THE PUBLIC FINANCE DEBATES:

“It’s <u>**not**</u> time…New Zealand adopted a social insurance approach to welfare”

John Gibson

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Why don't we just self-insure?

- Miss the advantages from pooling risk
  - Spatially
  - Inter-temporally
  - Inter-generationally
- Costly at individual level due to lack of scale and lack of diversifiable options
- In rich countries the short-sighted who under-insure are likely to get bailed out anyway

Contributory social insurance

- E.g. Bismark - statutory health insurance in 1883
  - Insured are gainfully engaged
  - Financed by contributions, usually with payroll tax
- Benefits depend (partially) on contributions
  - Such entitlements are difficult to reform
    - E.g U.S. Social Security Numbers and "individual accounts"

Otto von Bismark

Universal entitlement systems

- Eg. 1942 Beveridge report
- Includes the entire population
- Financed from general taxation
- Benefits are unrelated to individual productivity
  - Redistributes unlike a pure Bismark system
  - Generational social contract rather than an individual entitlement
    - These are also difficult to reform!

Lord Beveridge

Two problems for any insurance

- Covariate risk
  – Idiosyncratic shocks can be insured against locally but not covariate shocks
  – Generational shocks also matter, and can be insured against with PAYG entitlement systems if economic growth is sufficient
- Asymmetric information
  – Adverse selection
  – Moral hazard

Adverse Selection (1)

- "If you like your current [insurance] plan, you will be able to keep it. Let me repeat that: If you like your plan, you'll be able to keep it."

Remarks made in the Rose Garden,
White House,
July 21, 2009

Adverse selection (2)

- To get everyone into the risk pooling group requires some compulsion
- Without compulsion, if only the bad risks buy insurance the market eventually fails
- Work-related contributory schemes face the same problem
  - If payroll tax is high enough it distorts choices of where to work (covered versus uncovered), or to work at all
  - general taxation already deals well with compulsion

Moral hazard

- Offsetting behaviour
  - (Partially) insulate people from risk and they take on inappropriate levels of risk
    - E.g. drive more recklessly when wearing a seatbelt
- Contributors should face consequences and make more efficient decisions as a result
  - Yet likely to get bailed out if don’t

  ➔ If losses have to be socialized, why not go all the way and get scale advantages

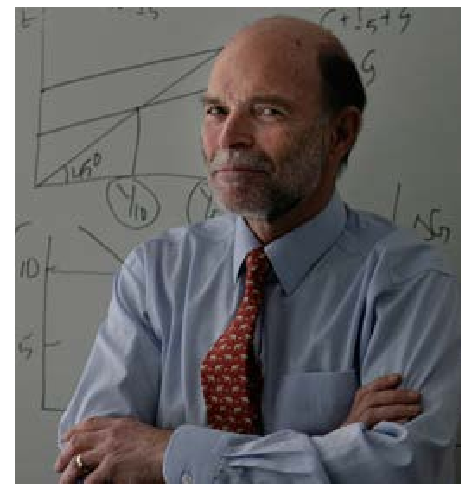
The “Tullock Spike” courtesy of Offsetting Behaviour Blog

Contributions and the Earmark

- Earmarked tax revenue has to be allocated for particular fiscal outlays
  - Reduces flexibility compared with general fund financing and is generally not favoured
  - Demand for the public service may be moderated and tax morale increases because of clear link between payment and outcome
    - As soon as free-riding is possible from large group size this can break down
- Managing demand for social welfare is a political issue

Funded, or Pay-as-you-go?

- Pension relies on exchanging current production when younger for a claim on future production when older
- Unless funding raises future production, funded vs PAYG debate is a diversion
- Promises have to be exchanged for a call on future labour (taxes)
- Financial assets have to be exchanged for goods
  - Terms of the exchange depend on the productivity of the next generation of workers



Nicholas Barr,
London School of Economics

Rent-seeking

- Who controls the pool of contributions to the social insurance scheme?
- Large pools of money attract rent-seekers
  - 'ethical' investment by the NZ Superannuation Fund
  - Push to invest locally but logically should invest almost all overseas
- Competing for recurrent taxes may be more contestable

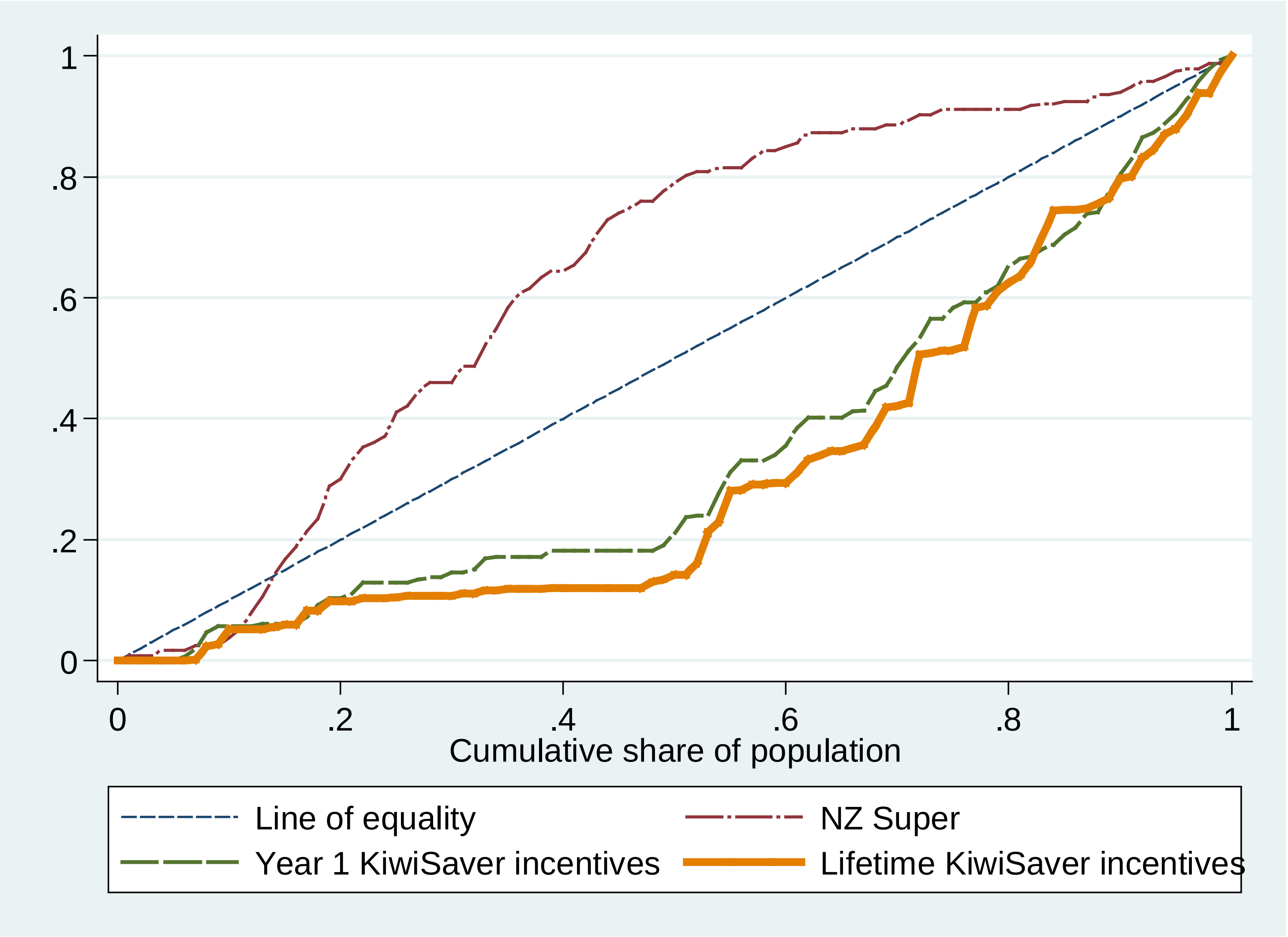
"Three groups spend other people's money: children, thieves, politicians. All three need supervision"

Dick Armey,
former House
Majority Leader

Inequality

- Contributory social insurance increases lifetime inequality
  - Shocks in the earnings phase ripple into the decumulation phase
  - Gender biases exacerbated
  - Contrasts with NZ Super and other social citizenship benefits which reduce lifetime inequality and gender bias
    - Gender-equal payments despite unequal lifetime earnings
- Attention biases and other behavioural quirks
  - Individual accounts are rarely optimally weighted for risk and reward

Inequality-reducing & inequality-raising welfare



Conclusions

- Contributory social insurance reduces flexibility
  - Reduces the pooling of risk
  - Limits possibility desirable redistribution
  - 2nd best (or worse) solution to excess demand for welfare ➔ economic solution to political problem
- increases lifetime inequality
  - Shocks in the earnings phase ripple into the decumulation phase
  - Gender biases get exacerbated