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A Discussion of Social Protection and Private Insurance

Abstract

[Excerpt] This is a thoughtful and thought-provoking paper, informative and interesting. I learned a lot from reading this and have already passed it on to others.

In my comments, I would like to do four things: highlight the major points and the rationale for them, raise a few quibbles, put forth some additional issues, and propose a possible resolution of a dilemma raised in the paper.

But let us first try to be clear about what we are talking about. Professor Pestieau characterizes social insurance as being mandatory, universal, and redistributive. I would define it slightly differently: "Social insurance is a state-run or state-mandated system that is mandatory and universal." Must it be redistributive? I would say that it may or may not be ex ante in an expected value sense. But of course, social insurance will surely be redistributive ex post once losses are incurred.

Keywords

social protection, private insurance, economic policy

Disciplines

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Comments

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A Discussion of Social Protection and Private Insurance

Gary S. Fields

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Introductory remarks

This is a thoughtful and thought-provoking paper, informative and interesting. I learned a lot from reading this and have already passed it on to others.

In my comments, I would like to do four things: highlight the major points and the rationale for them, raise a few quibbles, put forth some additional issues, and propose a possible resolution of a dilemma raised in the paper.

But let us first try to be clear about what we are talking about. Professor Pestieau characterizes social insurance as being mandatory, universal, and redistributive. I would define it slightly differently: “Social insurance is a state-run or state-mandated system that is mandatory and universal.” Must it be redistributive? I would say that it may or may not be *ex ante* in an expected value sense. But of course, social insurance will surely be redistributive *ex post* once losses are incurred.

Major conclusions and their rationale

What should social insurance do? Professor Pestieau’s answer is that social insurance should concentrate on fulfilling the role of “social protection.” He reaches the following major conclusions:

1. “Henceforth, one should think of reshaping social protection in the direction of *uniform* transfers to all current beneficiaries of its various components. If this transfer were fixed at a decent level, the cost for public finance would already be high, possibly higher than

the current one. Individuals with middle or high income could supplement these transfers by private insurance programs (presumably without tax advantages”).

2. “Social protection should progressively abandon its insurance mission and focus on universality and uniformity in benefits.”
3. “Financing should come from general revenue and be totally disconnected from the labor market.”
4. “The real alternative is between guaranteeing to the unemployed, the old, the sick, the disabled, and the poor a uniform but sufficient amount of benefits and keeping the current system subject to a continuous erosion that leads to increasing pockets of poverty”

Let me turn to the rationale he gives for these conclusions, most of which I share, and to a few quibbles.

He writes: “Social insurance is subject to many of the same incentives problems—moral hazard, adverse selection—that lead to private insurance market failures.” The point about adverse selection is dubious. Earlier in the paper, Professor Pestieau notes that *mandatory* social insurance can overcome the adverse selection problem. I come back to this below.

Professor Pestieau states: “Fiscal competition and economic integration make it more and more difficult to maintain ‘generous’ social protection programs.” I should think that in order for these factors to make something more and more difficult, they must be *growing*. Are they? Probably economic integration is, but it is not so clear for fiscal competition. I would have appreciated more evidence.

He claims: “The recent evolution of employment conditions leads to a widening gap between social protection program and labor markets.” The point he means to bring out here, I think, is that the old model based on the involuntary loss of a long-term job doesn’t hold for very

many people. This, however, leaves unanswered the question of what to replace the old model with. Also, he is talking here about a *change* in conditions, but the evidence he presents in the text is about *levels*.

He then says: “Recent economic and demographic developments call for increased public interventions in the area of redistributive income maintenance.” When I read this, I wondered what exactly are these developments. Here is what I think they are: On the economic side, tighter government budgets make it more difficult to sustain social insurance programs, while on the demographic side, population aging puts pressure on retirement income systems. Anyhow, I would have liked to have seen these brought out a bit more clearly.

Some issues to consider

Many issues arise in designing programs for social insurance and social protection. Elsewhere, Olivia Mitchell and I have tried to highlight some of the main decisions that need to be made. I would like to put these forward to this distinguished group of insurance specialists.

First, the objective needs to be clearly stated. The presumed objective of these programs, as we see it, is to ensure adequate consumption.

Next, it is necessary to determine the standard of adequacy. Is the goal absolute adequacy (for instance, in relation to a national poverty line), or is it relative adequacy (relative to one’s level of consumption prior to the precipitating event)? This choice gets to the heart of the insurance-protection decision, which Professor Pestieau has put forth so clearly.

The decision also must be made about whom to insure or compensate: the poor, the vulnerable, or the losers? They are not the same people. The poor are often chronically poor, while the biggest losers may well be the nonpoor or even the quite well-to-do.

Different programs are appropriate for these different groups. The poor have need for basic social protection. Social assistance programs aim to provide this. For the vulnerable, the need is for insurance. For example, old-age annuities deal with the problem of economic insecurity caused by outliving one's working years, given that the length of life is uncertain. Sound insurance principles can be used to decide such questions as whether to make these programs public or private and whether they should be mandatory or optional. As for the losers, they are frequently targeted in order to "buy" their support—for example, for World Bank-IMF structural adjustment programs. These losers (for example, laid-off civil servants) are often the least-deserving recipients of scarce public funds.

This raises the question of the fiscal tradeoff. How should scarce resources be divided among the poor, the vulnerable, and the losers? This decision should be made explicitly. Unfortunately, it often is made by default.

A possible resolution

Is there a way out of the insurance-protection dilemma? Let me raise one possibility.

A system could be created that is both fully-funded and redistributive. It could be fully funded in the sense that for a particular group of insureds (such as a birth cohort) the present value of expected benefits (PVEB) can equal the present value of expected contributions (PVEC). Yet by offering a higher PVEB/PVEC ratio for target groups such as the poor and those

born with certain defects, the program could also be redistributive. The U.S. social security system is redistributive in precisely this sense. Of course, to overcome adverse selection, such a system would have to be mandatory. Hence, it would be *social* insurance, but it need not be state *run*. It could be state *mandated*, allowing private insurance companies to handle *groups* of people on an actuarial basis while still redistributing *within* a group—for instance, by using unisex mortality tables.

Thus, I conclude that we do not yet need to abandon the insurance mission of social insurance programs. For as long as people turn to the state for help when they are poor, old, or sick, the state may require that they buy insurance against at least some of these risks. In so doing, the state would further establish its credibility and commitment to helping those in need—a point dealt with persuasively by Professor Pestieau in his text.

Such a system might provide both genuine protection and valuable insurance. For these reasons, mandatory redistributive social insurance systems might be worth considering further.