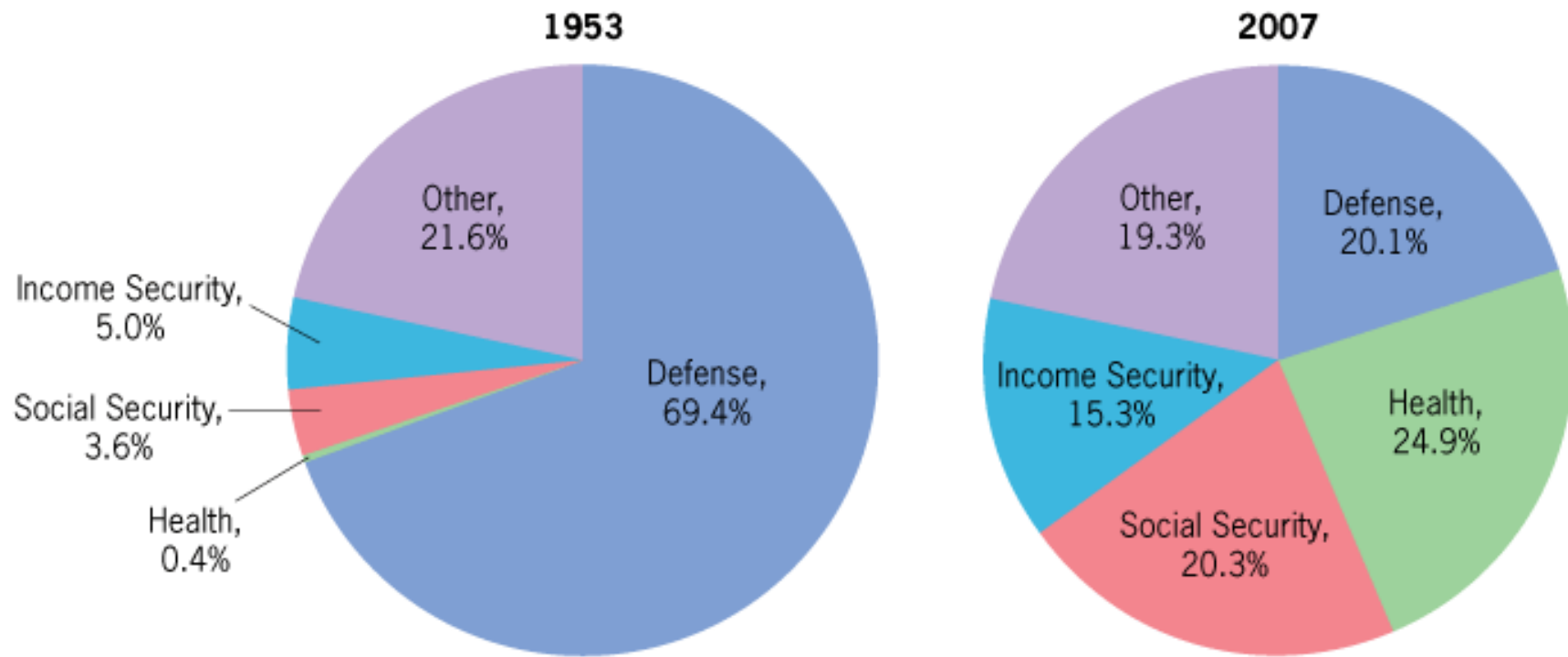


■ FIGURE 12-1



**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

	1953	2010
Defense	69.4%	19.1%
Income security	5.0	20.1
Social Security	3.6	15.9
Health	0.4	25.2
Other	21.6	19.7

## 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.
  - Healthy employees chose the cheap, generous plan.
- After 1995, there was a separating equilibrium.
  - Healthy employees dropped the now expensive generous plan.

## APPLICATION: Adverse Selection and Health Insurance “Death Spirals”

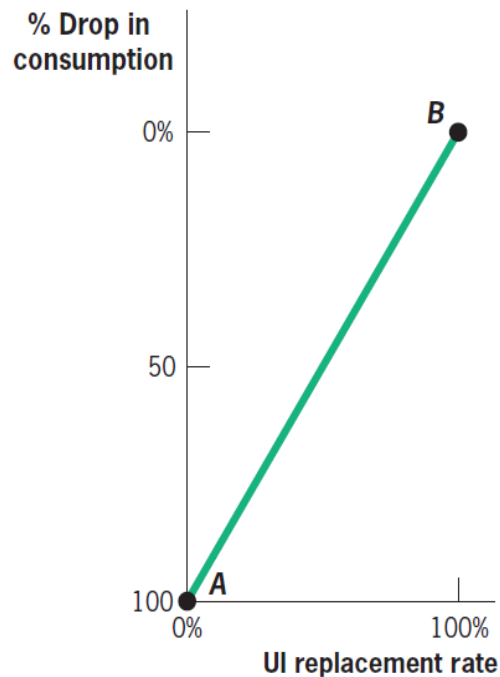
- Because the less-healthy employees used much more medical care, the experience-rated premiums of the more generous plans increased substantially.
- By 1998, the most generous plan had gotten so expensive that it was no longer offered.
  - Adverse selection had led to a “death spiral” for this plan.
  - It kept getting more expensive, and healthy people kept leaving, driving its price ever higher.

## Example: Unemployment Insurance

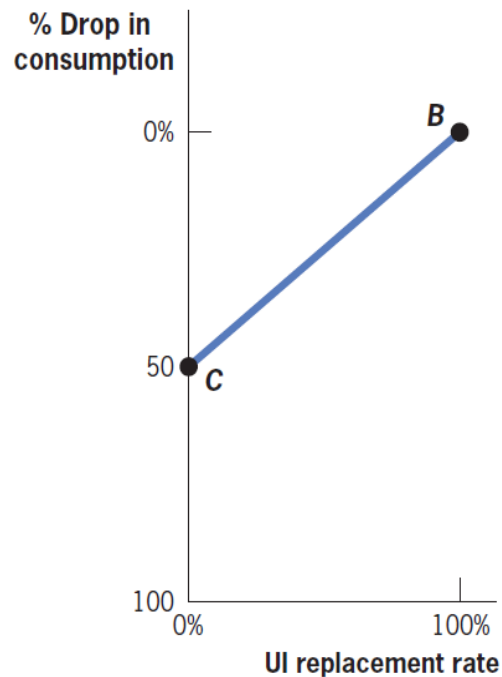
- Unemployment insurance provides benefits through the replacement rate.
- **UI replacement rate:** The ratio of unemployment insurance benefits to pre-unemployment earnings.
- A higher replacement rate corresponds to more generous insurance.
- But private insurance reduces the consumption-smoothing value of this insurance.

## 12.4

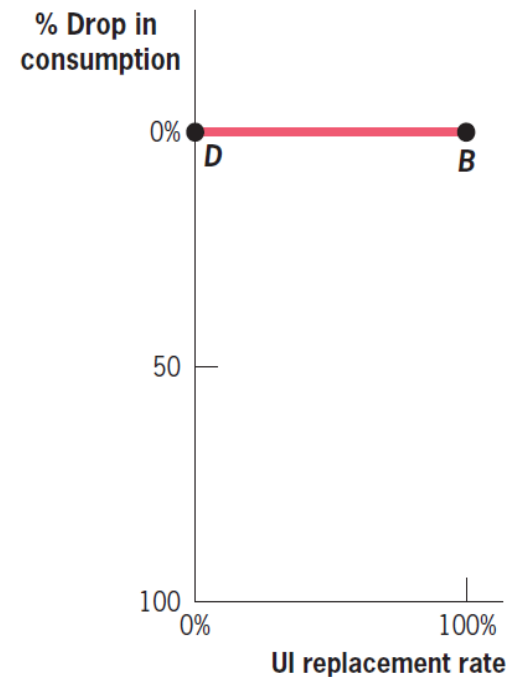
## Example: Unemployment Insurance



(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

## 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 Rocky Sherwood
  - Injured in traffic accidents. While claiming workers' compensation, coached little league team to California World Series victory.