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>Category</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.
  - 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.
  
  o Adverse selection had led to a “death spiral” for this plan.

  o 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
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.
utility

consumption

\[ w-d \quad \text{(probability } q) \]

\[ w \quad \text{(probability } 1-q) \]
utility

uninsured

expected

utility

(utility function)

w-d (probability q)

w (probability 1-q)

consumption
utility

insured

uninsured

with full insurance

consumption
Figure 10.15. The rise of the social State in Europe, 1870-2015

Interpretation. In 2015, fiscal revenues represented 47% of national income on average in Western Europe and were used as follows: 10% of national income for regalian expenditure (army, police, justice, general administration, basic infrastructure: roads, etc.); 6% for education; 11% for pensions; 9% for health; 5% for social transfers (other than pensions); 6% for other social spending (housing, etc.). Before 1914, regalian expenditure absorbed almost all fiscal revenues. Note. The evolution depicted here is the average of Germany, France, Britain and Sweden (see figure 10.14). Sources and series: see piketty.pse.ens.fr/ideology.
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