TREATING HEALTH AS AN ECONOMIC PROBLEM

Jeremy Sammut says market-based health reform will deliver greater equity, efficiency and sustainability

For almost a decade, there has been intermittent discussion of the impact that the unprecedented ageing of the population will have on Australian society. This discussion has predominantly focused on the projections contained in the federal government's three *Intergenerational Reports* (IGR), which have modelled the effects of rising health spending on the sustainability of government budgets in the coming decades.[1]

The older people get, the more health care they consume to maintain their health and prolong their life. It follows that a larger elderly population suffering ageing-related conditions will significantly increase demand for health care. This dynamic will put pressure on government budgets, given the public choice in countries like Australia to run the vast majority of health spending through government programs. In the absence of policy change, a fiscal gap could open over time between revenue and expenditure, creating either higher tax or bigger deficits and larger public debt.

Despite the plausibility of these scenarios, two features have characterised the response in policy circles to forecasts of a looming 'health and ageing crisis': skepticism and wishful thinking.

Scepticism

Scepticism is driven partly by political calculations. When the Howard government released the first IGR in 2003, there was a suspicion that its doom and gloom financial projections were an excuse to launch an ideological assault on Medicare.

Some commentators claimed the IGR ignored the way economic growth would make higher health spending a manageable issue. As the country grows richer in the future, so the argument goes, the community will want to spend more of its rising real income on 'superior' goods like health care. Thus the health needs of an ageing population can be met through 'moderate' increases in taxation.

This view has since prevailed to an extent in Canberra. The official Treasury view is that a mix of the '3 Ps'—growth in Population, Productivity, and Participation—could produce higher economic growth to offset the rising cost of Medicare and potentially defusing the so-called 'demographic time bomb.'

This relatively benign view of the challenges ahead minimises a number of important questions, starting with intergenerational equity and how fair it is for the younger generations to bear a higher tax burden to fund

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the health costs of the elderly. Downplayed also is the need for Australian tax rates to remain internationally competitive, given that many of our neighbours to the north do not face the same ageing-related issues.[2]

Furthermore, recent events in Europe suggest this is overly optimistic. The fiscal crisis confronting European social democracy demonstrates that there are limits to the size of government, to debt and deficits, and to tax and entitlement increases. Australians should be looking at the situation in Europe and asking whether we are simply lucky to be 20 years and a bust mining boom behind what is happening over there.

Wishful thinking

The second policy response has been to use the perception of a coming crisis as a pretext for so-called health 'reforms.'

Population ageing is often cited as a reason for boosting government spending on preventing lifestyle diseases to reduce long-term health costs—even though the effectiveness and cost-effectiveness of the so-called preventative interventions are not proven.[3]

Addressing ageing was also cited as a reason for the rollout of the federal government's GP Super Clinics program—even though there is little evidence that elderly patients who block emergency departments in overcrowded public hospitals can be more appropriately treated in 'lower cost' primary care settings.[4]

Ironically, this kind of policymaking by wishful thinking about new 'models of care' creates an even bigger and more costly public health system. The 'solutions' offered are ineffective because the problems ostensibly targeted, such as long waits for public hospital care due to bed shortages, are structural defects stemming from Medicare's inherent flaws.

Sacred myths

However, the conventional belief that the status quo in health is socially progressive and equitable, and the political obstacles in the way of revising health care entitlements, prohibits consideration of the real problems in the system and stymies genuine systemic reform. An example is the failure of any of the *Intergenerational Reports* to even canvass possible policy responses to the financial sustainability problems they outline.

Another example of the political quarantine that surrounds this 'sacred cow' is the inability to be honest about Medicare's fundamental realities and that a 'free' health system will always have to ration care, via some form of queuing, because government budgets are limited.

The quarantine extends to refusing to admit that ageing, or rather the intersection between ageing and rapid advances in medical science, will stretch government budgets and lead to more extensive rationing of care because of the competing priorities governments face. This could include longer queues and slower uptake of new technology, given that medical science continues to discover more and more things to do to for more and more patients at more and more cost.

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Governments already don't have enough money to pay for all the health care the community wants to consume each year. What is impossible now will be absolutely impossible in an ageing Australia. But because the political consensus insists that the only fair way to finance health care is through taxpayer-funded services consumed without user charges at point of access, alternatives such as self-financing and expanded private provision are marginalised.

Health systems such as Medicare were created when health care was relatively cheap and basic; most people died in their 60s; and relatively few lived into their 80s and beyond, as is increasingly the norm today. The sustainable way to fund all the sophisticated health care that people will want and need in the future is to pre-fund it—save up and pay for your own health over time.

In the twenty-first century, the focus of a prudent health policy should also be on maximising efficiency to ensure that our

health dollars are used cost-effectively and the community receives more and better services for the proportion of national income spent on health. Ways to generate efficiencies (such as microeconomic reform of the public hospital system[5]) and to control costs (such as levying user charges) are at least as controversial as the idea of pre-funding.

Unfortunately, health is a sacred cow, like education, where higher spending (aka 'record spending') is perceived to be an unadulterated good. To address the unrealistic expectations that abound in what the health system can deliver, the current approach to health requires major revision.

What it should mean for Australians, however, is ceasing to bask in false comparisons with the situation in the United States and ending the delusion that the Australian health system is wondrously equitable.

For a century, the Left has been allowed to treat health as a social problem that demands a 'welfarist' approach to ensure universal access to services regardless of income. Universality, or taxpayer supported access to services for those who need it, remains an important aspiration. But given the challenges ahead, the priority now is to treat health squarely as an economic problem.

Reconsidering the affordable way to pay for health care doesn't mean ignoring equity. Nor does it mean going down 'the US path'. What it should mean for Australians, however, is ceasing to bask in false comparisons with the situation in the United States and ending the delusion that the Australian health system is wondrously equitable. In fact, major inequities have stemmed from the inefficiencies at the heart of Medicare.

Together with the long-term financial challenges facing Medicare, the case for comprehensive health reform starts with understanding the malign effects of the status quo, which delivers far-from-optimal and actually quite perverse outcomes. By squandering and misallocating scarce resources, Medicare spends more on health than is necessary to fund less of the care that patients actually need.

How! Not how much

I examined the ways in which Medicare distorts the demand and supply of health services in a report published by The Centre for Independent Studies last year titled *How! Not How Much: Medicare Spending and Health Resource Allocation in Australia*.[6]

This report showed that in 2008–09, the total cost of all Medicare-funded medical services (GP and other non-hospital care) to the federal budget was more than $15.5 billion. This was almost double the cost of the private hospital system and approximately half as much as combined Commonwealth and state government spending on public hospitals ($30 billion).

By comparison, in 1967–68, for every $1 spent by Australian governments to subsidise medical services, $4.83 was spent on subsidising hospital services. This was total spending on federal hospital benefits and state grants to public hospitals. In those days, there were no hospital queues. By comparison, in 2008–09, for every $1 spent on the Medical Benefits Scheme (MBS), the total government subsidy for hospital care was only $1.99.

These figures draw attention to the faulty principles and design flaws of Medicare, rendering it an unsound insurance scheme. It is in fact a 'reverse insurance' scheme that provides 'inverse care' by forcing the minority of patients with major health needs to queue for treatment at overcrowded public hospitals which have capped budgets and rationed care. Meanwhile, the majority, many of whom have relatively minor needs, receive 'free' or highly subsidised GP visits and other medical services on demand under the uncapped MBS program.

In addition, people are also poorly covered for chronic conditions because the MBS primarily covers their doctor's fees rather than the full course of treatment. Thus many chronic disease sufferers can face out-of-pocket charges for non-GP services and medications not fully covered by Medicare.

Medicare is wasteful and unfair because it encourages unnecessary consultations and tests. Consumers can use their Medicare cards to either

'bulk bill' the entire cost of medical services to the federal government or to receive a rebate covering a significant proportion of the cost of each service. Given the size of the subsidies provided, it is impossible to tell how many billions of dollars are being wasted on unnecessary tests and trivial health needs.

However, the consequences are far from trivial. High, ever-increasing, and open-ended spending on the non-hospital sector has contributed to funding and service imbalances at the most acute hospital end of the health sector. To offset high spending on bulk billing and to control the total cost of health to the federal budget, the Commonwealth since the 1970s has tightly capped the level of funding it gives to the states for public hospital care.

This has left state governments heavily exposed to the financial risk of growth in using public hospitals. The predictable response has been to introduce blunt expenditure controls—frontline budget caps and bed cuts—to ration access to services.

In the last quarter of a century, Commonwealth and state funding caps have contributed to huge cuts to public hospital bed numbers in excess of the efficiencies generated by technical innovations that cut length of stays.[7] Bed cuts have in turn led to increased waits so that one in six elective patients in Australian public hospitals waits longer than clinically recommended for surgery; one in three emergency patients wait longer than eight hours before being admitted to a hospital bed.

Medicare thus leaves people over-subsidised and over-entitled at the least acute end of the health care spectrum, while the cost of the most serious, most expensive illnesses is inadequately covered, leaving patients underinsured against the risk of serious illness requiring hospitalisation.

Structural reform

As a matter of equity, the money the Commonwealth spends on bulk billing and the MBS could be better used to meet unmet demand for hospital care. But redirecting money into bureaucratic, inefficient and already high-cost public hospitals is no solution. Public hospitals are like other public sector monopolies, and additional inputs do not produce a proportional increase in outputs. Note, however, that governments have run hospitals using a productivity-killing command-and-control model to ration care and enforce budget limits.[8]

Medicare's chief flaw is that it exemplifies the intrinsic moral hazard and resultant problems that all subsidised, fee-for-service, third-party insurance arrangements create in both private and public health systems. This is the real lesson to learn from the increasingly unaffordable US private health system: It is impossible to insure people for all health services without overuse causing a cost and premium spiral. In a private system, moral hazard creates unaffordability; in a free public insurance system like Medicare, it causes arbitrary and unethical rationing.

Medicare thus leaves people over-subsidised and over-entitled at the least acute end of the health care spectrum, while the cost of the most serious, most expensive illnesses is inadequately covered.

The lesson is that a soundly constructed insurance system should not insure people for all services no matter how minor the health need and cost. It should instead enable people to share exceptional risk involving major health problems and high-cost medical procedures. Subsidies should be allocated on a differential needs basis. Minor medical costs should therefore not be covered from the first dollar spent as Medicare does. Instead, individuals should self-insure against these costs because people always spend their own money more responsibly than a subsidy from a third party. Only a minimum package of high-cost treatments for complex chronic and catastrophic conditions should be covered by third-party insurance. Personal responsibility, consumer sovereignty, and price signals should also feature by using front-end deductibles and copayments to control costs and deter unnecessary use of marginal, discretionary services and trivial claims.

To treat health as economic problem, four key principles should guide the genuine debate we need to have about health reform:

- Scarce health resources and subsidises should be allocated on a needs basis to ensure timely access to essential care.

- Most individuals must pay for minor health expenses out of their own pocket to prevent overuse, making use of personalised funding instruments (health savings accounts (HSAs) modelled on the compulsory superannuation system).

- Medicare should be replaced with a soundly constructed competitive insurance system along the lines of the Medicare Select risk-rated insurance 'voucher' proposal.

- And insurance deductibles and copayments should apply for non-chronic care and marginal hospital procedures.

Market-based reform that delivers greater choice and competition at the provider level will reduce the cost of services and achieve better value for money across the system.

Conclusion: Equity, efficiency, sustainability

Treating health as an economic problem would not be inimical to equity. The optimal health insurance structure sketched here combines enhanced efficiency (allocative and technical) with greater financial sustainability and improved equity.

Universal coverage would be maintained through appropriate government funding of HSAs, insurance vouchers, and rebates for low-income earners. However, waste caused by overuse of insured services would be curtailed, with the resources saved over time to fund better-targeted health care via a sound insurance scheme to meet the most important health needs.

The Medicare Select model (as proposed by National Health and Hospitals Reform Commission[9]), with its mix of taxpayer-funded vouchers plus additional private premiums, would also indirectly expose people to the cost of using health care. Cost control would be further enhanced as HSAs allow for selective use of prices at point of access to directly expose people to the cost of deciding to use some services.

Choice of insurer—the portability of vouchers—would encourage price competition and innovation among health insurance funds. A genuine purchaser-provider split in health would also introduce price contestability for hospital care and spur meaningful reform of public hospitals. Market-based reform that delivers greater choice and competition at the provider level will reduce the cost of services and achieve better value for money across the system.

Endnotes

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THE END OF SOCIALISM BUT NOT OF SOCIAL WELFARE

Allan H. Meltzer argues that although socialism has collapsed, the burdens of social welfare threaten their long-term viability in contemporary democracies

Socialism—public ownership of all (or most) productive assets—failed whenever (and wherever) it was tried. Only two avowed socialist states remain—Cuba and North Korea. Cuba is dragging itself slowly towards some private ownership. Literally no one admires North Korea.

For reasons that Friedrich Hayek and other classical liberals understood well, most socialist states were authoritarian and non-democratic. India and Britain are obvious exceptions. Both tried so-called democratic socialism. Both eventually increased free-market arrangements. Growth rose and poverty declined markedly.

Only capitalism achieves better living standards and personal freedom. Freedom depends on ownership of physical and human capital because capital permits people to become their own boss. But freedom and capitalist development require the rule of law. Rule of law mandates that all citizens are equal before the law, and to the maximum extent possible, all are treated the same.

Hayek claimed that the rule of law contributed greatly to the success of British and US capitalism. Socialist countries rarely observe the rule of law. They work to apply someone else's idea of a utopian society. What they believe is good and right replaces the rule of law with decrees that allegedly achieve conformity to the socialist ideal.

In contrast, capitalism adapts to many different cultures. Capitalism in Japan differs from capitalism in Western Europe, as these differ from the free-market capitalism in the United States or the state capitalism in China. In free societies, people choose the rules under which they live. In socialist societies, rulers impose their utopian vision.

The post-War years began with a widely shared belief that most countries would choose socialism. Even Joseph Schumpeter drew that conclusion. The founders of the Mont Pelerin Society dissented. They were a small minority, but they understood that freedom was valuable to people in a way that rigid socialist orthodoxies never could duplicate. And they understood that free men and women could achieve sustained growth.

The attraction socialism once had weakened as the Soviet Union failed to achieve either growth or freedom. With authoritarian China and socialist India expanding private ownership and adopting liberalising measures, all but a few small countries have abandoned socialist orthodoxy.

This defeat or rejection of socialism should not be misunderstood. One of the main appeals of socialism was its advocacy of an egalitarian distribution of wealth, income and influence. Hostility towards capitalism always highlights

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inequality and recessions or business cycles. But as many could see, and a few like Milovan Djilas wrote, socialism did not eliminate income differences. Rather, it transferred power, influence and high income to a 'new class.' And to the extent that measures of income inequality showed less dispersion, the price paid in income levels and freedom was high. People in East Germany, North Korea, and China compared their fate to residents of West Germany, South Korea, and the Chinese diaspora, including Hong Kong, Singapore, and Taiwan. The famous Berlin Wall restricted emigration but not immigration. No one chose to move to East Germany.

The failed policies for recovery in the European Union and the United States reflect the dominant influence of social welfare redistribution over recoveries.

Political pressure for redistribution remained. The social democratic welfare state offered grants and subsidies that redistributed wealth and income and increased the reported unemployment rate. After climbing to within 80% of the per capita income in the United States, on average, Germany, France and Italy began to pay some costs of the welfare state. From 1980 to 2005, these countries averaged 1% slower growth than the United States. After 25 years, a gap of nearly 25% growth rate was explained away by lower employment rates.

No country, democratic or authoritarian, will accept the market's decision about the distribution of income. All countries modify the market outcome, most of them by taxing and transferring from high incomes to low incomes. The politics of the social democratic welfare states can only reduce transfers and costly redistribution in a crisis.

Stimulating the US economy

The failed policies for recovery in the European Union and the United States reflect the dominant influence of social welfare redistribution over recoveries. In the United States, President Barack Obama's principal economic adviser, Lawrence Summers, said in 2009 that policy actions should be 'timely, targeted, and temporary.' The so-called stimulus policies that the United States adopted gave temporary relief to public employees, teachers and police and subsidised investment in solar power, batteries, electric automobiles, and insulation.

The results show that the subsidised autos did not sell well; the main subsidised producers of solar panels failed; and error, corruption, and political favouritism reduced effectiveness. A detailed study of the nearly $900 billion in stimulus offers some examples.*

In Illinois, inspectors failed to detect a gas leak from a newly installed furnace that could have seriously injured the home's residents. Contractors billed for labour that wasn't done and materials that weren't installed. Fourteen out of 15 homes visited failed inspection. In New Jersey, auditors identified 12 households that were approved for free repairs despite earning an income of more than $100,000. Agencies bought $1,500 GPS systems and underpaid their workers. The state's system of eligible applicants contained the social security numbers of 168 dead people. A nonprofit in Waukesha, Wisconsin, got stimulus money despite having spent weatherisation funds (federal funds to low-income families to make their homes more energy efficient and reduce energy bills by using the latest technology and testing methods) on Christmas decorations, gift cards for employees, and a parking ticket. West Virginia had to take over one agency's weatherisation program after finding 'shoddy work, falsified reports, credit card abuses, and missing inventory.' An inspection of a Houston nonprofit found that work was so sloppy that contractors had to go back and repair 33 of the 53 homes reviewed. Investigators in California found untrained workers. And Delaware suspended its entire weatherisation program for nearly a year after a scathing report documented problems with nearly every aspect

* Michael Grabell, *Money Well Spent?* (New York: Public Affairs, 2012), 11.

of the program, leading the Department of Energy to freeze the program's funds.

The most successful fiscal policies in post-War United States were the Kennedy-Johnson and Reagan tax cuts for households and businesses. These programs marshalled profit incentives to guide investment choices. The Obama program, like most political decisions, was less concerned about gaining economic efficiency and more about choosing who paid and who received. One of the major flaws in what are called Keynesian policies is that the designers act on the premise that what matters is the amount spent, not the way it is spent. Keynes did not make that mistake.

European Union

In the European Union and the European Central Bank (ECB), the daily discussion is about getting Germany and a few other fiscally responsible countries to bail out welfare state spending in the debtor countries. I am appalled by the pressure put on Germany by bankers and their friends to subsidise welfare states in the European Union. The *Financial Times* is particularly outrageous. Prime Minister Margaret Thatcher said that welfare states would shrink when they ran out of other people's money. We are there. But instead of adjusting down, the bankrupt governments are proposing institutional changes that, if adopted, would sustain profligate redistributive policies.

High unemployment and prolonged recession or slow recovery are serious problems that require rational policy action. Most welfare states are so large that rational policies are politically unpopular, perhaps even unacceptable.

We are reaching the point at which the welfare state's promises of redistribution will shrink. Or we will lose democratic capitalism. Voters will not end the welfare state and redistribution, but promises in many countries greatly exceed resources available for payment. Sweden, once the envied model of a welfare state, has made a start by reducing some transfers.

The crisis is here and now in the European Union and the United States. Even those who favour programs and policies that transfer responsibility and decisions from the market to the bureaucracy must see how difficult it is for government to develop meaningful reforms. No one believes that the unfunded promises that are driving future US debt and deficits will be paid if nothing is done. On the contrary, everyone who seriously discusses the future welfare state debt and deficits uses the word 'unsustainable.'

Many in the European Union point their finger at the 'rich' Germans requesting, even demanding, transfers of one kind or another. The German government responds by saying, 'We have given ample support. You, the debtors, must reduce domestic transfers and become more competitive by reducing real wages.' Another continuing stalemate. The widespread reluctance to recognise the problems of welfare states prevents a solution.

Germany recognises that the problem is real, not just monetary or debt related. Costs of production are 25% to 30% greater in Greece, Italy, Spain and Portugal than in Germany.

I find it appalling that almost all the discussion of the European crisis is about the debt incurred by Greece, Italy, Spain and Portugal. Almost every day, the *Financial Times* publishes articles that urge Germany to accept more inflation to bail out the banks and other lenders. Do the writers and the editors think that the problem is entirely monetary and can be solved by lowering interest rates and printing money?

Germany recognises that the problem is real, not just monetary or debt related. Costs of production are 25% to 30% greater in Greece, Italy, Spain and Portugal than in Germany. Without lowering costs in these countries, growth cannot resume or even continue unless some stimulus gives temporary relief. Germany wants real reform of labour, commodity markets, and government policy.

There are two ways to reduce real wages in a fixed exchange rate system. The so-called austerity favoured by Germany would both reform the economies and force reductions in real wages. After three years of economic decline, getting an additional 25% to 30%

reduction in real wages in this way seems to be politically impossible. Voters will not retain in office a government that cuts real wages; political opportunists oppose 'austerity.'

Devaluation is an alternative way to reduce real wages. The ECB should permit the indebted southern European countries to form a temporary weak euro. The strong euro countries would adopt the fiscal restrictions to which their own representatives agree. The weak euro countries would float down against the strong euro. Once devaluation reduces real wages, countries in the weak euro would rejoin the strong euro by agreeing to the fiscal rules.

The United States has also failed to reduce or moderate its future budget deficits. Again, the problem is a failure of the political system to reduce spending or agree on a comprehensive program to balance the budget.

Devaluation would work quickly. It is not without cost. Two are of particular importance. First, the devaluing countries must limit bank runs or currency runs by enforcing temporary exchange controls. And they must avoid subsequent inflation. Second, German and French banks would suffer losses on their holdings of foreign bonds. The French and German governments should require their banks to raise half of their capital shortfall. Government would supply the other half at concessional rates. If a bank failed to raise its half in the market, it would be declared insolvent and taken over by regulators. That gives the bank an incentive to raise its share of the capital infusion.

Social welfare state governments in Europe cannot agree on a solution to their major problem. They resist imposing the requisite costs on their voters. Often they fail to carry out the pledges they make. They cannot agree to change who pays and who receives, the main point of the welfare state. The most common demand is for Germany to be more generous. The German public refuses to transfer any more money to foreigners.

The euro problems are common problems for fixed exchange rate systems. Governments must limit their budget deficits, the size of outstanding debt, and keep their terms of trade close to their exchange rate. Like many other fixed exchange rate systems, the euro failed to meet these requirements. And it has not been able to agree on a program to restore stability and growth. These failures will restrict the welfare state and egalitarianism. It will not end pressures for redistribution.

The United States

The United States has also failed to reduce or moderate its future budget deficits. Again, the problem is a failure of the political system to reduce spending or agree on a comprehensive program to balance the budget.

The problem is not new. From 1930 to 2012, the federal government approved a balanced budget or a budget with a surplus of revenues over spending in successive years only twice. President Dwight D. Eisenhower was a fiscal conservative. He favoured balanced budgets in all years without a recession, and he gave many speeches about fiscally responsible spending. President Bill Clinton raised marginal tax rates early in his first term. But he also slowed spending growth enough to run budget surpluses for several years. Budget surpluses raise expectations that future tax rates will reduce and investment and growth will increase.

In contrast, from George Washington's presidency in 1789 to the Great Depression in 1930, the federal budget had a surplus in two-thirds of the non-war years. Wartime deficits did not continue after wars. Peacetime governments reduced debt. As late as the 1920s, Secretary Andrew Mellon was able to reduce tax rates and wartime debt by running budget surpluses.

The Great Depression was followed by several wars that led to increased government spending. The size of government, measured by the ratio of federal government spending to GNP or GDP, rose from 3% in 1930 to about 18% in recent decades. The Obama administration increased spending to 25% of GDP. Its budgets are rejected unanimously by Congress. Unlike

the early post-War budgets, which included a heavy defence component, social spending is by far the largest share of federal spending. Most of social spending is labelled 'entitlement spending,' suggesting (falsely) that it cannot be reduced without depriving recipients of something that is their due.

So-called 'entitlements' put future budgets on an unsustainable path in the United States and many other countries. For the United States, future spending on health care and retirement has a current value of more than $70 trillion. There is no combination of tax rates, expected growth, and reductions of other spending that permit the promised entitlements to be paid.

The gold standard

Why was the modest size of government in the nineteenth and early twentieth centuries maintained and accepted almost everywhere? I credit two main but related reasons: the international gold standard and the widespread belief that government, like households, should balance its budget. Persistent peacetime budget deficits raised concerns that a country would have to devalue against gold. The currency would move to the gold export point, requiring intervention. Intervention could succeed in stabilising the gold exchange rate only if the market expected fiscal discipline to improve.

I have never advocated a return to the gold standard mainly because the public prefers stable domestic prices and employment to a stable exchange rate. A second reason is that a single country that fixed its exchange rate to gold would buffer shocks for all other countries by inflating and deflating when others demanded to buy or sell gold. An effective gold standard must be universal, or at least, multilateral.

The enduring lesson from the gold standard years is that a publicly accepted monetary rule that maintains a stable domestic price level (or a low rate of inflation) also restrains budget deficits, just as fiscal restraint supports the monetary rule. Only a policy of rules can restore growth and sustain freedom. That is the policy we must aspire to.

Collapse of the welfare state

After John Maynard Keynes read Hayek's *Road to Serfdom*, he wrote to Hayek praising the book but disagreeing with its conclusion. Keynes claimed that if well-intentioned people made the decisions, the outcome would be beneficial and desirable. This is a major flaw in the organisation and operation of social democratic governments and welfare states. They presume most often that they are selfless and know better than the public about what is right.

Detailed regulation often proclaims that it is done 'in the public interest.' Most often it brings special privileges, crony capitalism, corruption and circumventions.

The great German philosopher Immanuel Kant had a better understanding of human character. He wrote: 'Out of timbers so crooked as that from which man is made, nothing entirely straight can be carved.' Christian theology at the time saw humans as morally imperfect. Some exceptions can be found in all eras, but it is a mistake to rely on goodwill and good intentions. Twentieth-century experience in authoritarian states and the democracies of Western Europe and India alike reminds us that 'power corrupts.'

Kant's judgment warns us that we should not expect benevolent government regulation. The rule of law directs government to treat all citizens as equal before the law. This is an ideal that guides regulation towards desirable outcomes. Like all good policies, it is a rule.

Detailed regulation often proclaims that it is done 'in the public interest.' Most often it brings special privileges, crony capitalism, corruption and circumventions. Powerful Soviet or Chinese officials had access to better opportunities, better food, and better health care than ordinary citizens. Democratic India became known for bribery and corruption of officials who wanted privileges.

After writing the Constitution of the United States, James Madison contributed to the

Federalist papers to promote ratification. He insisted that the Constitution limited the power of the federal government, and in *Federalist 10*, he warned about the threat posed by 'factions.' Today we have replaced factions with interest groups. As Madison warned, interest groups protect their interest at the expense of others.

Interest group politics makes it difficult to reform the welfare state or remove the pressure for egalitarian outcomes. Here are some examples. In the 1980s, it became clear that many savings and loan associations would fail. Deposit guarantees protected depositors, but failure imposed losses on taxpayers. The US Congress acted to hide the problem, but some managements understood that delay created opportunities to take risky gambles that would restore the value of equity if the investment paid off. Since equity was low or negative, the cost of additional losses would be borne by taxpayers. Some took the gamble. Taxpayers' losses reached $150 billion.

Every knowledgeable observer agrees that projected growth of federal government spending is unsustainable. Still, the federal government does not propose reductions.

A few years later, President Clinton appointed Jim Johnson to head the Federal National Mortgage Association (Fannie Mae or FNMA). FNMA began in 1937 as a purchaser and occasional seller of outstanding mortgages to smoothen fluctuations in mortgage rates and create a more liquid market. Later, the Federal Home Loan Bank Board (FHLBB) created a separate organisation, the Federal Home Loan Mortgage Corporation (Freddie Mac or FHLMC) to buy and sell mortgages.

Johnson had been a campaign manager in Walter Mondale's 1984 presidential campaign. He was well connected politically and wanted to make homeownership more egalitarian. He saw an opportunity to expand FNMA's operations while offering opportunity to low-income homebuyers. The political appeal of expanding homeownership was popular. To facilitate this program, the government agencies lowered down payments and later offered to buy sub-prime mortgages with no down payment for borrowers that had no credit history.

Selling sub-prime mortgages to the two government sponsored buyers, Fannie Mae and Freddie Mac, was a very profitable business. Some mortgage lenders actively worked to issue such mortgages that could be resold profitably. Major banks did the same. An international agreement required the banks to hold larger reserves behind mortgages in their portfolios. The banks circumvented the costly regulation by chartering subsidiaries that held the mortgages but evaded the requirement. Regulators did not object.

A few voices that pointed to the risk of defaults and losses were ignored or dismissed. Congressman Barney Frank was chairman of the house committee with oversight responsibility. He urged expanding the program. President George W. Bush viewed the programs as part of his 'ownership' program. He did not ask: 'What did the homebuyers own?' Many made no down payments; they 'owned' an option to gain home equity if home prices rose, but they also owned the prospect of loss if home prices fell.

Contrary to repeated forecasts that home prices would not fall throughout the country, the unthinkable happened. The social welfare experiment in expanding homeownership to minorities and low-income families failed in a wave of mortgage defaults and foreclosed houses.

In January 2009, the Obama administration inherited the housing and financial failures. Its program design called for a massive increase in government spending and temporary tax reductions. Professor Summers, head of the new president's economic staff, said that the program should be targeted and temporary. Bad advice! Decades of economic research showed that temporary tax reduction and spending increases get very little response.

Congress developed the program details. Their interest as always was in distributing financial support to their political supporters, so the supposed economic stimulus became an example

of welfare state redistribution. For example, money was spent to help states avoid laying off teachers. When the funding was not renewed, layoffs resumed. So what was achieved?

A principal weakness of the program was its short-term focus. A large stock of unsold houses and projected defaults on mortgages implied that the recession would be deep and long lasting. Properly designed policy changes would have avoided targeted and temporary changes and offered permanent incentives for investment. A better policy would have been to increase incentives for investment and adopt rules for future fiscal and monetary policies.

The social welfare state empowers interest groups that demand support from their political allies. Their main concern is benefits to them and their members. They oppose efforts to reduce spending on their benefits. Fire and police unions receive such large pension and health care benefits that state and local governments are forced to reduce spending on such basic functions of government as police or fire protection. At the federal level, spending for pensions and health care force reductions in spending for defence against terrorism.

Every knowledgeable observer agrees that projected growth of federal government spending is unsustainable. Still, the federal government does not propose reductions. Any 10 solutions that reduce spending act like a tax levied on particular groups—the retired and their families, the teachers union, or some other organised group. Greece, Italy and Spain waited for the crisis to force drastic changes that could have been phased in gradually and less painfully. Must the United States repeat their error?

Similar problems threaten the survival of the European Union. As in the United States, voters agree to increase spending on redistribution for pensions, health care, and the unemployed, but few vote to pay for the benefits. Budget deficits increase until they are unsustainable and markets are unwilling to finance them.

The political system cannot agree on a program. Short-term palliatives prevent an immediate crisis, but the problems remain. Uncertainty rises, so investment falls. The debtors urge the creditor countries to pay more and to forgive debts. The creditors demand reforms that open markets, reduce the power of labour monopolies, raise retirement ages, sell state industries, and reduce transfer payments. Each of these affects a powerful interest group. And it reduces the proliferation of the welfare state.

And perhaps we can convince governments that changing incentives and adopting policy rules, not exhortation and direction, are the most effective methods for bringing lasting change.

Conclusion

Madison warned that 'factions,' now called 'interest groups,' are a threat to democratic governance. His fears are now reality. The social welfare state has become the prisoner of interest groups that demand ever-increasing benefits and resist any changes that lower their benefits.

That puts the social welfare state on an unsustainable path leading to its eventual collapse. Experience in the European Union and the United States shows these political unions are headed for a crisis. But it will not end the welfare state. Political pressure for redistribution carried out in the name of equality is always present. The most we can expect is sufficient reduction in spending to maintain democratic capitalist governance. And perhaps we can convince governments that changing incentives and adopting policy rules, not exhortation and direction, are the most effective methods for bringing lasting change.