14.472 Public Finance II

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Fall 2022

Overview

Course Goals and Mechanics

Introductions

What is social insurance?

What are the rationales for social insurance?

What can and should gov't do?

Course Goals and Mechanics

Course Overview

- Two Broad Topics
  - Social Insurance
  - Redistribution
- Two Broad Questions (central to public fianance)
  - Rationale(s) for government intervention
  - Optimal form for that intervention
- Course Emphasizes:
  - Normatize as well as descriptive
  - Complementarities between theory and empirics
  - Complementarities across empirical methods

Course Goals

- Key public finance concepts
- Exposure to a range of empirical techniques
  - Including: RCTs, "reduced form" quasi-experimental work; sufficient statistics; "structural estimation"; calibrated life cycle models
- (Some of the) highlights of (some of the) literature
  - (Some of) what we know
  - Chime in if you think I've omitted something interesting / important!
- Help you generate research ideas
  - Will specifically try to highlight what I think are open/important areas for research

Institutional background

- Will spend minimal time on key instittutional details
  - Not an efficient use of limited class time
  - Have tried to focus course around economic issues rather than programs per se
    - In practice a given economic issue has often have been studied in the context of a particular program
    - Good strategy for students: can you apply these ideas / tools to a different program?
- A deep understanding of institutional details is essential for own research
  - You should also familiarize yourself with the basics on any topic we are discussing
  - Good sources (listed on syllabus)
    - For general orientation: Gruber textbook
    - For more details: Moffit 2016

Course mechanics

- Reading list
  - Read a small number of papers carefully
    - **Read the bolded papers before class** (next class: Einav and Finkelstein JEP 2011)
    - Read actively / critically.
    - Keep a list of research ideas that occur to you!
  - Additional listing hopefully a useful reference when a topic sparks your interest
- Strongly recommended
  - Attend public finance lunch (Mondays 12 – 1)
  - Attend applied micro seminar (Mondays 4 – 5:30)
  - Don't make attendance decisions based on whether content looks interesting, just always come.

Recitation

- Will cover some essential topics that I will assume knowledge of
  - e.g. one week will cover Rothschild-Stiglitz model (emphasizing its public finance implications)
- Will also cover (as needed / useful):
  - Review (or introduction) of techniques that I assume knowledge of in class
  - Sorting out confusions I introduce in class
- Attendence strongly advised (if time conflicts with another section we can re-optimize)

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- Final exam (closed book, 3 hours)

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- Parameters
  - Two comments on paper.
  - No more than 1 page (double spaced).
  - Due: by midnight before class they are due

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- Examples:
  - Suggestions for future research
  - Important question related to paper that paper does not address or leave unanswered
  - Alternative interpretation for paper's findings
  - Major substantive concern with analysis (ideally with suggestions for investigating / addressing)

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- What is the objective?
  - Ensure you read paper carefully so we can have a more informed discussion in class
  - Get you to think actively, critically, and **constructively** about research

"Big picture" comments II

- What is the objective?
  - Ensure you read paper carefully so we can have a more informed discussion in class
  - Get you to think actively, critically, and **constructively** about research
- If you have specific / narrow questions / concerns about paper please write them down and bring them up in class when we discuss the paper
- First comment due 9/14: Einav, Finkelstein and Cullen 2010

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Introductions

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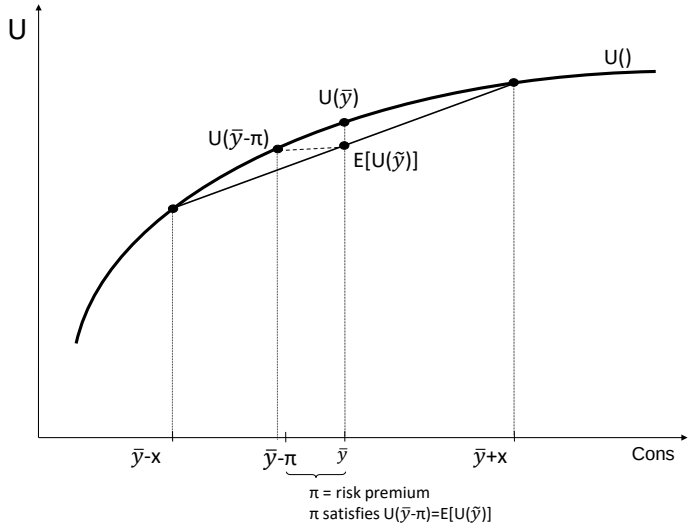
- Index card
  - Name
  - For credit vs auditor
  - Year in econ PhD program (or otherwise status)
  - Econ PhD courses taken to date
  - (Tentative) major fields

What is social insurance?

What is insurance?

- Insurance transfers resources from states of the world with low marginal utility of consumption to those with high MU of consumption
  - Goal: equate (smooth) marginal utility of consumption across states of the world
  - States of world: e.g. sick vs. healthy; car accident vs. not
- Key point: risk averse individual prefers to pay $10 for sure than face a one in ten thousand risk of having to pay $100,000
  - By pooling idiosyncratic risk, can make everyone better off

Insurance: A Free Lunch!



What is Social Insurance?

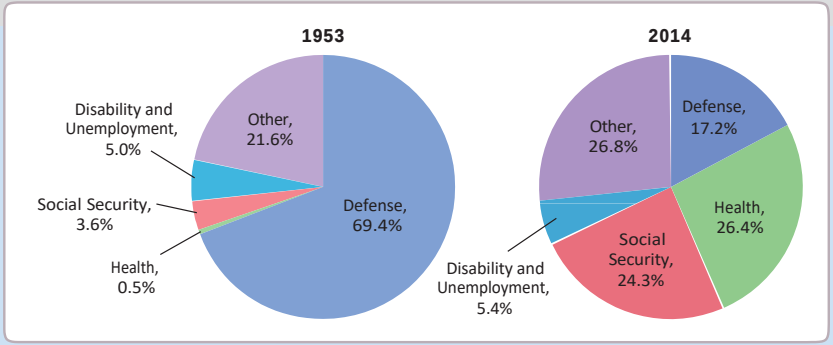
- Government intervention in provision of insurance
  - E.g: unemployment, disability, health, death
  - Motivation: share risk of idiosyncratic shocks to individuals
    - Consumption smoothing value to risk averse individuals (recall graph: free lunch!!)
- Is it different from means-tested redistribution (e.g. cash welfare, food stamps, subsidized housing, subsidized health insurance)?
  - Yes: Redistribution based on "permanent" differences (vs smoothing shocks)
  - Note: Redistribution can be thought of as insurance behind the Rawlsian veil of ignorance
  - Some programs explicitly involve both insurance and redistribution (e.g. Social Security / public pensions)

Social Insurance: The changing function of government

- SI share of federal expenditures has increased from ~9% (1953) to ~55% (2014)
- "Loosely speaking, the post-cold-war federal government is a big pension fund that also happens to have an army" (Peter Fisher, undersecretary of Treasury 2002)

The changing function of government

FIGURE 12-1



Government Spending by Function, 1953 and 2014 • Government today devotes a much larger portion of its budget to social insurance than it did 50 years ago.

Data from: Office of Budget and Management (2014); Bureau of Economic Analysis, nIPA Table 3.16.

Main Social Insurance & Redistribution Programs in the US

Program	People Receiving Benefits (Millions)	Annual Federal Spending (Billion $)	Year	Source
Medical Care				
Medicare	57	583	2016	HHS 2016 budget-in-brief
Medicaid	72.6	344	2016	HHS 2016 budget-in-brief
Old Age Assistance	50	765.6	2016	SSA monthly statistical snapshot, June 2016
Workplace Insurance				
Unemployment Compensation	?	32.3	2016	Congressional Research Service Report 33362
Workers Compensation	?	61.9	2015	Congressional Research Service Report 44580
Disability Insurance	10.7	132	2016	SSA monthly statistical snapshot, June 2016
EITC	62.9	54.9	2012	Congressional Research Service Report 44327
Welfare				
SSI	8.3	56.4	2016	SSA monthly statistical snapshot, June 2016
TANF	5.8	6.7	2012	Congressional Research Service Report 44327
SNAP	58	77.8	2012	Congressional Research Service Report 44327
WIC	8.1	7.2	2012	Congressional Research Service Report 44327
Housing Assistance	10.8	33.4	2012	Congressional Research Service Report 44327

Main Social Insurance Programs in US

- Prior slide gives (crude) sense of relative magnitudes (in terms of $ and "beneficiaries") of different programs (c. 2016)
  - Note: actual "beneficiaries" exceed those who receive benefits ex post (insurance value ex ante; incidence of costs to uninsured)
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- In terms of $ and people, Old Age Assistance and Medical Insurance dominate
- In terms of insurance value?
  - Insurance value is about variance, not mean
- Meta question: How to think about optimal allocation of $$ across programs (including those with potentially with different goals - eg insurance vs redistribution)?
  - Stay tuned for Hendren's "Marginal Value of Public Funds" (MVPF) and Hendren and Sprung-Keyser (2020)

What are the rationales for social insurance?

Rationales for social insurance

- Thus far: insurance can be very valuable and government is very involved
- Now: why would government be involved?

1. Private market failures

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1. Private market failures
2. Redistribution
3. Individual failures of rationality / optimization
4. Paternalism

Private market failures

- Imperfect Competition [go take IO]
- Asymmetric Information
- Aggregate Shocks
- Externalities

Asymmetric Information

- Selection markets: consumers vary not only in their WTP but in how costly they are to the seller
- Main applications:
  - insurance markets
  - credit / loan markets
- Other applications:
  - education
  - labor markets

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  - My favorite private market failure
- Moral hazard
  - Individuals take hidden actions in response to contract
    - In general not something the government has a comparative advantage in addressing.
    - Critical though for optimal policy design

Aggregate Shocks

- Economic downturn (UI), natural disasters, terrorist attacks

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  No one will have the endurance to collect on his insurance, Lloyd's of London will be loaded will be loaded when they go

  - Tom Lehrer "We Will All Go Together When We Go"

- Private insurance markets can diversify idiosyncratic risk cross sectionally but if want to smooth intergenerationally, government may have comparative advantage.
- Or perhaps the capital markets ("act of god" bonds)
  - Relatively little work here.

Externalities

- Examples: Infectious disease, thirdy party damages from driving; pollution
- Policies:
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- Inter-temporal externalities: Samaritan's dilemma

Samaritan's dilemma

- People are altruistic (Parable of the Good Samaritan)
- Lack of commitment creates a time inconsistency problem (Buchanan 1975)
- Scope of welfare-improving government intervention (Coate AER 1995)
  - rich altruists, and rich averse poor who face some probability of loss
    - public finance perspective: altruism provides an efficiency rationale for public provision of transfers to the poor (a public good; free-riding / underprovision of private charity; welfare improvement through government provision)
    - Coate insight: altruism also affects form of transfers - reason for in-kind transfers of insurance or investments (eg education or job training)
  - With unconditional cash transfers the poor may forgo insurance and rely on private (or publicly-funded) charity to bail them out
    - We can't commit not to take care of people in certain circumstances, which will lead them to under self-insure (e.g. food pantries; rebuilding after a flood; hospital charity care)
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Externalities: comment

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- Traditionally, externalities have gotten relatively little attention as motivation for social insurance
  - But are potentially important in some contexts
  - Spoiler Alert: Samaritan's dilemma may be crux to health insurance policy / reform
    - Will return to later in course / a great area for work

Redistribution

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- Note many models of redistribution share features w models of asymmetric information / adverse selection (e.g. Diamond-Mirlees and other screening models)

Behavioral Biases

- In purchasing insurance
  - Overconfidence / don't understand probabilities (young think they're invincible)
  - Overweight low probability events (buy flight insurance)
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- In consumption decisions
  - e.g. Myopia: too little savings; under-investment in preventive care

Paternalism

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- Why?
  - Non-individualistic social welfare function
    - Consumption of that particular good enters SWF not through individual utilities
  - "Consumption Externalities" My utility depends on your consumption

What can and should gov't do?

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  - regulate pricing (levels, formulas)
- Power to change quantities
  - Mandate individuals to purchase or firms to offer product
  - Publicly provide
  - Regulate (e.g. minimum standards)

Choice of Instrument

- SI takes many different forms:
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    - Regulate pricing and contracts in health insurance exchanges
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- Choice of Instrument = understudied question
  - Conditional on intervening, what form should it take?
  - Lamppost problem!

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  - What are costs from policy intervention?
  - What is the optimal policy intervention? (choice of instrument)