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The Cost of Maintaining the Welfare State

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Introduction

The purpose of this essay is to explain how the cost of maintaining the welfare state does not produce the results intended in addition to creating an economic burden on the taxpayer from which he does not obtain any significant benefit. By cost, I do not merely imply monetary cost, but also a social cost. The welfare state exists in almost every advanced economy whether it is in Canada, France, the United Kingdom, Australia, or Germany. However, the analysis of this essay focuses on the welfare system of the United States since it is the country in which I reside.

Hence, this essay argues about how the welfare state could be dismantled by a gradual approach rather than an abrupt and revolutionary approach. To elucidate how the welfare state could be dismantled gradually rather than abruptly, I proceeded with the inductive method by first analyzing the historical and statistical evidence related to the welfare state, then developed a hypothetical scenario of the dismantlement of the welfare state.

I – Historical Evidence

The welfare state exists in the United States since the 1930s. Before the 1930s, there was no system of social assistance. It was implemented as a system through the creation of various assistance programs to attenuate the impact of the Great Depression at the federal level. This system was principally developed under the presidency of Franklin Delano Roosevelt. It is undeniable that the welfare state was instigated with the best of intentions. In 1935, President Roosevelt declared: "The time has come for action by the national government to provide security against the major hazards and vicissitudes of life."[1] Following this declaration, President Roosevelt went on to implementing the first assistance and insurance programs such as Social Security, THE National Industrial Recovery Act, the Federal Housing Administration, or the Aid to Families with Dependent Children (AFDC).[2]

Thus, creating a welfare system was meant to help the citizens maintaining a certain level of subsistence. Hence the first welfare programs were financed by tripling federal taxes from \$1.6 billion in 1933 to \$5.3 billion in 1940.[3] However, the welfare state did not generate the results intended. For example, the National Industrial Recovery Act of 1933

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[1] Editors. "BRIA 14.3: How Welfare Began in the United States." *Bill of Rights in Action.* (1998). Constitutional Rights Foundation.

[2] Fishback, Price V. "New Deal." *Banking Crises: Perspectives from the New Palgrave Dictionary,* edited by Garett Jones, Palgrave Macmillan UK, pp. 241-250.

[3] Powell, Jim. *How FDR's New Deal Harmed Millions of Poor People.* (2003). Cato Institute.

cut production and forced wages above market levels, making it more expensive for employers to hire people—Blacks alone were estimated to have lost some 500,000 jobs because of that same policy.[4] The major result that the welfare state has delivered since its inception is the amplification of the powers of the federal government as well as the enlargement of its scope. Indeed, in the 1960s, the welfare state considerably expanded under the presidency of Lyndon Baines Johnson through the Great Society (Lyndon Johnson's economic policy). Under the Great Society, the federal government created many new social programs such as Medicare and Medicaid, which empowered the federal government to have a permanent foothold in the healthcare industry, the Primary and Secondary Education Act, which warranted the federal government to subsidize schools and to administer a national curriculum, and Affirmative Action policies, which enhance the capacity of the federal government to dictate schools the quotas that have to be reached to receive federal funds.

Since the expansion of the welfare state, government spending and welfare spending have considerably increased continuously as we can see in the following figures (figures 1 & 2).

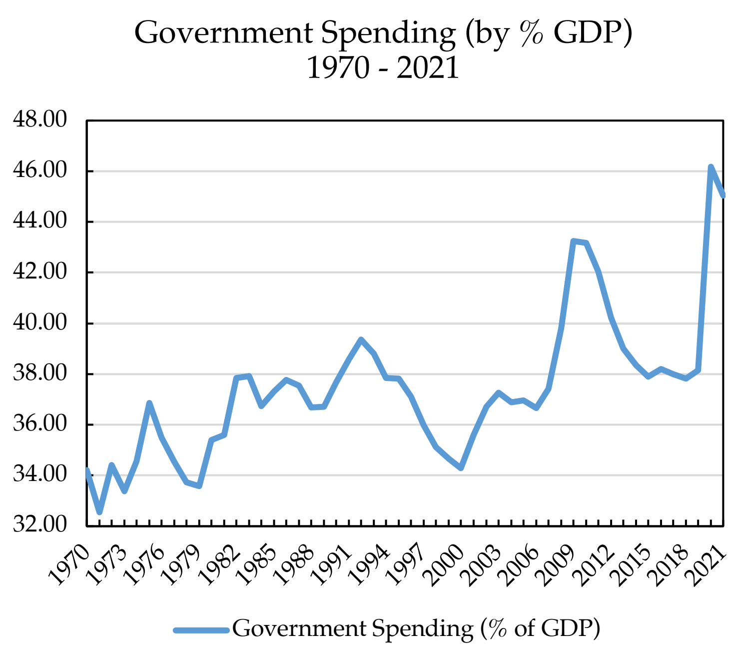

Figure 1. Source: OECD

[4] Ibid.

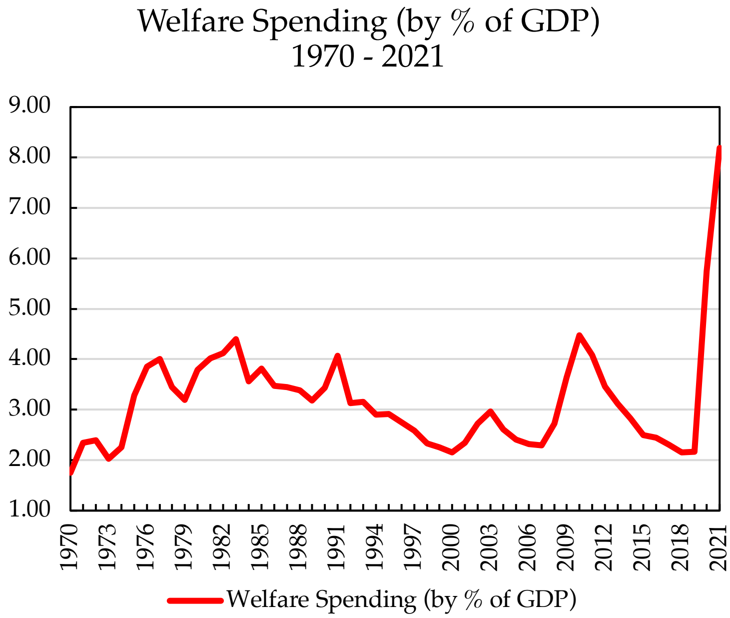

Figure 2. Source: US Census Bureau

The main predicament about the expansion of the welfare state is that it created a state of perpetual dependency of the recipient on the federal government. As a matter of fact, the number of participants in welfare programs has substantially increased, especially in programs such as Medicaid, which has the highest participation rate (84.1 percent) among families receiving government means-tested assistance. Among one-parent families, 81.7 percent received government means-tested assistance, and 86.1 percent of two-parent families do so.

Participation in specific means-tested government assistance programs among families with children under 18 (2014)

Programs	Percent receiving assistance		
	All families	One-parent families	Two-parent families
Housing assistance	21.80	37.80	8.3
Medicaid	84.10	81.70	86.1
Public Assistance	7.00	11.80	3.1
Supplement Nutrition Assistance Program (SNAP) (also known as food stamps)	51.60	66.40	39.3
Supplement Security Income (SSI)	9.9	12.5	7.8

Table 1. Source: US Bureau of Labor Statistics

In 2014, total expenditures for families receiving assistance were $36,398, about (50.3 percent of the $72,338 spent by families not receiving assistance. Total expenditures for one-parent families receiving assistance were $26,085, about three-fifths (58.6 percent) of the $44,516 spent by two-parent families receiving assistance.

The dependency on welfare programs can clearly be seen with the expansion of food stamps from 1969 to 2019. According to the Supplemental Nutrition Assistance Program (SNAP) data, the participation and cost of the program increased significantly. In 1969, only 2,878 participants were enrolled in the program and the cost was only estimated at $250. The participation rate has increased thirteen times since 1969 to reach 39,887 recipients for an estimated cost of $79,110.46. This exponential increase of recipients in food stamps programs shows how high is the level of dependency. The federal government has loosened the conditions of eligibility for low-income people to easily enroll in these welfare programs. Once entered, not many of them leave the program.

The government keeps subsidizing these programs at the expense of the taxpayer while most of the recipients of these programs reap the benefits without necessarily contributing that much back to society. However, it is important to emphasize that not every single recipient of these programs is an eternal free rider. Some do manage to leave the welfare state for a better financial and social condition, but it is nonetheless fair to say that most of the recipients who receive these means-tested benefits are disincentivized to seek higher aims for fear to lose what they are already earning from these programs.

II – Statistical Evidence

In this part of the analysis, my main concern is twofold. First, I want to understand the magnitude that the welfare state exerts on government spending. By how much do welfare programs contribute to government spending? Second, I want to understand the impact that government spending on poverty. Does government spending reduce or increase poverty in America? These are the main questions of my inquiry that need to be thoroughly assessed.

Specification of the models

To assess these two questions, I developed two independent statistical models that I will use to test my hypotheses:

(1) $Y_1 = \beta_0 + \beta_1 X_1 + \varepsilon$
(2) $\ln Y_2 = \beta_0 + \beta_2 X_2 + \varepsilon$

For equation (1), the independent invariable (X_1) represents welfare spending, and the dependent variable (Y_1) represents government spending. For equation (2) the independent variable (X_2) represents government spending and the dependent variable ($\ln Y_2$) represents the number of people officially in poverty in the United States since the unit is in millions of people. Using the natural log function is helpful to transforming an originally highly skewed variable into a more normalized dataset.

The Data

The dataset contains 52 observations ($n = 52$) was built from many sources. The 52 observations that make up our dataset were collected from 1970 to 2021. For equation (1), the values of both the dependent and independent variables were extracted from figures 1 and 2, which are sourced from OECD and the U.S. Census Bureau, respectively. For equation (2), the values of both the dependent and the independent variables were extracted from the Federal Reserve Bank of St. Louis (FRED) and the OECD, respectively.

Empirical Evidence and Results

Results for model (1): Correlation between welfare spending and government spending

SUMMARY OUTPUT					
Regression Statistics					
Multiple R	0.63553956				
R Square	0.40391053				
Adjusted R Square	0.39198874				
Standard Error	2.17577259				
Observations	52				
ANOVA					
	df	*SS*	*MS*	*F*	*Significance F*
Regression	1	160.387581	160.387581	33.880026	4.1528E-07
Residual	50	236.699317	4.73398635		
Total	51	397.086898			

Table 2

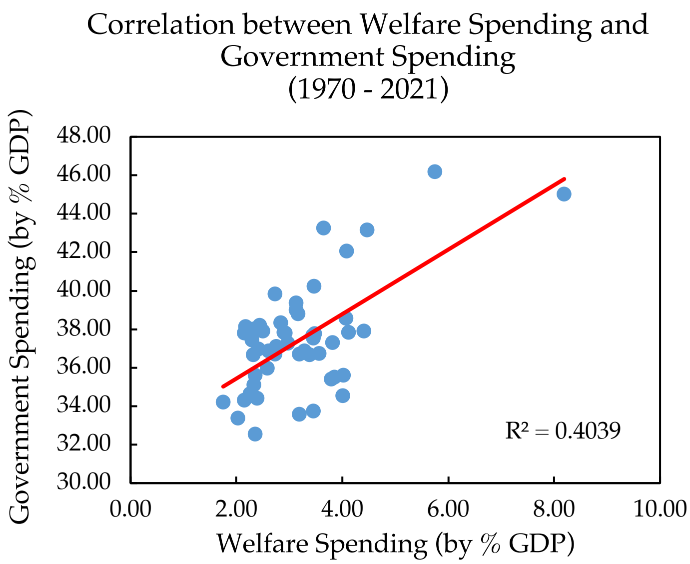

Figure 3

Result of model (2): Correlation between government spending and the number of people officially in poverty.

SUMMARY OUTPUT					
Regression Statistics					
Multiple R	0.71472157				
R Square	0.51082692				
Adjusted R Square	0.50104346				
Standard Error	0.13629895				
Observations	52				
ANOVA					
	df	*SS*	*MS*	*F*	*Significance F*
Regression	1	0.9699878	0.9699878	52.2133115	2.661E-09
Residual	50	0.92887022	0.0185774		
Total	51	1.89885802			

Table 3

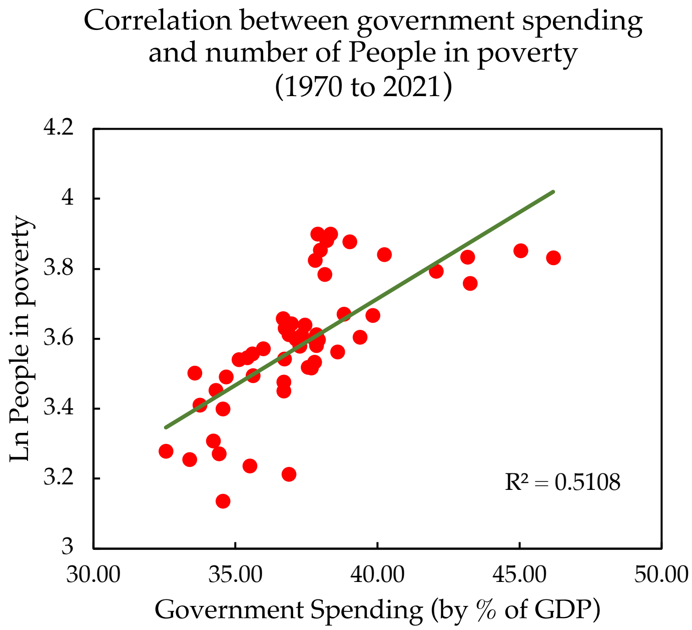

Figure 4

The results of the regression for the first model suggest that there is a positive correlation of moderate magnitude between welfare spending and government spending. Indeed, it is undeniable that the welfare system does contribute to the augmentation of government spending. One of the ways through which government spending increases is when the federal government borrows from bond markets or by changing the tax rates downwards in situations of expansionary fiscal policy. However, maintaining government expenditures requires a high level of taxation when borrowing becomes excessive. But this correlation also implies that the welfare state is not necessarily the primary or causal factor responsible for government spending. There are other factors such as defense spending which also contribute to the augmentation of government spending. The correlation between welfare spending and government spending illustrates, nonetheless, that the cost of maintaining the welfare state represents an economic burden for the citizen because the creation or the sustention of a new welfare program necessitates reducing the purchasing power of the individual, especially the high-income earners.

The results of the regression for the second model suggest that there is also a positive correlation of moderate magnitude between government spending and the number of people in poverty. This is the aspect of the welfare state that has been the most decried by many advocates of limited government—the welfare state maintains people in poverty. Government spending increases poverty to some extent because the maintenance of government programs, whether it is welfare programs or other government programs prevents low-income individuals from savings since a greater portion of their income that they could reinvest in other ventures. Moreover, low-income individuals spend a disproportionate amount of their money on housing, which is about 40 percent of their income on average.[5] In addition to the problem of housing, the federal government spends a lot on the criminal justice system. The criminal justice system is prejudiced against low-income people and people of color at every step from the top to the bottom, which has significantly impacted poverty for the worst.[6] The federal government supplies funds to state and local police but in the areas where the crime rate is at its peak, more resources are spent on policing whereas crime rates continue to skyrocket. In short, the federal government does not allocate resources where they are supposed to be in order to improve the welfare of low-income families. Welfare programs continue to expand while the number of poor people also continues to increase. Consequently, those who live below the poverty threshold continue to become the recipient of means-tested programs that do not increase their income overall.

Now the question to address is how can the welfare state be dismantled since it generated a negative externality on society?

III – Theoretical Propositions for the Dismantlement of the Welfare State

The historical and statistical evidence elaborated in the first two parts of this essay provide me a robust background to develop a theoretical framework of the welfare state's dismantlement.

Let me start this framework by assuming that a referendum has occurred, and more than two-thirds of the American people have voted that we shall no longer have a federal welfare system. But rather than abruptly terminating the system altogether, the system is now decentralized where U.S. states have the choice to either implement their own welfare state or to simply not.

Let us assume that most U.S. states (more than 2/3) do want to implement a welfare state because they believe that low-income people in their respective states still need assistance. If implemented, how costly it would be to maintain this system at the state level since federal funds will no longer be supplied once the implementation is completed. The only transfer cost that takes place is when the federal government transfers the last funds to the U.S. states who agreed to implement a welfare system, but once the system is implemented, the federal government can no longer supply anything to any state. U.S. states will then be on their own for the sustentation of their respective

[5] Tanner, Michael. "How Government Causes Poverty" *Cato's Letter.* (2019) Volume 17, No. 2. Cato Institute.
[6] Ibid.

welfare system. Now that the basic assumptions have been ensconced, let me develop the hypotheses.

Hypothesis 1: Expansionary fiscal policy will increase government spending and reduce income taxes, which will help funding welfare programs

The first hypothesis suggests that within the first phase following the implementation of the welfare system at the state level, income and price level will simultaneously increase. How so? Since the state government has received federal funds prior to the implementation of the welfare system, the government then used these funds to effectuate an expansionary fiscal policy that would stimulate consumer demand. Thus, this expansionary fiscal policy will have two effects: (1) it will increase the purchasing power of the consumer temporarily through the reduction of income taxes, and boosting employment, especially in the public sector, and (2) it will also increase the general price level of goods and services in the state economy since decreasing taxes increase aggregate demand and real GDP, and this demand, in turn, increases prices. In short, the state government used the last federal funds (transfer cost) to exert an expansionary fiscal policy to fund the welfare programs.

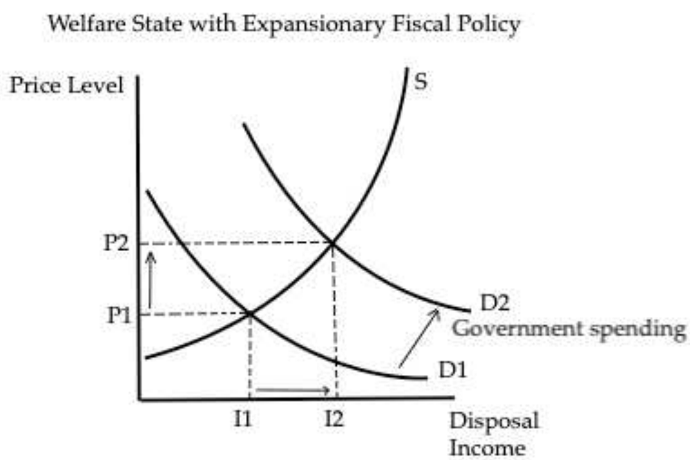

Figure 5

Hypothesis 2: Implementation of a progressive tax system on high-income individuals and corporations will increase price level but reduce people's purchasing power

The second hypothesis suggests that within the second phase following the implementation of the welfare system at the state level, the price level will increase while consumer's purchasing power will decrease. In this situation, two events have happened: (1) the federal transfer funds that initially helped U.S. states settled their welfare systems have officially expired. So, state governments do now have to change their method to increase revenues in order to keep funding these social welfare programs. Thus, the state government decided to raise taxes by enforcing a progressive income tax, especially on high-income earners who make more than $300,000.00 a year (upper class), and a high tax rate on corporations, and a high rate on sales tax; and (2) the high-income earners then decided to leave the state and relocate in another state where there is either no welfare or progressive tax systems. Hence, their relocation to another state negatively affects employment because the tax burden then falls on the top income-earners of the middle class (those making between $100,000 and $200,000 a year).

High-income earners are those who create employment in the private sector. Imposing a progressive tax system would essentially affect the labor market because it affects a person's decision on whether to work more hours, hire more workers, or invest in innovations or new businesses.[7] With lower taxes, high-income earners can make major investments in different industries of the economy which will create employment and drive economic expansion all across the state. But when government taxes seek to take a substantial portion of their earnings, high-income earners immediately react by avoiding paying taxes on the new rates. They either leave the state they currently reside in and relocate, or they keep their money in tax-exempt securities, which prevents that money from circulating in the economy. They will relocate their money to another state or overseas where the tax code is low. As the tax burden now falls on the middle-class, especially the top earners, people in the middle-class will be compelled to save less and take more credit which will increase their debt. Hence, the top income-earners of the middle will gradually be disincentivized to continue contributing to the maintenance of the welfare state even if some of them may morally agree with the cause of having one. Furthermore, the implementation of the progressive tax system will increase the general level of prices while decreasing people's purchasing power because there is a negative supply shock between what is offered and what people can afford. This negative supply shock is due to the increase in sales taxes which will discourage consumption.

[7] Heil, Daniel. "Tax Rate Hikes and the Economy." *Hoover Institution.* (2021).

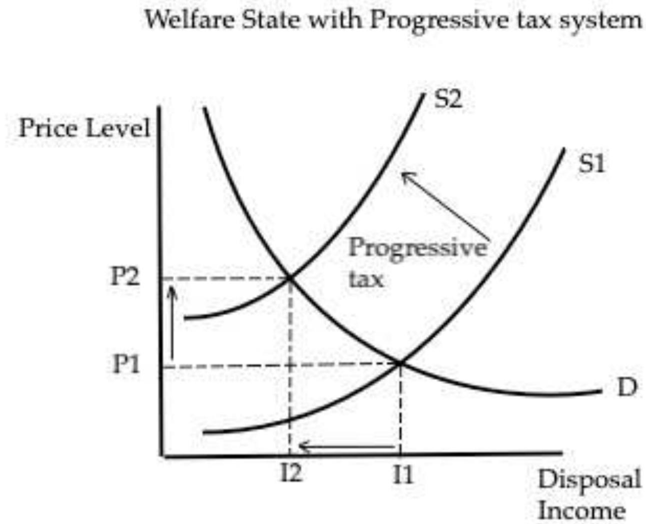

Figure 6

In short, the implementation of a progressive tax system on different parts of the economy to sustain the funding of social welfare programs will lead to a reduction of the disposable income (purchasing power) of the consumer, and an increase in the general level of prices. This will then generate a higher number of people in poverty and it will increase the number of recipients under these social welfare programs.

Hypothesis 3: Maintaining the welfare state decreases consumer's demand and as well as prices, which makes the welfare state even more unsustainable.

The third hypothesis suggests that within the third phase following the implementation of the welfare system at the state level, income will fall as well as the general level of prices because poverty will be higher since the high-income earners have either relocated or allocate their financial capital in tax-exempt securities. Hence, as I argued in the second hypothesis, the progressive tax system leaves a huge gap between the middle-class and the upper-class in terms of creating employment and stimulating economic expansion. Since the tax burden has fallen on the middle-class, members of the middle-class will continue to save less while government will continue to spend more in order to maintain the welfare programs.

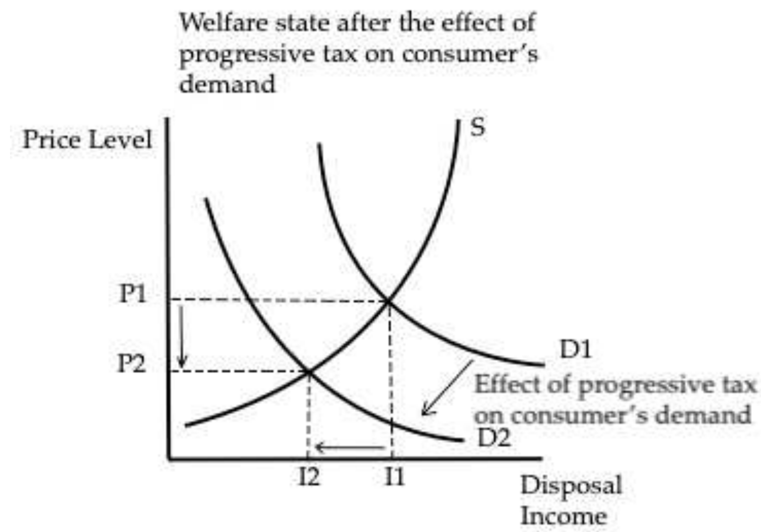

Figure 7

Since consumers can no longer spend due to a substantial reduction in their disposable income, the general level of prices will consequently fall too. In this case, two situations may happen: (1) the state government will attempt again to use an expansionary fiscal policy or (2) simply dismantle the welfare system to avoid increasing the poverty level as well as a long-term deflation. If we assume that the state government will not opt for the second option, it will still result in the same outcome, which is the degradation of the welfare state, the application of expansionary fiscal policy can only be effective in the short-term. If the goal of the state government is to maintain the welfare system as much as it can, then its sustentation can only be temporary because an excess of government spending will slow economic growth and increase poverty. Since low-income people cannot contribute to maintaining the welfare state, it will come to its self-dismantlement.

IV – Conclusion

The inductive method of this analysis helped me developed a theory that holds valid based on historical and statistical evidence. The welfare state produces a higher cost to the taxpayer as well as government to be maintained rather than the benefit of making more people financially independent. The welfare state in the United States has created a high level of dependency between low-income people and the government. What it has perpetuated is the idea that nothing could be done without government. This dependency and reliance on needing the government for everything have drastically expanded the powers of the federal government far beyond its constitutional scope. The welfare state was created with the only intent to help people financially until they regain their financial autonomy. However, the opposite is what has happened as more welfare programs are created following the increasing number of recipients from these programs. Dismantling the welfare state gradually seems to be a realistic solution to alleviate the tax burden on the taxpayer. This dismantlement approach will be an eye-opener for both the people and their regional governments. Lastly and more importantly, decentralizing the welfare state to the state level will significantly reduce the scope of government.

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