The Government Versus the Market in Protecting Against Economic Misfortune

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> [T]he interpretation of the fundamental principle of liberalism as absence of state activity rather than as a policy which deliberately adopts competition, the market, and prices as its ordering principle and uses the legal framework enforced by the state in order to make competition as effective and beneficial as possible- and to supplement it where, and only where, it cannot be made effective- is as much responsible for the decline of competition as the active support which governments have given directly and indirectly to the growth of monopoly.
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> Hayek, Address at Mont Pelerin, April 1947[1].

Perhaps the greatest reason leading many to reject the market in favor of the government as the most fundamental institution of social ordering is the concern that the marketplace alone can never deal adequately with the inevitable consequences of misfortune, whether in the form of poverty, ill-health, or the effects of old age. Today, virtually everyone endorses the market over the government as a source of greater economic productivity. Many endorse the market over the government on grounds of empowering greater liberty and individualism. Few, however,[2] would deny that there exists an important role for government to implement humanitarian elements of social policy: to help those worst off in society from the deprivation that would otherwise succeed the multiple potential forms of economic misfortune.

In the modern era, the most salient conception of this role is to regard the government as an insurer or, more specifically, as the residual insurer in contexts where citizens have suffered losses that remain uncovered by the market or by market-based insurance. In the United States, the role of the government as an insurer was the central unifying idea of the New Deal which, shortly after the onset of the Great Depression, enacted the Federal Emergency Relief Act, the Emergency Farm Mortgage Act, and the Social Security Act, among other insurance-like relief programs. Some years later, in Lyndon Johnson's (not Hayek's) Great Society, the insurance role of government was extended to provide basic health insurance for the poor (Medicaid) as well as for the elderly (Medicare). Of course, the insurance role for government lies behind the even more extensive economic support provisions of the various European welfare states. Although many government insurance programs in both

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Europe and the United States have been trimmed back in recent years in order to reduce budget deficits, the basic superstructure of these insurance programs remains intact; the role of the government as an insurer remains today largely unchallenged.[3]

Indeed, the idea of the government's role as an insurer extends beyond practical social policy. The conception of the state as an insurer or risk spreader is the basis of the most influential statement of moral philosophy of our century: John Rawls' *A Theory of Justice.* Rawls' philosophical and social judgement proceed from the evocative metaphor of the "veil of ignorance" behind which none of us as citizens can know what our abilities or endowments will be or what misfortunes in life we might face. According to this analysis we should define our public institutions as if all future differences among individual citizens and among personal experiences are risks. The role of the government, according to this conception, is to minimize the losses from those risks for each member of the citizenry. Some have criticized Rawls' assumption of extreme risk aversion, but his approach has a very simple insurance basis: to equalize marginal returns over potential sates of the world. Rawls' basic theory, thus, is to define justice as achieved through the broad provision of social insurance.

The acceptance of the role of the government as an insurer stands today as the most significant challenge to the primacy of the market. Hayek recognized the "concern with the unfortunate ones in society" as giving rise to the conception of social justice, a conception which Hayek so eloquently opposed.[4] Indeed, *The Mirage of Social Justice*, the second volume of his great book *Law, Legislation and Liberty* represents Hayek's attempt to convince readers that random sources of economic misfortune are natural, and do not constitute some failing of a just world. Thus, Hayek argued that, in order to capture the virtues of the marketplace in terms both of productivity and liberty, citizens must simply accept the proposition that economic outcomes in life-whether success or failure-occur totally by chance, and are not related to merit or justice that would justify some subsequent societal correction. Yet, despite these views, even Hayek acknowledged a role for the government as an insurer. Hayek wrote;

> There is no reason why in a free society government should not assure to all protection against severe deprivation in the form of an assured minimum income, or a floor below which nobody need to descend. To enter into such an insurance against extreme misfortune may well be in the interest of all; or it may be felt to be a clear moral duty of all to assist, within the organized community, those who cannot help themselves.[5]

This essay seeks to take this insurance conception seriously and to attempt to understand the relative merits of the market to the government in the provision of insurance against economic misfortune. Modern economics scholarship has taught us a great deal about the operation of private insurance markets. We know less about the operation of government insurance systems; in fact, the lessons of the market insurance literature have been seldom applied to government insurance contexts. In the spirit of Hayek's original charge to this Society- in the quotation preceding this essay- to promote liberalism as a policy adopting competition, markets and prices as fundamental, this essay seeks to examine what the differences between market and government insurance actually are.

There is a second reason that the question of the government's role as an insurer is important. The humanitarian impulse to provide for those worst off runs deep in all societies. It is not clearly an appropriate moral response to simply reject this humanitarian ideal or to do no more than emphasize how its implementation has generated many government actions that one can regard as undesirable.[6] Providing support for the worst off is a feeling so broadly endorsed, over periods of such extensive vintage, and with such great depth as to suggest that it is an important and lasting human impulse which, to

those who respect individualism, is not appropriately disregarded. It is incumbent upon those who believe in the virtues of the market over government to explain with some care the appropriate role of the market in responding to this important humanitarian value.

Finally, this essay seeks to advance our understanding of the market versus the government or politics as alternative organizing mechanisms of societal life.[7] As Professor Buchanan has emphasized, politics and the market can regarded as alternative means of aggregating the preferences or demands of the citizenry with respect to societal resources. The "government" and the actions that it takes to control economic activity represent only the result, the expression, of some aggregation of citizens' preferences effected according to the rules and procedures of a society's political organization.[8] Similarly, the market is a mechanism for aggregating citizens' demands which, in contrast to politics, operates through the interactions of individual citizens by means of trade or exchange. While many members of this Society (including myself) advocate the general superiority of decisions made through the mechanism of the market as opposed to the mechanism of government,[9] it is important to understand what the basis is for the differences in the outcomes of these alternative allocative mechanisms. Comparing government-provided to market-provided insurance is a means of extending that inquiry.

Part I explains (quite conventionally) how the market for private insurance operates. Part II compares how government insurance is different both in concept and through a review of government-provided or- regulated insurance programs in a variety of contexts. Part III describes the normative significance of these differences.

I. How Market Insurance Operates

Why is the government regarded as particularly effective in providing insurance? The central basis of the conception is quite simple: Many view the fundamental objective of insurance as to spread risks. To take a straightforward statement of the point, a loss ruinous to a single individual is less ruinous if spread over a larger set of individuals and, if spread broadly enough, can become minuscule.[10] The government can act as an effective insurer because the government is the largest social entity and so appears in a position to spread risks most broadly. The government, unlike any specific group of citizens, maintains a continuous existence over time, and so can spread losses not only within one generation, but over multiple generations, reducing the incidence of any loss to a small fraction. Because of its scope and inclusiveness, the government comprises a wide range of disparate activities- indeed, the widest range of disparate activities- son that it can achieve maximum diversification by pooling disparate risks, such as the risks of unemployment with the risks of floods with the risks of industrial disability, and so on.

While this basic advantage of government -to market- provided insurance appears uncontroversial, closer analysis raises some questions. At the outset, it is important to larger set of the population, and reducing risk, which is reducing the magnitude of losses that occur. Risk spreading or shifting is different than risk reduction. As I shall explain, the most important function of insurance is to reduce risks, not merely to spread or shift them. The examples below are all drawn from market insurance contexts; the points will be extended to government insurance contexts in Part II.

There are three principal features of insurance that reduce risks.[11] The first is the aggregation of uncorrelated or statistically independent risks. This is a statistical point, but an important one. The aggregation of statistically independent risks *reduces* the risk level by causing error terms to cancel out, reducing the cumulative magnitude of loss and, therefore, increasing predictive accuracy. What this means is that, if an insurer carefully aggregates risks that are truly statistically independent, then it will need to

keep a lower – indeed, far lower of reserves for expected losses than if each person were individually to reserve for the same risks.

The second way insurance reduces risk is by segregating high-risk from low-risk insureds into separate risk pools, charging them premiums appropriate for only the risk that they bring to the pool. Segregation has a similar statistical effect: it reduces the variance of loss and, thus, increases predictive accuracy. But, in addition, by charging premiums that most closely approximate the risk level brought to the pool, segregation affects the underlying activity of insureds as to whether and how much to engage in the risky activity. As a commonplace example, charging higher auto premiums to 16- to 25-year old males (or their parents) and then rapidly increasing those premiums if a driver commits a traffic violation or causes an accident serves as a market rationing device for teenage male driving in general and for high-risk driving in particular. Put more simply, it reduces the accident rate.[12] Segregating the high-risk from the low-risk also increases insurance availability. For example, segregating pilots of general aircraft or, more prosaically, smokers into separate life insurance pools reduces the life insurance premiums that those not pilots or smokers have to pay, and so increases their ability to buy life insurance protection.

The third way that insurance reduces risk is by controlling moral hazard which is the tendency of persons who have insurance to subsequently increase the level of risk-causing activity. Market insurance controls moral hazard through the introduction of deductibles, coinsurance, and exclusions of coverage in insurance contracts. For example, all life insurance policies exclude coverage of death by suicide. Hospitalization coverage that requires the patient to pay 20 percent of costs encourages patients to stay in bed only if they are really sick. Many universities provide their faculties accident coverage when attending a conference, but exclude coverage if a faculty member uses the trip to go mountain climbing or caving. In market insurance, deductibles, coinsurance and exclusions of coverage are omnipresent, and they reduce risk either by leading the insured to avoid or to reduce the level of risky behavior or they expand insurance availability by reducing insurance premiums for the rest by requiring the high-risk to pay some proportionate amount of the loss.

II. The Government versus the Market as a Risk Reduction Mechanism

These three ways in which insurance reduces the losses from risk-related activities are quite familiar-there is nothing whatsoever controversial in what has been presented. How effective is the government or is government-provided insurance in reducing risk in these ways?

1. The government versus the market with respect to risk aggregation

Perhaps the strongest intuitive case for government-provided insurance derives from the risk aggregation function. It seems plausible that the government, as the broadest and most inclusive social entity, would be far superior to any private insurer in its capacity to aggregate risks and spread them. Indeed, it is this intuition, I believe, that provides the strongest support for the government as insurer idea.

There is some reason at the outset, however, to be suspicious of this claim from what we see in the structure of private insurance markets. That is, the government's purported advantage in achieving economies of scope in risk spreading, one would think, would also be operative in the private sector. In fact, private insurance markets are extremely fragmented. As a quick illustration, the market share of the largest carrier in the U.S. property/casualty industry is only 12.6 percent.[13]

Indeed, if one gives a little thought to the subject, an aggregation advantage to government insurance is not obvious at all. As the most basic statistical awareness makes clear, within any distribution, risk terms can be canceled out by the aggregation of relatively small numbers, as long as the risks are inde-

pendent and uncorrelated. The most obvious example is modern polling. Polling organizations, such as the Gallup or Roper polls, can estimate with great accuracy the voting behavior of 80 million U.S. voters or the consumption behavior of 200 million U.S. consumers from a sample of very small numbers, typically 1,000 or 1,200 persons.

Similarly, the advantage possessed by the government in terms of the scope of activities it comprises is not clear. Error terms are canceled out and predictive ability is enhanced -which is to say the risk level is reduced- by aggregating *independent* risks, not by aggregating highly variant risks. The idea that diversification can be achieved by lumping together highly variant risks-disability risks, flood risks, unemployment risks- is misleading. To reduce the risk level by achieving predictive accuracy requires very careful risk sorting and evaluation and ultimately specialization. This is why market insurance firms that are small can spread risks very effectively. There is no advantage to government insurance from the broad scope of activities that it can incorporate.

Indeed, the ability of the government to reduce risks through aggregation is problematic in its essence. The government, by definition, must be inclusive in the insurance coverage it offers. That is, where the government provides insurance, it must typically make it available to all citizens desiring coverage. A compulsion of inclusiveness, thus, requires offering coverage to highly correlated risks, not statistically independent risks. The government's obligation as government, therefore, *diminishes* its ability to reduce risks through aggregation.

2. The government versus the market with respect to risk segregation

The second risk-reducing function of insurance is the control of adverse selection by segregating high-risk from low-risk insureds and charging risk-appropriate premiums in order to reduce the level of risky behavior and increase insurance availability by reducing the premium level. Private insurers reduce risk toward this end by competing to define underwriting classes that are particularly appropriate to low-risk individuals, thus segregating higher-risk individuals into separate insurance classes with appropriately higher premiums. At the extreme, if adverse selection cannot be adequately controlled, insurers will exclude market coverage entirely, which is to say, they will segregate out the very high-risk into classes of the self-insured, compelling these individuals personally to bear the burden of (or to mitigate) their high-risk activities.

How effective is government-provided insurance in reducing losses and increasing insurance availability through risk-segregation? Government insurance typically engages in no efforts to control adverse selection through risk pool segregation. Uniformly, discrimination in government insurance premiums is suppressed and, most often, eliminated entirely. Where insurance is offered without discrimination to all parties at some average premium, adverse selection necessarily follows. First where the government insurance plan is self-supporting, some number of low-risk parties necessarily will find the insurance not worth the premium. Few government plans, however, are fully self-supporting. Adverse selection still occurs, but through the effect of a budget constraint imposed on the insurance plan. Because there is little government effort to control adverse selection, government insurance plans typically face severer budgetary problems. The most typical government response to a budget constraint, however, is not to increase the level of discrimination in order to expand insurance availability, but rather to lower the average level of benefits, reducing the attractiveness of insurance and reducing the extent to which the insurance serves to protect insureds.

3. The government versus the market with respect to the control of moral hazard

Finally, the third risk-reducing function of insurance is to control moral hazard through deductibles, coinsurance, and exclusions of coverage. How effective is government-provided insurance toward this end? The government as an insurer seldom makes efforts

of this nature to control moral hazard. Though some government insurance plans incorporate small deductibles and limited amounts of coinsurance, the extent to which these contractual methods are relied upon to reduce risk is vastly less than in the private sector. As a consequence, virtually every study of government insurance activities shows moral hazard problems to be severe.

4. Why is the government ineffective at risk reduction?

This brief review suggests that, in terms of each of the three risk-reducing functions of insurance -aggregation, risk segregation, and the control of moral hazard-government-provided insurance is *less* effective, not more effective, than market insurance. Why is this so? This is not a point about privatization. The point does not relate to bad management, sloppiness, or a lack of financial incentives, but is deeper. The ethic and the principles of government are antagonistic to risk reduction.

Effective risk reduction is achieved by market discipline: by differential charges according to risk level: by constraints on benefits to control moral hazard; and by discrimination and narrow risk pool definition to control adverse selection. Private insurers are rewarded in the marketplace according to their ability to reduce societal risks in these ways.

In contrast, the government, for reasons intrinsic to its operation, is unable to engage in any of these forms of market discipline, I shall discuss the sources of the differences in operation as between government -and market- insurance in greater detail below. As an initial summary, however, there are many obvious differences. The size and necessary inclusiveness of government obstructs optimal risk aggregation. By definition, the state must provide benefits to all citizens, not exclusively to citizens chosen according to risk proclivities in order to create appropriate risk pools.

Similarly, the government's commitment to non-discrimination among citizens prevents control of adverse selection through risk segregation. Government, committed as it generally is to principles of equal treatment, is constrained in the extent to which it can engage in discrimination among citizens according to risk proclivity -even risk proclivity by class of citizen- to set premiums to correspond closely to the risk that the citizen brings to the insurance pool.

Finally, the political responsiveness of the state to voter interests in benefits cripples efforts to control moral hazard. Given that the typical reason that a government engages in insurance is a humanitarian response to loss, governments generally do not, once they have entered the insurance business, introduce deductibles, coinsurance or, surely, exclude coverage entirely to those activities or to those individuals most likely to suffer the loss, as a result, a government's insurance programs do little to reduce risk levels.

It is frequently claimed that the government has an insurance role because it can offer coverage in contexts in which there are incomplete insurance markets, for example the special government programs providing flood and other disaster insurance. The sources of the special government expertise here, however, are not clear. Private insurance markets are incomplete, not by chance or lack of interest, but because risks are essentially uninsurable where moral hazard and adverse selection cannot be controlled. In these contexts, no insurance market can survive. The government cannot influence the innate survivability of an insurance pool. Indeed, because the government is less able to control moral hazard and adverse selection through mechanisms such as risk segregation, deductibles and coinsurance, the government is less able than the private market to make risks such as these truly insurable.

These points are not simply analytical. When one reviews the empirical literature on the effects of government-provided insurance, the findings support these conclusions unanimously. I shall first review examples of government insurance of financial losses; next of casualty losses; and, then, of social

welfare insurance programs that are the more specific topic of this session:

A. Financial insurance contexts:

1. Deposit insurance. Prominent recently in the United States has been government- provided insurance for savings and loan deposits, initiated under the New Deal, but expanded significantly in the early 1980s. In the first 50 years of operation, the government charged what were, in essence, uniform deposit insurance premiums, regardless of risk. As long as levels of insurance coverage remained modest (the coverage level for an individual account was limited to $20,000 and later $40,000), there was limited exposure to loss. In the early 1980s. however, coverage was extended to $100,000 Per account, creating incentives for savings and loans to dramatically shift investment risks to the government insurer.[14] leading to what has been called the "S L Debacle", costing American taxpayers hundreds of millions to bail out failed banks. Following this experience, the U.S. government in the 1990s imposed risk-related premiums and increased the level of direct risk regulation,[15] though recent studies have confirmed that the new regulation/premium regime has been inadequate, allowing high-risk, undercapitalized banks to continue to shift investment risks to the government.[16]

2. Insurance guaranty funds. Closely related are insurance guaranty funds which have been established in every U.S. state for the purpose of insuring the solvency of companies providing insurance within the state, these government-mandated and designed guaranty funds are generally defined to provide coverage according to each individual line of insurance, from life insurance to property/casualty. First, it is clearly established for those guaranty funds in which costs of insolvency are chiefly borne by taxpayers, for example in the case of various state life insurance guaranty funds, that insurers hold investment portfolios of substantially higher risk levels leading, as a consequence, to a greater frequency of insolvency.[17] In other guaranty fund contexts, risks are borne, not by taxpayers directly, but by the remaining set of solvent insurers. Here, too, however, the design of the insurance program by the state government fails to adequately control moral hazard and adverse selection which pervade all aspects of insurance operations. It has been shown, for example, that the riskiness of insurers' asset portfolios significantly increase upon the creation of such funds[18] and, more precisely, that as those insurers posing the highest-risk approach insolvency, their premium growth dramatically increases, multiplying default risks and ultimate insolvency losses.[19]

B. Casualty insurance contexts:

The examples above of government insurance of financial institutions might be thought distinguishable because moral hazard and adverse selection problems can be expected to be severe where the sources of the risks to be insured -loan investments, asset portfolios- are so distinctively within control of the insurers themselves.[20] There have been similar experiences, however, in other contexts of government-provided insurance, even where the source of the loss might be regarded as an Act of God.

3. Catastrophe insurance. In the U.S., the federal government provides extensive insurance for losses caused by natural disasters. The U.S. government offers direct insurance to businesses and homeowners for losses from floods as well as insurance to various groups of farmers for crop losses as a consequence of bad weather. In other contexts, state or federal governments mandate the provision of natural disaster coverage by private insurers, such as the State of California's mandate of earthquake coverage in homeowners' insurance policies.

The problems attending these government-provided or -mandated insurance programs are exactly similar. Although catastrophes would appear to provide the most appropriate role for the government as an insurer, the government is systemically disabled from reducing risk in the context of natural disasters. As explained above, insu-

rers, reduce risk by aggregating independent and uncorrelated risks. Where a government provides insurance, however, it must provide it inclusively; it must make it available to all citizens who desire coverage. In the context of natural catastrophes, the compulsion of inclusiveness *diminishes* risk reduction through aggregation. An event is labeled a catastrophe where there is a highly correlated incidence of loss among the population. Providing coverage of highly correlated losses is exactly the opposite of the risk reducing function of aggregation.

The provision of government insurance for losses from natural disasters is also antagonistic to the control of moral hazard and adverse selection. Government flood insurance, for example, increases building on flood plains and, thus, increases losses from flooding. The government mandate of earthquake insurance increases building on fault lines and, thus, increases losses from earthquakes. Government disaster insurance for specific crops increases crop losses.[21] For example, studies show that, since the introduction of federal disaster aid for turnip green crops in the late 1980s 45 percent of insurance loss payouts have been distributed to farmers in counties, none of which had reported any acreage of turnip green planting prior to the enactment of the disaster program.[22]

Perhaps these various examples are peculiar because they deal chiefly with economic losses for which moral hazard problems might be more severe. There are, again, similar experiences with respect to government-provision or regulation of insurance for personal injury loss.

4. Insurance for employment-related injuries. State-provided or regulated workers' compensation insurance typically imposes substantial constraints on the extent of experience rating (setting premiums according to the previous loss experience of the employer). It is well established that these limits increase the number of worker injuries.[23]

5. Automobile insurance. Within recent years, the Parliament in the Canadian Province of Quebec has imposed a prohibition of insurance discrimination by age, sex, violation record, and accident experience. Following the imposition of these limitations on the underwriting practices of market insurers, which had the principal effect of reducing premiums for high-risk drivers and increasing premiums for the low-risk, accident rates dramatically increased: property damage claims increased 5.3 percent; bodily injury claims, 26.7 percent; and fatal accidents, 9.6 percent.[24]

C. Unemployment and disability insurance contexts:

The previous examples, of course, are all from contexts where the provision of private market insurance has been more typical. There have been similar experiences, however, in what are more commonly social insurance contexts, such as unemployment, disability, health and old-age pensions.

6. Unemployment insurance. It has been universally found that government-provided unemployment insurance increases both the magnitude of the unemployed population and the duration of unemployment spells.[25] Indeed, the moral hazard and adverse selection effects of government-provided unemployment insurance have been demonstrated with even greater particularity. An interesting recent study, for example, shows a dramatic increase in the likelihood of becoming unemployed in the specific week during which the worker qualifies for benefits.[26] Higher levels of unemployment insurance benefits have been shown to decrease the level of spousal earnings.[27] To the same point, though conversely, other studies show that the likelihood of re-employment significantly increases as unemployment insurance benefits are exhausted.[28]

7. Disability insurance. The U.S. Social Security Disability Insurance Program provides income maintenance for workers adjudged to be "disabled."[29] In the U.S. today, there are over 5 million beneficiaries who, in

aggregate, receive annual benefits of almost $40 billion.[30] Once again, moral hazard problems in this insurance program are severe. Studies show repeatedly that the existence and structure of the program increase claims of disability, especially among older workers.[31] And the magnitude of the effect is substantial. A recent study of a similar Canadian government program demonstrates that an increase of disability benefits of 36 percent -note an increase in benefits, not a change in standards of eligibility- increased by 11.5 percent the number leaving employment to claim qualification for disability benefits.[32] A different study showed, conversely, that for each 10 percent increase in the rate of eligibility denial, the labor force participation rate increased 2.8 percent.[33]

D. Health and pension "insurance" contexts:

Although government health and pension programs in the U.S. (as elsewhere in the world) are denominated as "insurance" and are most commonly justified by the government-as-insurer idea, they are universally administered as welfare programs. Thus, there typically is little effort made to correlate the level of payouts to the level of premiums paid by beneficiaries, as would be characteristic of a true insurance program; the analog to insurance premiums are in fact taxes, often levied on individuals -even generations- different from those receiving benefits. Correspondingly, there is no effort made to correlate the premium/tax level to a participant's risk level as would be characteristic of true insurance. Of course, the extent to which deductibles, coinsurance and coverage exclusions are employed is vastly less than in market insurance programs; often, not at all. As a consequence, the distortions introduced by government health and pension programs are immense, grossly outstripping those of the other government programs described above that more closely resemble true insurance.

Given the absence of a correlation between aggregate benefit levels and premiums paid as well as between individual "premiums" and individual risk levels, and given greatly reduced deductible, coinsurance and exclusion features, it is not surprising that citizens, upon attaining eligibility for these programs, switch from private insurance to government benefits, a phenomenon repeatedly demonstrated in the "crowding out" literature.[34] These substantial differences from market insurance, however, prove *that* any level of crowding out represents an increase in aggregate risk and a corresponding welfare loss.

8. Health programs. In the U.S., the principal government-provided health programs are Medicaid, providing coverage to the poor, and Medicare, providing coverage to all retired persons over age 65. Medicaid has been shown to extend health care coverage to some individuals who would not otherwise possess coverage.[35] Many studies, however, have shown substantial crowding out effects. For example, the substantial expansion of Medicaid eligibility between 1987 and 1992 increased the number of children receiving government coverage by 1.5 millon, but led to a decline of 700,000 in the number covered by market insurance. For women of childbearing age, the crowding out effect was more dramatic. The increase in those covered by Medicaid equalled 800,000; the decline in those covered by market insurance was exactly the same, resulting, therefore, in a 100 percent crowding out effect.[36] This increase in Medicaid eligibility generated many other related effects. It is estimated, for example for 1993, that the availability of Medicaid benefits generated a reduction of total wealth holdings by eligible participants of 17.7 percent.[37]

The crowding out effects of Medicare are similar. Indeed, because Medicare is a universal health benefit program for all citizens over age 65 (costing the U.S. $200 billion in 1996),[38] the crowding out effects are, if anything, more extensive. *Every* person age 65 and over who had previously purchased basic health insurance from a market carrier is crowded out. Even ignoring the market in-

surance comparison, Medicare has been shown to be unattractive as a tax system. It is well established, for example, that because relatively higher income participants make more intensive use of both physician and ambulatory services and have significantly longer survival rates, there is a substantial redistributional transfer from the low-income to the high-income through the provision of Medicare benefits.[39]

9. Pension programs. Although Social Security was promoted in the U.S. as a form of insurance for old age,[40] it is peculiar to regard old-age as a probabilistic occurrence, a risk. For its principal participants, Social Security is a substitute for personal savings.[41] Social Security in the U.S., like retirement pension programs around the world, is financed on a pay-as-you-go basis,[42] which is to say, in a method that compels discontinuity between those paying "premiums" and those receiving benefits.

Social Security, along with Medicare and private pensions, has been shown to be the source of the dramatic decline in aggregate national savings in the U.S. and to have significantly increased incentives for retirement.[43] Although these various effects are attributed to the combination of government-provided Social Security and Medicare and privately-provided pension benefits, the implications of government-versus private-provision as a source of the effects are substantial. Private pensions represent individual savings for retirement, and so are determined by individually rational choices over a lifetime as to the length and extent of employment and as between current and future (post-retirement) consumption. Government-provided Social Security and Medicare, in contrast, represent benefits which at the time of receipt are in essence paid for by someone else. As a consequence, the effects of Social Security and Medicare on reduced savings and early retirement do not clearly correspond to individually rational savings and retirement decisions.[44] The incentives created by the definition of Social Security benefits are perverse in an additional way. Unlike private pensions, Social Security imposes a heavy tax on any post-retirement earnings through a mandated reduction in benefits. This tax has been shown to significantly reduce incentives for employment of any kind after basic retirement,[45] again, quite unlike incentives created by private market pensions.

III. Normative Implications of Government-versus Market-Provision of Insurance

The previous Part has demonstrated that in terms of each of the risk-reducing features of insurance -risk aggregation, risk segregation, and the control of moral hazard and adverse selection- government insurance is less effective -indeed, in many cases, dramatically less effective- than market insurance. There are several important normative implications of this conclusion.

First, in terms of providing protection against life's misfortunes, insurance provided through the market is superior to insurance provided by government. In terms of the range of individuals to whom coverage can be provided, the level of benefits, and the costs of insurance, market insurance is more effective than government insurance. This means that accepting -not challenging- the humanitarian goal of providing protection to citizens against losses that they might suffer in the future, market insurance can achieve that goal more effectively than government insurance.

This conclusion, thus, challenges squarely the most fundamental modern justification for government activity: to ensure the economic welfare of its citizens. The analysis and the various examples above demonstrate that the market, not the government, is the more effective instrument for ensuring the economic welfare of a citizenry. This point is substantially different from most criticisms of government, even by liberals. This is not a point about the extent to which political outcomes or the values expressed through a democratic process are inimical to individual freedom. Instead, embracing the humani-

tarian goal of ensuring economic welfare, the analysis shows that the market is the more effective mechanism for achieving this goal than the government.

There is a related normative implication that follows from the focus on insurance as risk-reducing, rather than as merely risk-spreading. No loss is ever fully compensable. This point is obvious with regard to personal injury loss, but it is true of every loss since, given a limited life span and limited life opportunities, every loss is a loss of an alternative opportunity. This point, however, provides an independent normative difference between government-and market-provided insurance, government insurance provision can be viewed as inflicting incommensurable loss on the society and on its citizenry. Citizens can debate issues of redistribution. Indeed, often the support for government insurance proceeds as if the only issue is one of redistributin wealth to those who have suffered loss from those who have escaped it. Preferences for redistribution of this nature cannot be morally defended, however, where the redistributional institution that has been selected *increases* the frequency and magnitude of loss to the society. This subject of the government's role in serving as an insurer of societal losses has been dominated by an admirable humanitarian impulse. But humanitarian actions that increase the frequency and magnitude of incommensurable losses cannot be morally defended.

A third normative implication of the comparative effect of government versus market insurance relates to a conception of how government can advance society. Here, I want to address insurance finance as between market insurers and the government. How do market insurers finance their activities? They charge premiums according to the best estimate of the risk level that the insured brings to the pool, and then they invest these premiums to create the largest possible fund from which to pay off subsequent losses. How does the finance of government insurance compare? First, as described earlier, in all government insurance contexts there is a very loose relationship between premium levels and risk levels. Indeed, often, there is no relationship: losses are charged against general tax revenues. The provision of "coverage" of this nature does not reduce risk, but only shifts risk to taxpayers. Many commentators treat the government as risk neutral or comparatively risk neutral. But the risks to taxpayers associated with tax increases are not zero.[46]

Assumptions about risk preference, however, ignore the more important comparison. Government provision of insurance systematically redistributes wealth toward relatively risky activities. As a consequence, the contrasting financial effects of government versus private provision of insurance are profound. Progressive income taxation is designed to most heavily tax those most productive individuals, corporations, and enterprises in the society. Under the progressive income tax, the burden of taxation falls most heavily on the greatest income-producing activities of the society. In contrast, private insurance, through premiums, taxes, the riskiest activities of the society -and so reduces the risk level -and then invests these premiums in the most productive activities to reduce the effective cost of these risks even further. Thus, government insurance organizes taxes and investment exactly backwards private insurance taxes the most risky activities and invests the amounts most productively while government insurance taxes the most productive activities to redistribute to the most risky.

Of course, the principal motivation of many who promote government provision of insurance is the empirical proposition that, at least over some period of time, the market appears not to have provided universal insurance against all of life's misfortunes. There are many sources of loss against which some individuals will lack market insurance. For example, very common today is the claim that 40 million U.S. citizens lack insurance for health care, just as there are individuals who will fail to save for old age, or who suf-

fer poverty and need some form of income maintenance.

These empirical claims cannot be accepted as indicating failings of market insurance, however, without substantial further study. First, as is obvious, the existence of government insurance will affect the demand for market insurance. With respect to the allegation of 40 million uninsured for health care in the U.S., as described earlier, the U.S. government provides residual health care benefits for the poor through the Medicaid program. Where residual benefits are provided based upon a defined income level, individuals to some degree above the level or who anticipate the possibility of falling to the level should illness or injury strike, do not clearly benefit from the purchase of market insurance.[47] Such individuals, however, are uninsured only formally: They are uninsured until they need health care at which time they qualify for government assistance and become "insured."[48] In any society in which the government provides assistance directly or guarantees that individuals can retain some level of assets regardless of their debt level (bankruptcy protection), there will always be members of the population who will be better off uninsured.

With respect to old age, much of the justification for the adoption of Social Security in the U.S. in the 1930s derived from the observation of the limited extent of private pension accumulation at the time. The absence of private pension accumulation for many in the 1930s, however, is not the equivalent of an absence of protection against insufficient retirement savings. There are a vast range of institutions (as there would be in the absence of Social Security) to deal with the income needs of the elderly, including families, fraternal organizations, and welfare general assistance, among others. There has occurred a tremendous increase in the wealth of the society and in private pension accumulation since the 1930s, despite the existence of Social Security, as there has been a shift away from reliance on other income maintenance institutions -such as the family- perhaps because of Social Security's existence. Many predict that pension accumulation would be even greater if Social Security were privatized, at least upon the Chilean model, if not more extensively.[49]

Finally, as quoted earlier, even Hayek believed it necessary that governments provide some form of general income maintenance as insurance against poverty.[50] In evaluating this recommendation, however, it should be noted that we have yet to observe a modern society that has eliminated all obstacles preventing individuals from lifting themselves from poverty, in particular, obstacles such as the minimum wage,[51] various occupational health and safety requirements, environmental requirements, and the like, all of which increase the basic costs of labor above the productivity levels of the poorest of our society.

IV. Conclusion : The General Moral Superiority of the Market

All citizens of the world must acknowledge today that the socialist ideal has failed and that capitalism is inevitable. Yet, the ideological battle over socialism- in which this Society has played such an important role- has not truly ended. It has only shifted to what might be called socialism in the small: debate over the details of government programs purportedly responsive to some societal ideal. This essay accepts that battle and proposes to show that the organizing principles which Hayek emphasized now over 50 years ago -"competition, the market and prices"- are more effective than government or politics toward achieving the most basic and fundamental goal endorsed by all societies: protecting against economic misfortune.

Curiously, it is a common view that politics and governmental activities are informed by much greater ethical constraints and much greater idealism than are markets. Surely, the reverse is true. As Professor Buchanan has emphasized, through the rules of contracts, property law, the criminal justice system prohibiting theft and fraud, along with some additional statutes, such as the antitrust laws

preventing contracts harming third parties, our legal system constrains market operations to only allow market exchanges where society in the aggregate and citizens individually benefit from the exchange.[52] In non-exchange interactions, tort law constrains individual behavior so to benefit the society in the aggregate, though some individuals will inescapably suffer loss. Political decisions are not constrained in the same way. There is some influence toward the general good by limitations on governmental discrimination among citizens (however incomplete), though those limits are harmful in the context of insurance. In other respects, however, there are few bounds on governmental operations, allowing governments to respond to particular sets of constituents with particularly focused demands (such as victims of natural disasters) without regard to the broader and longer term impact of such policies on the populace as a whole.

The ethical superiority of the market to politics is insufficiently emphasized. The point, however, is proven by the comparison of market-to government-provided insurance. The government's provision of insurance cannot withstand moral scrutiny. This conclusion should inspire much greater questioning of political behavior in all of its forms.

NOTES

1. Reprinted as "'Free' Enterprise and Competitive Order" in *Individualism and Economic Order* at 107, 110.

2. Perhaps with the exception of members of this Society. Though, see the views of Hayek, *infra,* text at n.5 & n.5.

3. There is a growing literature documenting what is called the "crowding out" phenomenon of government insurance in which government insurance provision displaces private provision. *See, e.g.,* Robert T. Jensen, Public Transfers, Private Transfers and the 'Crowding Out' Hypothesis: Theory and Evidence from South Africa (mimeo, 1996). The focus of this literature, however, is largely to demonstrate the rationality of citizens as economic actors, shifting away from private coverage when government coverage becomes available.

4. Hayek, *The Mirage of Social Justice* at 79.

5. *Mirage of Social Justice* at 87. Similarly, in his address at this Society's first meeting, following the passage preceding this essay, above, endorsing competition, the market, and prices as the central ordering mechanism, Hayek stated: "we must take it for granted that some sorf of provision will be made for the unemployed and the unemployable poor." Individualism and *Economic Order* at 112.

6. *See,* for example, Hayek's *Mirage of Social Justice* and *The Fatal Conceit.* Note even Hayek's ambivalence as reflected in his acknowledgement that some form of income maintenance is appropriate. Text at n.5. *supra.* To my knowledge, Hayek never explained in detail how to reconcile some level of government provision of income maintenance with the broader endorsement of limitations on government activities.

7. For an early and important discussion of this point, *see* Gary S. Becker. Competition and Democracy, 1 *J. Law & Econ.* 105 (1958). Of course, this approach has been extensively developed by Professor Buchanan. *See infra.*

8. James M. Buchanan, *Liberty, Market and State, e.g.* at 22, 79, 86-91 (1985).

9. For an earlier, and somewhat more extensive, discussion of this point, *see* G. L., Priest, The Ambiguous Moral Foundations of the Underground Economy, 103 *Yale L. J.* 2259 (1994) and *see, infra,* Part IV.

10. *See generally.* Guido Calabresi, *The Costs of Accidents* (1970).

11. For a more complete discussion of these points, *see* Priest, The Government, the Market, and the Problem of Catastrophic Loss. 12 *J. Risk & Uncertainty* 219 (1996).

12. For an illustration, see *infra,* text at n.24

13. Best's *Aggregates and Averages Property-Casualty,* 1994 ed. (measured in terms of net premiums written).

14. S. A. Buser A. H. Chen & E. J. Kane. Federal deposit insurance, regulatory policy, and optimal bank capital. 35 *J. Finance* 51 (1981). L. S. Goodman & A. M. Santomero. Variable-rate deposit insurance: A re-examination, 10 *J. Banking & Finance* 203 (1986).

15. *See* Robert C. Merton & Zvi Bodie, Deposit insurance reform: a functional approach, 38 *Carnegie-Rochester Ser, Pub. Polic'y.* 1 (1993).

16. Armen Hovakimian & Edward J. Kane, Risk-Shifting by Federally Insured Commercial Banks, NBER Working Paper # 5711 (Aug. 1996).

17. E.Brewer. III. T. S. Mondschean & P. E. Strahan, The Role of Monitoring in Reducing the Moral Hazard Problem Associated with Government Guarantees: Evidence from the Life Insurance Industry, 64 *J. Risk & Ins.* 301 (1997).

18. S. J. Lee. D. Mayers & C. W. Smith, Jr., Guaranty funds and risk-taking: Evidence from the insurance industry, 44 *J. Fin. Econ.* 3 (1997).

19. J.G. Bohn & B. J. Hall, The Moral Hazard of Insuring the Insurers, NBER Working Paper # 5911 (Jan. 1997). There are many similar examples involving the various extensive programs of federal loan guarantees. As an illustration, venture capital small business investment companies that obtain federal loan guarantees have significantly higher rates of failure than those using private sources of funding. S. N. Mehta, "SBICs Using Federal Loan Guarantees are Likely to Underperform." *Wall Street Journal*. Aug. 30, 1996 at B&B.

20. Of course this is exactly the point: One would expect to see the insurance of financial institutions to be quite differently structured under private, rather than government, management.

21. For further analysis and examples of these points, *see generally*, Priest, *supra* n.11

22. U. S. Senate, Comm. on Agriculture, Nutrition and Forestry, Staff Rep., "Questionable Disaster Payments: $92 Million to 8 Non-Program Crops in 9 States, 1988-93." August 1994 (indicated "DRAFT 9/9").

23. J. W. Ruser, Workers' Compensation Insurance, Experience-Rating, and Occupational Injuries, 16 *Rand J. Econ* 487 (1985).

24. Rose Anne Devlin, Liability Versus No-Fault Automobile Insurance Regimes: An Analysis of Quebec's Experience, *U. Toronto Law & Econ. Programme* (1988).

25. Eric Engen & Jonathan Gruber, Unemployment Insurance and Precautionary Savings, (mimeo, M.I.T., 1995). For a more general discussion, *see* G. C. Leef, Unemployment Compensation: The Case for a Free Market Alternative, 21 *Regulation* 19 (Winter 1998).

26. M. Baker & S. A. Rea., Jr., Employment Spells and Unemployment Insurance Eligibility Requirements, 80 *Rev. Econ. & Stats.* 80 (1998). This finding suggests that the incentives created by moral hazard affect employers' decisions as to when to lay workers off. For a discussion of further studies demonstrating this effect, *See* Leef, *supra* n.25 at 25. *See also*, K. Baiker, C Goldin, L. F. Katz, A Distinctive System: Origins and Impact of U.S. Unemployment Compensation, NBER Working Paper # 5889 (Jan. 1997) (showing the adoption of higher levels of unemployment benefits (presumably because of employer lobbying) in states with increased levels of seasonal manufacturing).

27. J. Gruber & J.B. Cullen, Spousal Labor Supply as Insurance: Does Unemployment Insurance Crowd Out the Added Worker Effect?, NBER Working Paper # 5608 (June 1996).

28. K. Carling. P-A. Edin, A. Harkman & B. Holmlund, Unemployment duration, unemployment benefits, and labor market programs in Sweden, 59 *J. Pub. Econ.* 313 (1996).

29. Income replacement, of course, is not complete but is equal to roughly 42 percent of pre- "disability" earnings, though benefits are not subject to taxation.

30. J. Gruber, Disability Insurance Benefits and Labor Supply, NBER Working Paper # 5866 (Dec. 1996).

31. *E.g.*, D. Parsons. The Decline of Male Labor Force Participation, 88 *J. Polit. Econ.* 117 (1980).

32. J. Gruber, *supra* n.30.

33. J. Gruber & J.D. Kubik, Disability Insurance Rejection Rates and the Labor Supply of Older Workers, 64 *J. Pub. Econ.* 1 (1997).

34. *See. e.g.*, Jensen, *supra* n.3.

35. J. Gruber, Health Insurance for Poor Women and Children in the U.S.: Lessons from the Past Decade, NBER Working Paper # 5831 (Nov. 1996). This effect must be tempered, however, by consideration of other government policies which I shall argue, *infra*, increase the magnitude of the poor population.

36. D. Cutler & J. Gruber Does Public Insurance Crowd Out Private Insurance?, 111 *Q. J. Econ.* 391 (1996).

37. J. Gruber & A. Yelowitz, Public Health Insurance and Private Savings, NBER Working Paper # 6041 (May 1997).

38. M. McClellan & J. Skinner, The Incidence of Medicare, NBER Working Paper # 6013 (Apr. 1997).

39. *Id.*

40. For example, in Franklin Roosevelt's message to Congress on Social Security, he explained his desire to introduce legislation to further "the security of the citizen and his family through social insurance... to provide at once security against several of the great disturbing factors in life -especially ... unemployment and old age." Arthur J. Altmeyer. *The Formative Years of Social Security* at 3 (1966).

41. In the U.S., there is a small life insurance feature to Social Security in benefits provided to spouses and children though, of course, the mechanism of premium payment and the definition of benefit levels do not correspond to market life insurance.

42. J. Gruber & D. Wise, Social Security Programs and Retirement around the World, NBER Working Paper # 6134 (Aug. 1997).

43. Gruber & Wise, *id.*; P. Diamond & J. Gruber, Social Security and Retirement in the U.S., NBER Working Paper # 6097 (July 1997).

44. Because Social Security and Medicare are universal programs, it is difficult to disentangle the government- versus private- provision effects or the extent to which individual private pension accumulation decisions can offset distortions created by the government systems.

45. Diamond & Gruber, *id.*

46. *See. e.g.,* Bev Dahlby, Progressive taxation and the social marginal cost of public funds, 67 *J. Pub. Econ.* 105 (1998).

47. Of course, other individuals may anticipate dealing with health care costs through savings, family sharing, or other risk-reducing mechanisms.

48. An interesting recent study found that the extension of Medicaid eligibility requirements had no effect on the extent to which homeless adults in New York City obtained health care, since even without Medicaid "insurance," these individuals had obtained care through hospital and general assistance programs. S. Glied, C. Hoven, R. Moore & A.B. Garrett, Medicaid and Service Use among Homeless Adults, NBER Working Paper # 5834 (Nov. 1996).

49. *See. e.g.,* O. S. Mitchell & F.A. Barreto, After Chile, What? Second-Round Pension Reforms in Latin America, NBER Working Paper #6316 (Dec. 1997).

50. *See* text at n.5, *supra.*

51. For a recent study of the deleterious effects of the minimum wage on the poor population, *see* D. Neumark, M. Schweitzer & W. Wascher. The Effects of Minimum Wages on the distribution of Family Incomes: A Non- Parametric Analysis, NBER Working Paper # 6536 (Apr. 1998).

52. Buchanan, *Liberty, Market and State* at 89 (1985).

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