Government Spending by Function, 1953 and 2007 • Government today devotes a much larger portion of its budget to social insurance than it did 50 years ago.
Government spending, 1953 and 2010

<table>
<thead>
<tr>
<th></th>
<th>1953</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defense</td>
<td>69.4%</td>
<td>19.1%</td>
</tr>
<tr>
<td>Income security</td>
<td>5.0</td>
<td>20.1</td>
</tr>
<tr>
<td>Social Security</td>
<td>3.6</td>
<td>15.9</td>
</tr>
<tr>
<td>Health</td>
<td>0.4</td>
<td>25.2</td>
</tr>
<tr>
<td>Other</td>
<td>21.6</td>
<td>19.7</td>
</tr>
</tbody>
</table>
12.2 APPLICATION: Adverse Selection and Health Insurance “Death Spirals”

• In 1995, Harvard stopped subsidizing its most generous plans, which were experience-rated.

• **Experience rating:** Charging a price for insurance that is a function of realized outcomes.

• Before 1995, there was a pooling equilibrium.
  o Healthy employees chose the cheap, generous plan.

• After 1995, there was a separating equilibrium.
  o Healthy employees dropped the now expensive generous plan.
APPLICATION: Adverse Selection and Health Insurance “Death Spirals”

- Because the less-healthy employees used much more medical care, the experience-rated premiums of the more generous plans increased substantially.

- By 1998, the most generous plan had gotten so expensive that it was no longer offered.
  - Adverse selection had led to a “death spiral” for this plan.
  - It kept getting more expensive, and healthy people kept leaving, driving its price ever higher.
Example: Unemployment Insurance

- Unemployment insurance provides benefits through the replacement rate.

- **UI replacement rate**: The ratio of unemployment insurance benefits to pre-unemployment earnings.

- A higher replacement rate corresponds to more generous insurance.

- But private insurance reduces the consumption-smoothing value of this insurance.
Example: Unemployment Insurance

(a) No self-insurance; full consumption smoothing by UI

(b) Partial self-insurance; partial consumption smoothing and partial crowding out by UI

(c) Full self-insurance; full crowding out by UI
Chapter 12  Social Insurance: The New Function of Government

APPLICATION: The Problems with Assessing Workers’ Compensation Injuries

- Prison guard Ricci DeGaetano
  - Supposedly injured by an inmate. Collected $82,500 in claims over three years while operating a karate school.

- Waitress Christina Gamble
  - Too injured to “stand” and “change positions.” Received $360/week in insurance payments while working as a stripper.

- Detective Rockey Sherwood
  - Injured in traffic accidents. While claiming workers’ compensation, coached little league team to California World Series victory.