understandings of the economy, not differences in the extent to which the government should interfere with the market.

In the same vein, the value of the dollar is hugely important in determining the trade balance for the United States, since it is the main factor determining the international competitiveness of U.S. goods and services. This has both macroeconomic and microeconomic effects on labor markets. On the macro side, in the context of a labor market that is well below full employment, the trade deficit that results from an overvalued dollar keeps many Americans from working and puts downward pressure on the wages of those who are working.

On the microeconomic side, the high dollar disproportionately puts downward pressure on employment and wages in the sectors of the economy that are most vulnerable to international competition. First and foremost this means the manufacturing sector, which still accounts for the vast majority of international trade. This sector has historically been a source of relatively well-paying jobs for

2. In *Getting Back to Full Employment: A Better Bargain for Working People* (2013), Jared Bernstein and I estimated that a sustained 10 percent reduction in the unemployment rate is associated with a 9.4 percent increase in the wages of workers at the 20th percentile of the wage distribution. There was also a substantial negative effect on the wages of workers at the middle of the distribution, but the effect on workers at the 90th percentile was insignificant.

less-educated workers. An overvalued dollar therefore puts downward pressure on the wages of U.S. workers at the middle and bottom of the wage distribution.

This also is a matter of policy. In trade negotiations the United States has pushed its trading partners to respect patent and copyright monopolies of U.S. corporations. It has also pushed for more open markets for the foreign expansion of a wide range of industries. Alternatively, it could have pushed for a lower valued dollar, trading off concessions in other areas. In addition, the fact that less-educated U.S. workers are put in competition with low-paid workers in the developing world is not an accident. We could have designed trade agreements that focused on eliminating the barriers that make it difficult for foreigners to become doctors, lawyers, or other highly educated professionals in the United States. If that had been the focus of trade policy it would have led to enormous economic gains in a way that made the U.S. distribution of income more equal.

Similarly, we can envision a different structure of labor law that is more advantageous to workers. As it stands now, employers can rush into court and get an injunction against workers for a number of illegal labor practices, such as a wildcat strike or secondary boycott. This means that workers face imprisonment if they continue the action.

By contrast, if employers break the law, for example by firing a worker attempting to organize a union, the case is brought to the National Labor Relations Board. This typically takes months and the potential penalties are trivial. No employer ever risks going to jail for violating the law to break a union.

It is easy to imagine a world where the legal sanctions are reversed. Suppose workers could get an injunction threatening an employer with jail if he did not immediately rehire a worker fired for union activity. In such a world, unions would have considerably more power than they do today. This would increase the power of labor relative to capital which would likely mean a larger share of income going to labor.

If we envision a world in which the rules have been structured to favor workers instead of employers, it is likely that most workers would be earning much higher wages. In this world, there may be much less interest on the part of liberals in minimum wage laws. It would likely be the case that nearly all workers would already be earning enough to ensure a decent standard of living (recognizing this as a relative concept) as a result of the natural workings of the market.

Government welfare state: Statement of values, or efficiency?

Turning to the first point, it is at least an oversimplification to argue that supporters of government programs like Social Security and Medicare in their current form are necessarily supporters of big government, in contrast to people who want to reform these programs. There are strong efficiency arguments for these programs in their current form, which is a separate issue from the question of values and the role of government.

Taking the case of Social Security, with which I am most familiar: In more than twenty years of debating the program I have never once been opposite someone arguing for the strong libertarian position that retirement savings should be entirely left to the individual. Many people have argued that we can better meet workers' needs for retirement savings with private systems of mandated savings, but not one person has ever said that retirement savings should be entirely the responsibility of the individual—that those who fail to save should suffer the consequences in their own age. (Whether the mandated-private-savings position reflected their actual views, or was simply a posture they were taking for political purposes, I have no idea.)

If there is agreement that the government has responsibility for ensuring that workers save for their retirement, then the next question is the best mechanism for accomplishing this result. There is a large body of research showing that a centralized system like the Social Security program in the United States has far lower administrative costs than privatized systems like the ones in Chile and the United Kingdom (see, e.g., Orszag and Stiglitz 2001; National Academy for Social Insurance 1998). The costs are an order of magnitude lower with Social Security spending around 0.6 percent of annual benefits on administration compared with the privatized systems in Chile and the UK spending between 10 percent and 20 percent of annual payouts. In addition, the cost of annuitizing an accumulation can easily exceed 10 percent of the sum, further increasing the cost differences.

Given the efficiencies of a centralized system, there is a strong argument for a government-run system like the one in the United States regardless of whether someone is in general a supporter of big government or prefers outcomes being left to the market. If the point is to ensure that workers have a minimal retirement income, the evidence strongly indicates that this is done most efficiently through a public system.

There is an argument as to how large the benefit should be and the extent to which it should be related to lifetime earnings. Positions on how large may to some extent reflect individuals' attitudes towards the government, although even here that is not entirely clear. If nearly everyone except for the very wealthy will want to ensure that they have a relatively high replacement rate in retirement, then a program that offers a high replacement rate would reduce waste in the economy.

The link between the benefit structure and earnings also does not provide a clear basis for a pro-government/pro-market divide. A uniform, near poverty-level benefit may seem more consistent with a minimal government approach. However, if the benefit is financed through a payroll tax mechanism, this makes the program into a tax-and-transfer scheme rather than an income-related pension. That is not obviously smaller government.

There is a similar story with Medicare and indeed publicly run health care programs like the ones in Canada or the system of socialized medicine in the UK. The administrative costs in these public systems are far lower than in the private systems in the United States. It is entirely reasonable to support these programs on the grounds that they are more efficient than their private sector counterparts rather than out of any desire to see the government take over a larger share of the economy.

In short, it is misleading to see the world as divided between those who support big government programs and those who support leaving matters to the market. There are important empirical questions on the relative efficiency of centralized systems—which don't have to be public—compared with decentralized market systems. It is possible that people's prejudices towards or against the government influence how they view this evidence, but, in principle, the choice of systems can be driven by evidence rather than prejudices.

Conclusion: The divide between the government and the market is not obvious and simple

I have argued that the perceived need for various forms of regulatory interventions stems in large part from how the rules are structured. In the United States at present, many of the rules have been written in ways that work to the advantage of the rich and powerful. Under these circumstances, many liberals who identify with the less advantaged are pushing for regulations that will protect their interests. This does not reflect an inherent preference for government intervention in market outcomes, but rather a recognition that the rules have been rigged to work against the vast majority of the population.

In the same vein, the desire to protect welfare state programs stems at least in part from the fact that these programs are the most efficient way to provide the security that people across the political spectrum claim to value. If in fact the public programs are the most efficient way to ensure an agreed upon level of public well-being, then the opponents of these programs effectively want to deliberately waste resources to reduce the role of government.

It is an open question as to the extent to which either liberals or conservatives are amenable to having their views change on these issues in response to contrary evidence. However, it is certainly arguable that the differences are as much or more in perceptions of the relative strength of the evidence as in political preconceptions.

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