Milton Friedman and Public Sector Economics

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Thank you. I'm very honored to be part of this celebration of Milton Friedman's 90th birthday. There is no one whose work over a wide range of subjects I admire more than Milton's. And there is no one whose ideas have had a greater favorable influence on public policy. I'm particularly pleased to be part of this panel on a subject on which Milton Friedman has had so much influence for the good.

I'll focus my remarks on two issues that have been particularly important to Friedman: the first is Social Security and the second is Taxes and the Size of Government. In both areas, Milton has powerful, important, and unusual views.

Unlike many of you here, I never studied with Milton Friedman in the economics department here at Chicago. But like all of you I have studied with him vicariously by reading some of the things that he has written.

On my shelf at home there's a copy of Capitalism and Freedom that I bought in England in 1964 when I was a graduate student. I was then a very impressionable 24 year old and the book had a major influence on me – probably more than I realized at the time.

Social Security

In Capitalism and Freedom Milton has a brief but powerful and bold discussion of Social Security. He argues that there is no reason for the government to compel people to participate in a pension, for the government to manage the fund, for the government to set the retirement age, etc.. I'm certain that the logic of his arguments induced many people to seek ways to end the Social Security program as we know it – or to change its character to eliminate some of its adverse effects. Milton himself offered no compromise solution, no modified design for a Social Security program. Much of the power of his argument was its purity.

I recently reread the discussion of Social Security in Capitalism and Freedom and I was struck by the fact that there was no mention of the adverse effect of Social Security on national saving. That

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was consistent with Friedman's emphasis on individual freedom rather than on economic efficiency as the basis for policy decisions.

Giving individuals the freedom to choose for themselves might also increase economic efficiency but freedom was the primary goal and the resulting economic efficiency a happy by-product.

But the absence of a discussion of the effect on saving was particularly striking to me because my original interest in Social Security had focused so much on its adverse effect on household saving and therefore on national capital accumulation. That interest in the effect of Social Security on household saving began when I read Milton's Theory of the Consumption Function while I was a graduate student. I was very impressed by the importance of its argument and by Friedman's ingenious use of statistical evidence. In the 1950s, when that book was written, that kind of regression analysis and errors in variables argument was still very unusual. The book was pioneering in its methods as well as in its conclusions.

But reading it as a budding public finance economist, I was struck by the absence of Social Security in Friedman's empirical analysis of household saving – even though for most households Social Security would be the primary source of retirement income. Part of that no doubt reflected the gap in time between when Friedman did his work in the 1950s and when I read it in the mid-1960s. I decided to see if I could extend Friedman's consumption function analysis by introducing what I called Social Security wealth – the present actuarial value of future Social Security benefits – as a determinant of household saving.

Although I believed that Social Security wealth would act as a substitute for ordinary wealth accumulation, I realized that the net effect of Social Security on household saving was theoretically ambiguous because the presence of Social Security would also induce earlier retirement – and the earlier retirement would in itself lead to increased saving.

The theory was ambiguous but the evidence – both time series and cross section evidence – indicated that higher levels of Social Security wealth reduced household saving. And since Social Security as we know it is essentially an unfunded program, that meant that Social Security reduced national saving and capital accumulation.

I took that negative effect on national capital accumulation as a reason to believe that traditional Social Security has an adverse effect on the economy. More specifically, although an unfunded pay-as-you-go Social Security program pays participants an implicit rate of return equal to the rate of growth of the payroll tax base, that return is substantially less than the marginal product of capital. Social Security therefore forces individuals to substitute a low implicit rate of return "asset" for real capital with a substantially higher rate of return.

This is not an efficiency loss in the strict sense. Although each generation of employees suffers a loss of consumption, the initial generation of retirees gets a lump-sum transfer without ever having to pay Social Security taxes. The net loss of consumption caused by Social Security is the difference between this initial windfall and the present value of the losses of all future generations.

Some economists have claimed that there is no net loss because the present value of the loss of future generations is just equal to the size of the initial windfall. However, some simple algebra shows that this equality is true only if the marginal product of capital is the same as the net return that individuals receive on their investments. But in an economy like ours in which taxes put a significant wedge between the marginal product of capital and the net return to savers, the present value of the future losses is substantially greater than the initial windfall. The net present value of consumption over all the generations is therefore substantially reduced by the introduction of a mandatory Social Security program.

Moreover, the low return on compulsory saving also acts as tax on labor income, bringing about further deadweight losses. The transfer to the initial generation of retirees, has no offsetting favorable effect on labor supply because the recipients were already retirees when the program began.

Some years later, I took these adverse effects to be a reason to seek a reform of Social Security, particularly a reform that would shift from the existing pure pay-as-you-go system to an investment based program. Properly designed, such programs can meet many of the objections that Friedman raised.

Such Friedman-inspired reforms are now happening in many parts of the world. They are not as complete as Friedman suggested. But they involve investment-based programs with individual accounts that reduce or eliminate much of the role of government, that allow individuals to decide when to retire and how much to withdraw from their accounts, and that permit individuals to bequeath accumulated funds to children or other heirs.

The most famous of these reforms occurred in Chile and has spread to several other countries in Latin America. Similar reforms have happened in Australia, Great Britain and, to a small extent, even in Sweden. The Chinese government is officially committed to such a system although they have difficulty in implementing it.

The US is a laggard in this reform process. But I believe it will come. President Bush endorsed investment based Social Security reform in his successful campaign for the Presidency. He believes strongly in this type of reform and he correctly concluded that young people would welcome the opportunity to shift to such an alternative. The recent decline in the stock market didn't help to develop support for this type of reform but the opinion polls still show substantial support among younger voters. Perhaps the outcome of the recent election will provide the opportunity to move forward on these reforms

Taxes and the Size of Government

Let me turn now to taxes and the size of government. Again the basic text for anyone who wants to think about these issues is Milton's Capitalism and Freedom.

His message is clear. When it comes to government, less is better. Reducing the size of government is a virtue because it gives individuals the freedom to do what they want with their money and with their lives.

Once you've read Milton, there is not much to add – at least not at the basic philosophical level of the argument.But there is also a narrower economic reason for reducing the size of government – the fact that raising taxes to finance government activities involves a dead weight loss that increases the true cost of government. Government spending should therefore be cut back to the point at which the benefit of the expenditure is not less than the full cost of providing that benefit – including the deadweight loss of raising the revenue.

My own calculations suggest the deadweight loss is large – much larger than is generally assumed even by economists who have thought about these issues. [1] The size of the deadweight loss depends on the extent of the distortion caused by the taxes used to finance government. Since that deadweight loss is proportional to the square of the marginal tax rate, a shift to the type of flat tax that Milton has proposed would significantly reduce the deadweight loss of raising revenue – and ironically support a higher level of spending, higher that is than would be optimal with today's marginal tax rates but not necessarily higher than today's actual spending. In any case, the decision about spending should now reflect the actual marginal tax rates and the distortions that they cause.

The deadweight loss is proportional to the relevant elasticity of response of the behavior affected by changes in the marginal tax rate. Economists tend to understate the deadweight loss of incremental revenue because they think about the compensated elasticity of labor supply with respect to the net wage and then measure labor supply by hours and participation rates. But once you start thinking about labor supply, the number of hours worked is just the tip of the iceberg. High marginal tax rates also reduce the incentive to work hard, to accumulate human capital, to take riskier jobs, to enter less pleasant occupations, etc.. So looking at hours and participation rates misses the most important part of labor supply.

Moreover, high marginal tax rates distort more than labor supply – even labor supply broadly

[1] See my "Tax Avoidance and the Deadweight Loss of the Income Tax," in Review of Economics and Statistics, November 1999, 81(4): pp 674-680.

defined. High marginal tax rates induce individuals and firms to change the form of compensation from taxable cash to taxfree fringe benefits, including nicer working conditions and other perks. Since these fringe benefits only have to be worth the net-of-tax opportunity cost to make them preferred by employees to taxable cash, there is a substantial deadweight loss from this distortion.

And high marginal tax rates induce individuals who itemize the deductions in their tax returns to spend more on housing and other tax deductible forms of consumption – again causing substantial waste because the marginal spending on tax deductible consumption need only be valued at the net-of-tax cost.

The relative costs to the taxpayer of all three ways of reducing the individual's income taxes – working less, taking compensation in untaxed forms, and spending on tax deductible forms of consumption – do not change with the tax rate. That implies that the deadweight loss should be calculated by looking at how marginal tax rates affect the combined effect of all three actions, i.e., how marginal tax rates affect taxable income.

The key elasticity in determining the deadweight loss of the income tax is therefore the elasticity of taxable income with respect to the marginal net-of-tax share – i.e., to one minus the marginal tax rate. It's clear that that elasticity is much higher than the traditional elasticity of working hours with respect to the net wage.

In fact, the experience before and after the 1986 tax reform act implies that the relevant elasticity is about one. The implied cost of an extra dollar of government spending is about $2 or more.

This implies that a dollar of taxpayer money should be spent only if it creates at least two dollars of value to the beneficiaries of that spending.

Milton Friedman's philosophical case for limiting government is therefore supported by this simple economic calculation.

The challenge is to communicate these philosophical and economic arguments to the political decision makers.

I'm sure that the size of government will never be as small as Milton would like. But the experience of the past few decades shows that it may not be impossible to lower government spending relative to other uses of national income.

I've already talked about the future of Social Security – the largest government program. A key question is whether that and the Medicare program for the aged can take a declining share of taxes because of reforms in the way that they are financed. I'm optimistic that they eventually will do so.

What about the rest of government – the so called "discretionary" part – after we set aside the "mandatory" programs like Social Security and Medicare? Back in 1980, total discretionary spending by the federal government took 10.1 percent of GDP. Now that number is down to 6.3 percent of GDP – a really remarkable decline. It's true that a significant part of that spending cut was in the defense department. But even looking at non-defense discretionary spending, we see a one-third decline from 4.7 percent of GDP in 1980 to 3.1 percent in 2002

Perhaps even more striking has been the decline of the top marginal tax rates – from 91 percent in the year that Capitalism and Freedom was published (1962) to 50 percent in 1982 and 31 percent in 1992. Unfortunately, that top MTR is now back up to more than 40 percent. Again this Congress may be able to make a difference.

A Concluding Comment

So where does all of this leave us?

Milton provided a philosophical and political mandate for smaller government and for letting individuals manage their own retirement savings.

Economic analysts have added to these arguments by showing (and quantifying) the losses that Social Security causes by reducing national saving and by the distortions in labor supply broadly defined.

I may be too optimistic but I feel that the policy climate is changing in the direction that will place more responsibility on individuals and reduce the deadweight losses.

I hope that when we gather to celebrate Milton's 100th birthday we will have seen a major shift to investment based Social Security and a general reduction in the size of government and in the taxes needed to finance it.

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