American and European Welfare States: Similar Causes, Similar Effects

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The American welfare state is not as different from the European welfare state as conventional wisdom would have it. If we define the welfare state as that part of the state (the whole apparatus of government at all levels) devoted to taking charge of the welfare of the public, welfare-state functions cover social protection (which includes public pensions), health, and education. As shown in Table 1, these functions make up 57 percent of total U.S. government expenditures compared to 63 percent for the typical eurozone country.[1] In this sense, the American welfare state is only about 10 percent smaller than the European welfare state.

The data in Table 1 overestimate the size of the American welfare state in one important way. Since overall government expenditures are higher in Europe than in America, the gap in the ratio of welfare-state expenditures to GDP will be larger. Indeed, welfare-state expenditures are 21 percent of GDP in America compared to 30 percent in the typical eurozone country. The 10 percent gap shown between the American and the European welfare states thus gets amplified to 30 percent. This is still a difference of degree rather than a difference in kind.

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[1]The "typical eurozone country" is represented by an unweighted average, that is, a simple average of the proportions in all countries—as opposed to the weighted figure, which adds up all debts and all GDPs before calculating their ratio.

TABLE 1
Government Expenditures by Function, All Levels of Government, as a Percentage of Total Government Expenditures, 2007

Category	EU-10[a]	United States
1. General Public Services[b]	14%	14%
2. Defense	3%	11%
3. Public Order and Safety	4%	6%
4. Economic Affairs	8%	10%
5. Environmental Protection	2%	NA
6. Housing and Community Amenities	2%	2%
7. Health	14%	21%
8. Recreation, Culture, and Religion	2%	1%
9. Education	11%	17%
10. Social Protection	40%	19%
11. Welfare State Expenditures (7+9+10)	65%	57%
Welfare State Expenditures (unweighted)	63%	57%

[a]EU-10: Austria, Belgium, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain.
[b]Includes interest on public debt.
Sources: Lemieux (2013), OECD (2011).

Other differences exist between the two welfare states, like the higher sense of entitlement in Europe, and their wall-to-wall social welfare coverage. Yet, many authors who have studied the situation, from the right or from the left, agree that the difference between the American and the European welfare states is much overestimated.

One feature of the American welfare state is that it is heavily biased toward the elderly and health care. Social Security and Medicare account for three-fifths of federal welfare-state expenditures and for one-third of all welfare-state expenditures in the country. In their recent book, *The Clash of Generations*, Laurence Kotlikoff and Scott Burns (2012) argue that the benefits granted to the elderly are a "Ponzi scheme," and that the accounting system hiding the scheme "goes far beyond Bernie Madoff's wildest dreams." This does not help make the American welfare state more sustainable than its European cousin.

Taxes Not as High in America

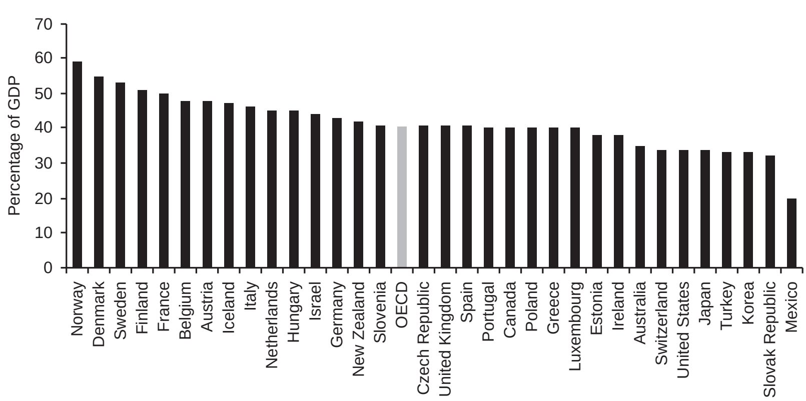
Another relevant fact is that taxes are lower in the United States than in most other countries. Virtually all government revenues are taxes or ultimately come from taxes, so the global tax rate of a country can be measured by the ratio of total government revenues to GDP (which is also national income). According to OECD data, in 2007, this ratio was 34 percent in the United States compared to 42 percent in the OECD and 44 percent in the 10 eurozone countries (Figure 1). The global tax rate is thus 23 percent lower in America than in the eurozone.

The Fiscal Crisis

Now, if the American welfare state is 30 percent smaller than its European cousin, and if the gap in the global tax rate is not much lower (that is, 23 percent), we would expect the American welfare state to develop the same sort of problems as the European one. Indeed, the debt problem looks as bad in America as in Europe. Much of the American welfare state has been financed by deficits, that is, by increases in public debt and thus by future taxes.

In 2007, total gross public debt in America was already very close to the average for the eurozone—that is, 67 percent compared to

FIGURE 1
Government Revenues as a Percentage of GDP, OECD Countries, 2007



Sources: OECD (2011).

72 percent. It was even higher than in the eurozone if we take the countries' unweighted average, which was 56 percent. At the end of 2012, the U.S. gross public debt stood at an estimated 109 percent of GDP, and has overtaken the weighted eurozone ratio of 99 percent.[2]

Another crucial fact to understand is that most of the government debt was accumulated before the Great Recession. Of the outstanding debt at the end of 2010, three-fourths was accumulated before the Great Recession in Europe, and two-thirds in America. The proportions are not much different if we take the unweighted, instead of the weighted, figures for Europe. It is thus misleading to present the public debt problem as an offspring of the Great Recession, which only exacerbated an existing problem and just advanced the day of reckoning.

It is true that public debts have continued to accumulate since 2010. But even if we calculate the debt at the end of 2012 instead of 2010, the proportion of accumulated debt before 2008 still reaches two-thirds in Europe, and more than 60 percent in America. Moreover, the continuing growth of the public debt is partly due to the feeble recovery, which can itself be traced in part to the debt crisis. So it is not unreasonable to assume that any debt incurred after 2010 is not the product of the Great Recession. The bottom line is that the largest part of the public debt both in America and in Europe—that is, between two-thirds and three-fourths—was generated by the growth of the welfare state before the Great Recession.

Since the same causes have the same effects, it is realistic to expect an American crisis similar to the current (and developing) crisis in Europe. The nature of the threat becomes even more striking if we consider the tax increases or the expenditure cuts that would be required to merely keep constant the current ratio of the federal debt to GDP. (I will now ignore the part of the public debt due by state and local governments.)

Let me focus on the simulations of the Government Accountability Office (GAO 2012), a nonpartisan congressional agency that audits the government. The fiscal gap is the difference in present value between revenues and noninterest spending over a certain time horizon—75 years in this case—assuming that the debt remains constant as a proportion of GDP. Under the most realistic

[2]The unweighted eurozone figure is even lower, at 86 percent.

scenario, which assumes that recent policies will continue, the federal fiscal gap amounts to 8.2 percent of GDP between now and 2086. Closing the fiscal gap by increasing revenues would require an immediate and permanent increase of 46 percent of revenues, which basically means an immediate and permanent increase of all federal tax rates by 46 percent. Alternatively, solving the fiscal gap problem on the expenditure side would require an immediate and permanent cut of 32 percent in noninterest spending. Any delay means that future tax increases or spending cuts would have to be larger.

Estimates from the Congressional Budget Office (CBO 2012: 21) are in the same range.[3] These adjustments are so steep that it is difficult to imagine that they can be achieved without a major crisis.

Prospects for Economic Growth

Many observers seem to count on economic growth to solve the public debt problem created by the unaffordable welfare state. After all, the American economy has a record of flexibility, efficiency, and growth. This solution, however, is questionable because the growth of the American economy will, if anything, be lower in the future. GAO and CBO scenarios incorporate an assumption of 2.1 percent or 2.2 percent for long-term real annual growth, which is at least one percentage point below the historical growth rate. In fact, the growth of the American economy has slowed down over the last few decades, for reasons that are hotly debated.

It is a fair bet that one of the causes of the slowing down of economic growth lies in the decline of economic freedom and the consequent loss of flexibility in the American economy. The decline of economic freedom in America has become more visible recently, and is shown by the two major international indexes of economic freedom. The Fraser Institute index puts the United States at the 18th rank (among 144 countries), while, before the new century, the country used to be very close to the top (Gwartney, Lawson, and Hall 2012: 6, 10). The other index, published by the Heritage Foundation and the *Wall Street Journal*, estimated that around 2008, the United States fell from the rank of the "free" countries to the "mostly free"

[3]This article was written before the January 1, 2013, fiscal cliff deal and new CBO forecasts. These did not imply any significant change the long-term outlook presented here.

category (Miller, Jones, and Feulner 2012: 8). With mounting regulation, we have been witnessing the Europeanization of the American economy. Consequently, we can expect economic growth to continue slowing down.

Another reason why economic growth may be even lower than the official forecasts reported above is that, as the CBO itself admits, increasing debt or taxes will by themselves exert a negative impact on growth.

Conclusion

Let me summarize my argument. Combined with an inflexible economy, the welfare state is the main cause of the euro crisis. Since the American and European welfare states show only a difference of degree, and since the American economy is being Europeanized, we should expect a similar debt crisis in the United States. That crisis will develop when investors realize the magnitude of the U.S. public debt problem.

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