FE431: Public Finance Course Notes

Part III: Social Insurance, Redistribution, and Low-Income Assistance

- Recall, reasons why free markets may fail to allocate resources efficiently:
    1. Insufficient competition
    2. Property rights or information problems
        - ⇒ Externalities and common-property resources
        - ⇒ Public goods
        - ⇒ **Some types of insurance**

I. Insurance Markets

- Private insurance markets that work well (without government intervention):

Work well	Don't work well

- Problem with insurance markets on the right are:

  1.

  2.

  3.

- Can we view government "redistribution" programs (e.g. welfare, Medicaid, food stamps, public housing) as "poverty insurance" or "social insurance" that we pay for when we are working or in a fortunate situation, and which pays us when we are not working or in an unfortunate situation?
- Or are these "legalized Robin Hood" programs that take from the wealthy and give to the poor because the poor have sufficient political power to get such programs passed?

- Even government actions meant to improve *efficiency* typically result in wealth redistribution to some extent, and therefore have *equity* implications. For example, tax payments for public goods are not necessarily (or probably ever) directly proportional to benefits received, so provision of public goods indirectly impacts the wealth distribution.
- However, many government programs directly transfer wealth. Some important questions:

  ⇒ Are such redistributive transfers "acceptable" or "right"?

  ⇒ Under what conditions (regarding the wealth distribution under free markets) are such transfers warranted?

  ⇒ How should transfers take place?

  ⇒ How do social insurance and redistribution programs impact individual's choices?

II. Some views on equity, distributive justice, and redistribution

"How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortunes of others, and render their happiness necessary to him, though he derives nothing from it, except the pleasure of seeing it... [T]his sentiment, like all the other original passions of human nature, is by no means confined to the virtuous or the humane, though they perhaps may feel it with the most exquisite sensibility. The greatest ruffian, the most hardened violator of the laws of society, is not altogether without it."

- Adam Smith, *The Theory of Moral Sentiments* (1759), opening line

1. Pareto efficient redistribution

- Redistribution is acceptable (even necessary for *efficiency*) if it results in a <u>Pareto improvement</u>

  $\Rightarrow$

  $\Rightarrow$

  $\Rightarrow$

- In this last case, if person A is "wealthy" and person B is "poor", then the Pareto efficient transfer from A to B is characterized by the point where

- May want the <u>government</u> to be involved in the transfer because

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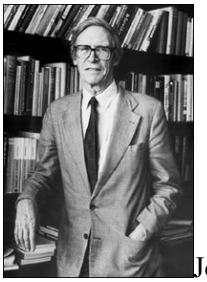
2. Social welfare maximization
   - Redistribution of income / wealth / goods may increase *social welfare*.
   - Examples of *social welfare functions*

     ⇒ Utilitarianism

Jeremy Bentham (1748-1832)

⇒ Rawlsian principle of distributive justice


John Rawls (1921 – 2002)

3. Desert-based principles

- Economic benefits should be distributed according to what people "deserve". Each person should be compensated based on:

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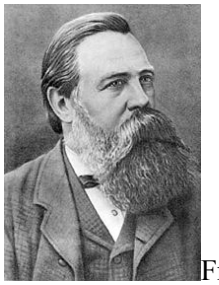
- *Redistribution may be acceptable, even necessary, to make sure people are justly compensated based on one of the above desert criteria.*[1]

Karl Marx (1818 – 1883)


Friedrich Engles (1820 – 1895)

[1] Capitalism versus socialism / communism → which leads to a just distribution of total social output? Does capitalism lead to the exploitation of workers, as Marx and Engles perceived?

4. Strict egalitarianism

-

5. Resource egalitarianism

-

6. Commodity egalitarianism

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7. Libertarianism / Commutative Justice

"We must face the fact that the preservation of individual freedom is incompatible with a full satisfaction of our views of distributive justice."

--Friedrich Hayek

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- Emphasis on strong protection of <u>property</u> rights. But how does one "justly acquire" property?

  ⇒

  ⇒

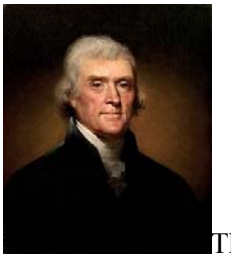
  ⇒

- *Redistribution may be consistent with a "principle of rectification for past injustices" → unjust property loss or acquisition.*[2]

[2] Practical implementation may be difficult for many injustices → consider the injustice of slavery (different people are alive today, and it is impossible to differentiate between justly and unjustly acquired property. And the views on "property" have changed over time. The modern view now is that everyone "owns" themselves → people cannot be others' property).

Classic libertarians

John Locke (1623 – 1704)

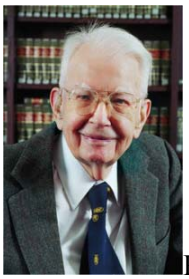

Thomas Jefferson (1743 – 1826)

"Austrian School" of economic thought[3]

Ludwig von Mises (1881 – 1973)

Friedrich Hayek (1899 – 1992)

"Chicago School" of economic thought[4]


Ronald Coase (1910-)

Milton Friedman (1912 – 2006)

[3] Libertarian school of economic thought based largely on logical propositions, the superiority of free markets and free human economic decisions, and the rejection of economic interventionism by government.

[4] Libertarian school of thought based largely on scientific modeling and empirical evaluation. The Chicago school is, perhaps, more open to the possibility that government intervention may improve upon free market outcomes, if only the right conditions for it to work are identified.

8. Civil rights and feminist movements

- Concerned with the historical political and economic disadvantages experienced by women and minorities, even in modern liberal democracies (e.g. property ownership, political participation / voting, man as "legal head of household", child rearing responsibilities, etc), which may be responsible for persistent inequalities in wages, income, job opportunities, and the distribution of wealth.

For discussion:

What is Adam Smith's view on "social justice"? Would he support *any* government programs to achieve "social justice" or greater income equality? Or was Adam Smith a strict libertarian (who viewed government's only role as protecting people's property rights)?

III. Measures of poverty and inequality

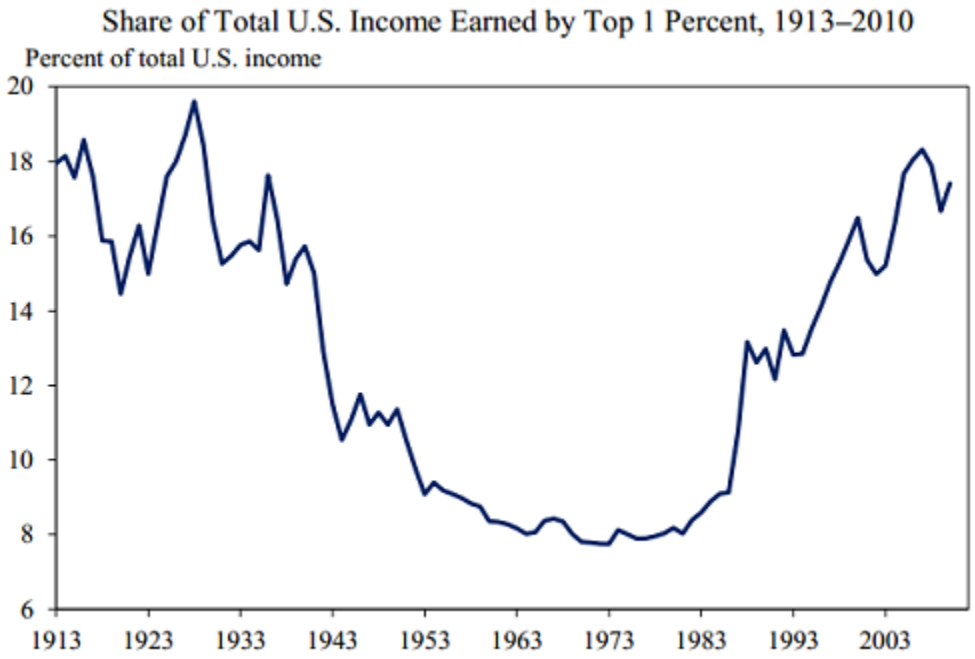
A. Some statistics

- Per-capita income in U.S. ≈ [5]
- Median household income in U.S. ≈
- U.S. poverty line = $
- U.S. poverty rate = (million people)[6]
- Uninsured rate in U.S. = (million people)
- Number of homeless persons in U.S. = million (estimate) during the year (≈ _____ on a given night)
- Number of federal food assistance person in U.S. = million (about _____% of population; over half are children)
- Warren Buffet's current wealth = $ billion[7]
- Bill Gate's current wealth = $ billion
- U.S. unemployment rate = ("underemployment rate" =)
- U.S. Federal minimum wage = $ (was $5.85 in 2007)
- Max state minimum wage rates = $ (Washington State)

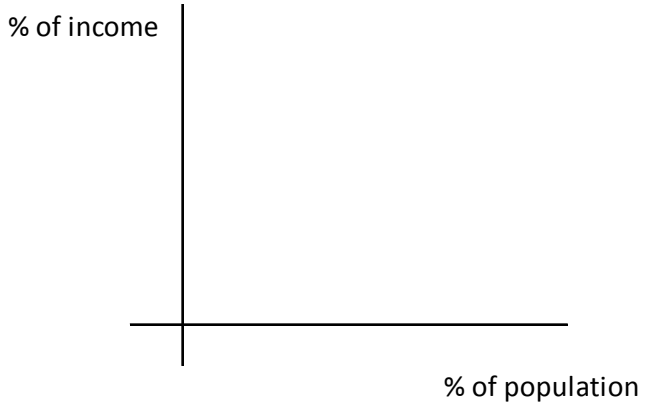
[5] Qatar, Luxembourg typically at top,, southern African countries at bottom.

[6] 86% in Zambia, 8% in China, 1% in Taiwan

[7] See http://www.nytimes.com/ref/business/20070715_GILDED_GRAPHIC.html.

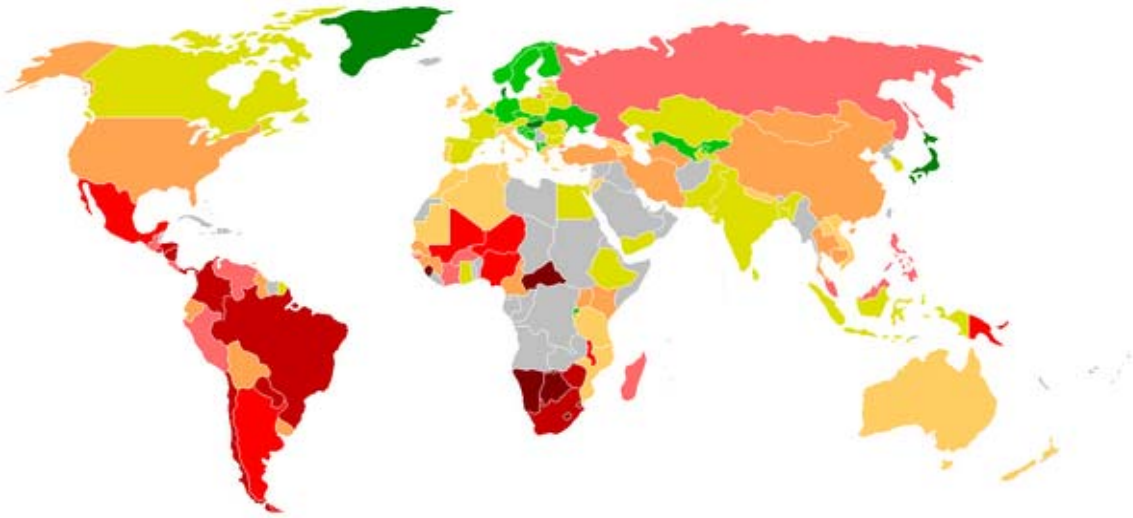

Share of Total U.S. Income Earned by Top 1 Percent, 1913–2010
Percent of total U.S. income
20
18
16
14
12
10
8
6
1913
1923
1933
1943
1953
1963
1973
1983
1993
2003

B. The Lorenz Curve



- World Gini Coefficient ≈ 55
- Gini coefficients by country (according to CIA World Factbook):

1	Namibia	70.7		46	Nicaragua	43.1		91	Bosnia and Herzegovina	34.1
2	South Africa	65		47	Thailand	43		92	United Kingdom	34
3	Lesotho	63.2		48	Cambodia	43		93	Switzerland	33.7
4	Botswana	63		49	Kenya	42.5		94	Bulgaria	33.5
5	Sierra Leone	62.9		50	Burundi	42.4		95	Bangladesh	33.2
6	Central African Republic	61.3		51	Russia	42.2		96	Greece	33
7	Haiti	59.2		52	China	41.5		97	Mongolia	32.8
8	Colombia	58.5		53	Argentina	41.4		98	France	32.7
9	Bolivia	58.2		54	Senegal	41.3		99	Tajikistan	32.6
10	Brazil	56.7		55	Turkey	41		100	Taiwan	32.6
11	Guatemala	55.1		56	Venezuela	41		101	Canada	32.1
12	Honduras	53.8		57	Morocco	40.9		102	Italy	32
13	Hong Kong	53.3		58	Turkmenistan	40.8		103	Spain	32
14	Paraguay	53.2		59	Georgia	40.8		104	Romania	32
15	El Salvador	52.4		60	Mali	40.1		105	Estonia	31.4
16	Chile	52.4		61	Tunisia	40		106	South Korea	31.4
17	Panama	51		62	Jordan	39.7		107	Ukraine	31
18	Papua New Guinea	50.9		63	Burkina Faso	39.5		108	Netherlands	30.9
19	Zambia	50.8		64	Ghana	39.4		109	Pakistan	30.6
20	Niger	50.5		65	Israel	39.2		110	Australia	30.5
21	Swaziland	50.4		66	Mauritania	39		111	European Union	30.4
22	The Gambia	50.2		67	Mauritius	39		112	Kyrgyzstan	30.3
23	Zimbabwe	50.1		68	Macedonia	39		113	Ethiopia	30
24	Dominican Republic	49.9		69	Malawi	39		114	Montenegro	30
25	Peru	49.6		70	Portugal	38.5		115	Kosovo	30
26	Sri Lanka	49		71	Guinea	38.1		116	Ireland	29.3
27	Mexico	48.2		72	Timor-Leste	38		117	Croatia	29
28	Costa Rica	48		73	Yemen	37.7		118	Denmark	29
29	Singapore	47.8		74	Japan	37.6		119	Cyprus	29
30	Madagascar	47.5		75	Moldova	37.4		120	Slovenia	28.4
31	Mozambique	47.3		76	Armenia	37		121	Belgium	28
32	Nepal	47.2		77	Vietnam	37		122	Iceland	28
33	Uruguay	47.1		78	Indonesia	37		123	Belarus	27.9
34	Ecuador	46.9		79	India	36.8		124	Germany	27
35	Rwanda	46.8		80	Uzbekistan	36.8		125	Finland	26.8
36	Philippines	45.8		81	Benin	36.5		126	Albania	26.7
37	Uganda	45.7		82	Azerbaijan	36.5		127	Kazakhstan	26.7
38	Jamaica	45.5		83	New Zealand	36.2		128	Slovakia	26
39	United States	45		84	Latvia	36		129	Austria	26
40	Cameroon	44.6		85	Lithuania	36		130	Czech Republic	26
41	Cote d'Ivoire	44.6		86	Algeria	35.3		131	Malta	26
42	Iran	44.5		87	Poland	34.9		132	Luxembourg	26
43	Malaysia	44.1		88	Tanzania	34.6		133	Serbia	26
44	Nigeria	43.7		89	Laos	34.6		134	Norway	25
45	Guyana	43.2		90	Egypt	34.4		135	Hungary	24.7
								136	Sweden	23



Legend:

Color	Gini coefficient
	< 0,25
	0,25 - 0,29
	0,30 - 0,34
	0,35 - 0,39
	0,40 - 0,44
	0,45 - 0,49
	0,50 - 0,54
	0,55 - 0,59
	> 0,60
	NA

The Lorenz Curve:

- Gini coefficients for the United States at various times, according to the US Census Bureau:

- 1970: 0.394
- 1980: 0.403
- 1990: 0.428
- 2000: 0.462
- 2009: 0.468

IV. Education

"For a very small expense the public can facilitate, can encourage, and can even impose upon almost the whole body of the people, the necessity of acquiring those most essential parts of education.

The public can facilitate this acquisition by establishing in every parish or district a little school where children may be taught for a reward [fee] so moderate that even a common labourer may afford it; the master being partly, but not wholly paid by the public; because, if he was wholly, or even principally paid by it, he would soon learn to neglect his business."[8]

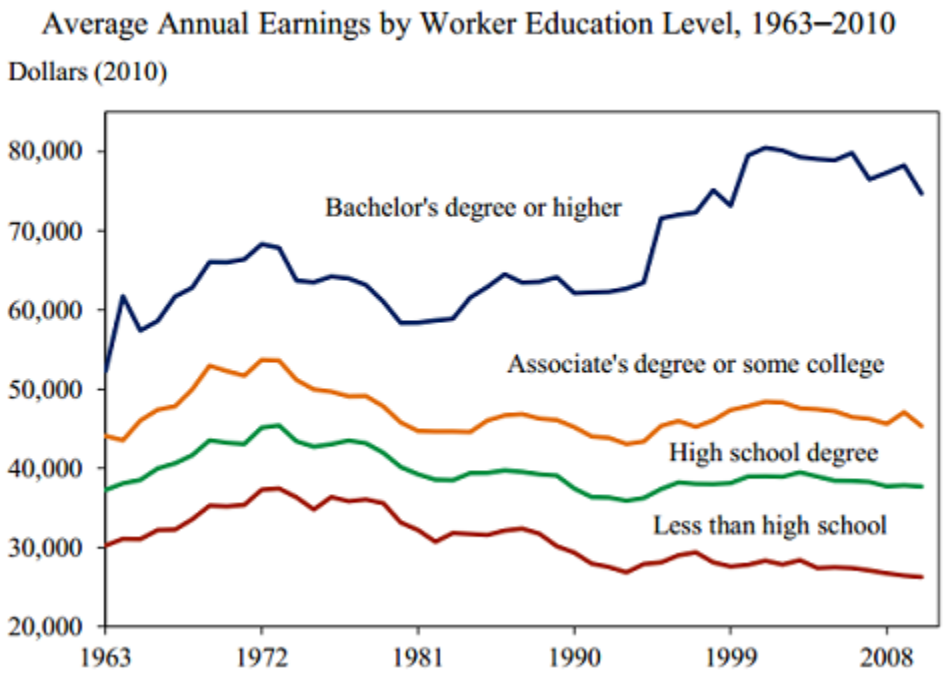
"An instructed and intelligent people besides, are always more decent and orderly than an ignorant and stupid one. They feel themselves, each individually more respectable, and more likely to obtain the respect of their lawful superiors, and they are therefore more disposed to respect those superiors…they are… less apt to be misled into any wanton or unnecessary opposition to the measures of government."

- Adam Smith, The Wealth of Nations (Book V), 1776

Reasons for public provision of education:

[8] See Adam Smith quote later in this section under TANF. He was speaking specifically about teacher pay and performance.

Reasons against public provision of education:


Average Annual Earnings by Worker Education Level, 1963–2010
Dollars (2010)
80,000
70,000
60,000
50,000
40,000
30,000
20,000
1963
1972
1981
1990
1999
2008
Bachelor's degree or higher
Associate's degree or some college
High school degree
Less than high school

Brief history of education in America:

- 1600's (Colonial days) → upper class only received basic education; home schooling (likely a tutor from England); later sent to a private boarding school (typically in England, and boys only)
- 1700's → private English Grammar schools and private "Academy" schools founded (admitted women); missionaries taught Native Americans
- 1800's → The "Common School Period"; transformation of completely private school system (available only to upper class) to statewide common-school systems (1840's); intended to increase opportunity, prevent crime and poverty, strengthen "social bonds")
- Mid to late 1800's → higher education movement; many state colleges and universities founded (previously nearly all private)
- By 1918 → all states had adopted compulsory attendance, free public education, and local school boards
- 1925 → Supreme Court ruling that children cannot be compelled to attend public schools (may attend private schools)
- Mid 1900's → desegregation of schools (1954 Brown v. Board of Education ruled segregation unconstitutional)
- 1990's → increased awareness of declining performance of U.S. school children
- 2001 → No Child Left Behind Act (NCLB)
- Currently → about 70% of Americans graduate high school (in four years with "regular diploma")[9]

[9] Reported graduation rates vary widely and inconsistently. This data from http://www.all4ed.org/files/National_wc.pdf.

Education reform options:

- Standardized testing

- Charter & Magnet Schools

- School choice

- Vouchers

V. Unemployment insurance

- Unemployment in 17th century England was one reason for emigration to the American colonies
- Involuntary unemployment → not thought to be a major problem or political issue until the late 1800's; first measured in U.S. in 1878. Why?

- Unemployment Insurance[10] (UI) http://atlas.doleta.gov/unemploy/

[10] Hard to believe, but involuntary unemployment is largely a twentieth century phenom

VI. Social Security – see Appendix for program specifics

Discussion questions:

⇒ Why not just have "welfare" programs (that apply regardless of age), and let people make their own savings and retirement decisions? Why have Social Security at all?

➢

⇒ Should everyone be <u>required</u> to save for retirement? If so, what percentage of income (at minimum)?

➢

⇒ Should people be able to save in their own personal accounts? Should people be required to pay into a retirement system with set rules and guidelines on contributions, benefits, and where the money is invested?

⇒ What are the advantages and disadvantages of private accounts?

<u>Advantages</u>

➢

➢

➢

<u>Disadvantages</u>

➢

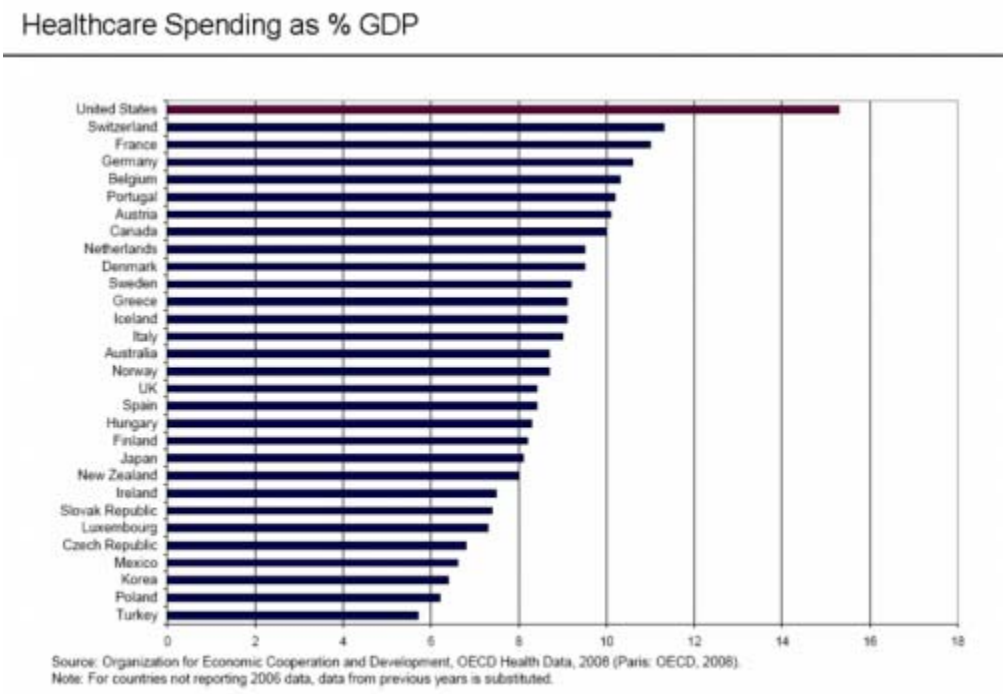
➢

➢

⇒ What is likely to happen to Social Security?

VII. Health Care, Medicare, and Medicaid

- Around 16% of GDP is spent on health care in U.S. (around 8% in Britain)
- About 60% of people in U.S. have private health insurance; around 25% have insurance through government (Medicare and / or Medicaid)
- About 15% (45 million people) are uninsured



- Medicare http://www.medicare.gov/
  - Mandatory; begun in 1965; for seniors over 65; administered by U.S. Dept of Health and Human Services
  - Second largest domestic spending program in U.S.
  - Financed with 1.45% payroll tax on both employee and employer (for 2.9% total tax)

- Medicaid http://www.cms.hhs.gov/medicaid/
  - Health insurance program for low-income households
  - Jointly funded by federal government and states; administered by states

- Why may a purely private health insurance market be unacceptable?

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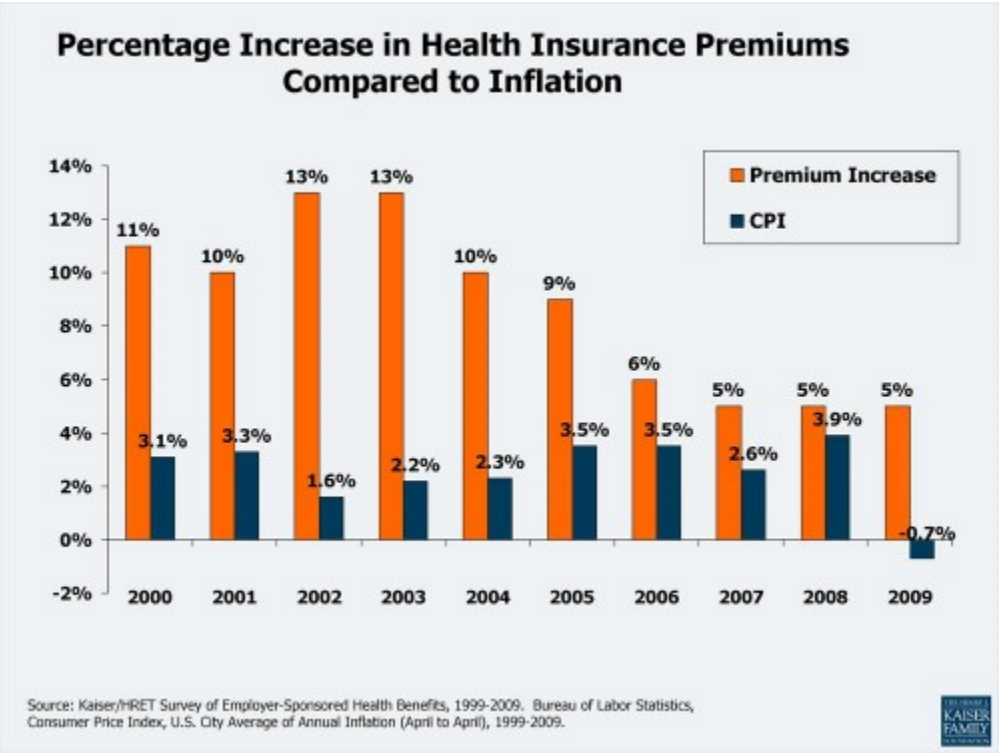

⇒ Some economists advocate increased use of "catastrophic" insurance policies →

⇒ Insurance companies have incentive to limit costs by

⇒ Problems with employer-based coverage:

- Reform options:

VIII. Low-income assistance programs

- Remember that the non-profit sector plays a significant role in providing low-income assistance in the U.S. To what extent does government assistance "crowd out" private assistance?

- Some other important questions:

  ⇒ Should we provide monetary assistance (i.e. cash), or "in-kind" transfers (i.e. provide certain goods directly, or "vouchers" that can only be used to purchase the goods)? Do cash transfers affect behavior differently from in-kind transfers?

  ⇒ How do you design a "good" monetary income assistance programs? How do differences in program design affect the behavior of recipients?

  ⇒ What qualifications should there be to receive assistance (e.g. income, drug tests, proof of job search, criminal record, etc)?

- In-kind transfers vs. Cash assistance: Food Stamp Example

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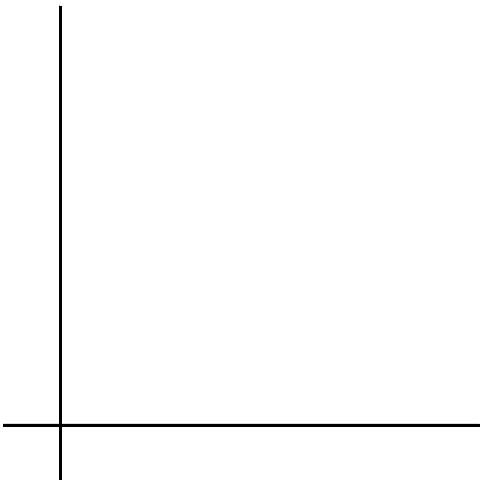
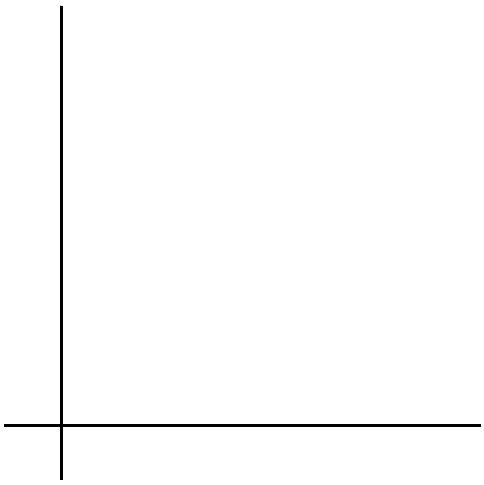
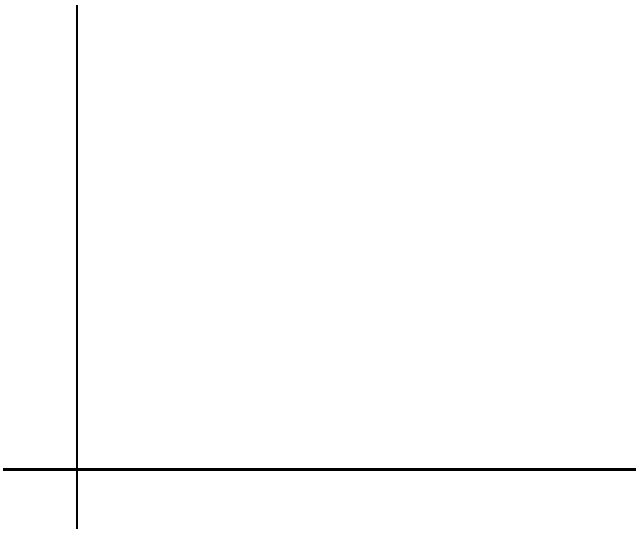




- Let's analyze the pros and cons of specific programs meant to provide monetary assistance to low-income families:

  1. Minimum wage laws - used:

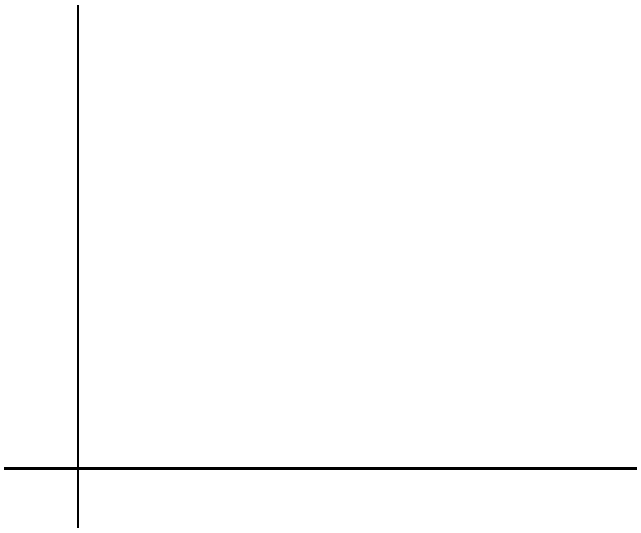
2. Wage rate subsidy (WRS) – (used through the EITC – see later):



"It is in the interest of every man to live as much at his ease as he can; and if his emoluments are to be precisely the same, whether he does, or does not perform some very laborious duty, it is certainly his interest, at least as interest is vulgarly understood, either to neglect it altogether, or, if he is subject to some authority which will not suffer him to do this, to perform it in as careless and slovenly a manner as that authority will permit."

- Adam Smith, *The Wealth of Nations* (Book V)

3. Temporary Assistance to Needy Families (TANF) – used:



\+ TANF requires

(1)

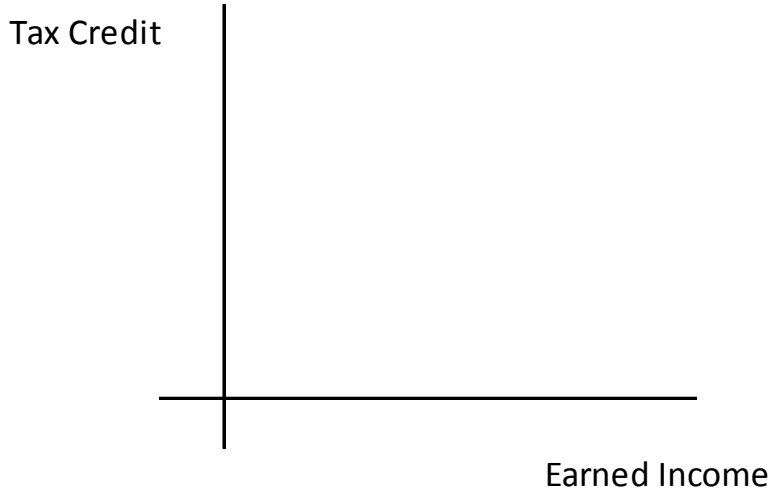
(2)

(3)

4. Negative Income Tax (NIT) – proposed, but never used:

5. Earned Income Tax Credit (EITC) – used:

   + / - The fourth largest Federal social insurance program (after Social Security, Medicare, and Medicaid) and largest low-income cash assistance program



IX. Appendix – Partial list of social insurance and low-income assistance programs

SOCIAL INSURANCE AND LOW-INCOME ASSISTANCE PROGRAMS

The following is a partial list of social insurance and welfare programs and online sources of detailed information:

"Social insurance" programs (also called "entitlement programs" → because payer is entitled to certain benefits):

- Social security http://www.socialsecurity.gov/
  - Mandatory for all U.S. workers (unless covered by various independent state employee programs (e.g. State Teachers Retirement System of Ohio)); Begun 1935, converted to "pay-as-you-go" 1939; administered by U.S. Soc. Sec. Admin.
  - Largest domestic spending program in U.S.
  - Financed with 6.2% payroll tax on both employee and employer (for 12.4% total tax)
  - Some redistribution from young to old, high income to low income, individuals without to individuals with spouses, short life expectancy to long life expectancy persons
- Medicare http://www.medicare.gov/
  - Mandatory; Begun in 1965; for seniors over 65; administered by U.S. Dept of Health and Human Services
  - Second largest domestic spending program in U.S.
  - Financed with 1.45% payroll tax on both employee and employer (for 2.9% total tax)
- Unemployment Insurance (UI) http://atlas.doleta.gov/unemploy/
  - Mandatory; Begun 1935; administered by each state
  - Unemployment cannot be "employee's fault"; approx. 26 month limit on payments; average weekly payment = $295 (in 2010)
  - Financed by employer-paid payroll tax

Low-income assistance programs (with no "entitlement" to those who fund it):

- Supplemental Security Income (SSI) http://www.ssa.gov/notices/supplemental-security-income/
  - Income program for disabled persons; admin. by U.S. Soc. Sec. Admin.
  - Funded by general tax revenues
- Medicaid http://www.cms.hhs.gov/medicaid/
  - Health insurance program for low-income households
  - Jointly funded by federal government and states; administered by states

- Temporary Aid to Needy Families (TANF)
  http://www.acf.hhs.gov/programs/ofa/

  - Replaced Aid to Families with Dependent Children (AFDC) which ran 1935-1996
  - Administered by states which determine benefit reduction rate, limit to duration of payments (generally 5 years)
  - Involves a "work requirement" (specifics determined by each state)

- Food Stamp Program http://www.fns.usda.gov/fsp/

  - Administered by U.S. Dept of Agriculture and states; funded by fed gov
  - "Cannot be used" for tobacco, alcohol, animal food, or imported food
  - 23.9 million recipients; Avg. monthly household income of recipients approx. $640/month
  - Max. allotment for family of 4 around $500/ month
  - 51% of all participants are children

- Public housing http://www.hud.gov/offices/pih/programs/ph/index.cfm

  - U.S. Dept of Housing and Urban Development
  - 1.3 million households participate
  - Rent-controlled housing units

- Energy aid http://www.acf.dhhs.gov/acf_services.html#energy

  - U.S. Dept of Health and Human Services
  - Low-income home energy assistance program

Education programs:

- Public schooling, federal student aid for college
  http://www.ed.gov/index.jhtml

- Federal job training http://www.doleta.gov/

  - U.S. Dept of Labor
  - Training services provided primarily by state and local governments, funded in part by federal grants

Other programs:

- Federal Disaster Relief
  http://www.fema.gov/rrr/inassist.shtm

- Foreign aid http://www.usaid.gov/