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WHAT'S WRONG WITH EQUALIZATION: SOCIAL INSURANCE AND MORAL HAZARD

HERBERT GRUBEL

Equalization: Welfare Trap or Helping Hand? (PAPER #3)

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by

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Section 1 Introduction

The world is full of risks that cause harm to persons and property for reasons beyond their control. Insurance offers the possibility to protect oneself against the harm done by such accidents. All one has to do is pay relatively small periodic premiums, which are pooled by the insurer and used to provide compensation for damage experienced by the few among the many who are insured.

In the twentieth century, the Government of Canada, just like those of most industrial countries, faced growing public demand for insurance against risks not sold by private industry—unemployment, poverty upon retirement, catastrophic illnesses, and substandard living conditions due to living in a region with high unemployment and low productivity. In response to these demands, Canada created a comprehensive and universal program of social insurance. Mandatory premiums or taxes are collected by the government to finance the system.

Economists justified the creation of the social insurance programs on the grounds that the private market for insurance had failed to provide the coverage demanded by the public. Presumably, the private sector's failure to provide such insurance was due to excessive costs. It was believed that governments could operate the insurance system so much more cheaply that it would be self-financing. These efficiencies were seen to arise from the compulsory and universal membership, which prevents the problems of adverse selection afflicting all private insurance schemes and reduces the cost of administration and marketing. In addition, since the government operated the system, there was no need to cover the profits required in the operation of private sector insurance schemes.

After several decades of experience, many problems have arisen in operating and financing social insurance programs in Canada and most industrial countries. The health insurance and public pension schemes are in financial distress. The costs of the unemployment insurance schemes has risen much more than expected and has put heavy burdens on the productive sectors of the economy. There are concerns that the benefits paid to individuals and regional governments have created dependence and, in fact, retarded economic growth.

The following analysis focuses on the inherent bias of social insurance programs to overspend and cause unexpected harm to many of those they were designed to help. The causes of this overspending and the adverse consequences are considered in the context of the transfer payments, which have flowed in large quantities, and for a long time, to the Atlantic Provinces. All of these transfers are justified as payments due under the existing social insurance programs, in particular unemployment insurance and protection against the relative poverty of Canadian regions.

The main theme of the following analysis is that most of the problems associated with these transfers are due the reaction of individuals and governments to incentives created as a by-product of the transfers themselves. These incentives are common to all insurance schemes, private as well as public. They result in what the private insurance system has called, “moral hazard behavior”.

The first part of this paper discusses the nature of moral hazard in general. It then considers how such behaviour affects the transfer of unemployment insurance and regional equalization benefits, which are of great importance to the Atlantic Provinces and equal to a large proportion of regional national income. The next part outlines the economic and social costs associated with moral hazard. The concluding section draws on the concept to suggest how the distortions introduced by the social insurance programs can be eliminated, or at least minimized, and how the long run economic future of the Atlantic Provinces can consequently be improved.

Section 2
The Moral Hazard Phenomenon Generally

Moral hazard[1] is said to arise when people with dental insurance have more visits to the dentist; restaurants that are insured burn more often; homes with burglary insurance are burglarized more often than those without the insurance coverage. The increased incidence of the risk leading to insurance claims represents a clear economic cost attributable to the existence of the insurance.

The existence of this added cost due to moral hazard does not imply that insurance against the risk of fire, burglary and dental disease should not be provided. In principle, the added cost is embodied in the premiums charged for the insurance. At these premiums, private insurance companies earn the normal profits needed to stay in business. As will be discussed more in a later section, these private insurance companies take measures to limit moral hazard through the use of coinsurance, deductibles, and incentives to prevent claims and the policing of fraudulent claims.

As an aside, it should be noted that in the case of some risks, the moral hazard effects are so large that at the cost-recovering premiums, no one wants to buy the insurance. An example is insurance against losses from entrepreneurial activities, which depend on a very large number of uncontrollable factors. Joe Stiglitz, one of the Nobel laureates honored in 2001, has lamented the absence of such insurance as a market failure. In fact, it is no more a market failure than is the absence of a market for wings designed to let people fly by flapping their arms.

The most important issues surrounding moral hazard is what causes it and how its effects can be limited. Broadly speaking, there are two major sets of causes:

1) Illegal behavior – It occurs when arson is used to start fires, people arrange to have their houses burglarized, or individuals fake injury to collect benefits. Private insurance companies employ their own agents to work with the police and courts to limit illegal behavior. Fines and even jail are relatively effective deterrents, though the very nature of the crime makes it impossible to know with any certainty the true magnitude of the problem.

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[1] The analysis of moral hazard draws on Grubel (1971), where references to the main literature in this field can be found

2) Rational adjustment – It occurs when adjustments are undertaken by the insured in response to changes in relative prices. For example, the owners of insured homes receive less return from measures to prevent break-ins. So they are less likely to install alarms, keep watchdogs or trim hedges around the house. Their rational behavior causes more break-ins in insured than non-insured houses. For analogous reasons there are reduced incentives to drive carefully if accident insurance covers any damage. Homeowners with fire insurance are less likely to clean their chimneys and remove flammable materials near potential sources of fire than those without insurance.

Private insurers limit such rational adjustment in behavior of the insured through a variety of means. Buildings with burglar alarms and sprinklers and located near fire stations enjoy preferential premium rates. Most important, moral hazard is limited by the use of coinsurance and deductibles. These measures raise the cost to the insured of damage from a burglary or fire.

Section 3
Moral Hazard and Unemployment Insurance

Canadians with strong beliefs about the merit of social insurance programs are inclined to argue that moral hazard in these public schemes either does not exist or is minimal. This belief is part of a more pervasive view held by socialists and people of similar ideological persuasions, that with the proper education and moral standards, people can be persuaded to suppress personal interests for the benefit of society as a whole. In this spirit, they will not change their behavior to reap personal benefits from social programs to which they are not entitled.

The fact is, however, until the ideal social man has been created, moral hazard behavior also is rampant in the context of public social insurance programs. Moral hazard behavior is pervasive and well known in the context of unemployment insurance.[2]

First, there is outright illegal behavior. Claimants for benefits fail to look for work and instead enjoy leisure, holidays or work in the underground economy. Others hold jobs in the formal sector and earn an income while they also collect unemployment insurance benefits. Many quit jobs voluntarily in the expectation of receiving benefits, even though they are not legally eligible.

The bureaucrats administering the unemployment insurance system have few incentives to discover and limit fraud because of perverse incentives. On the one hand, if they find fraud and stop it, they receive no rewards. They are just doing their job. On the other hand, if they make a mistake and stop benefits to a deserving person, the resultant media outcry and demands from powerful lobby groups endanger their career and those of their political bosses. Because of the asymmetry in the benefits and costs, all estimates of the size of outright cheating in the unemployment insurance system must be treated with considerable skepticism. Casual and episodal evidence suggests that there is much more cheating than is admitted by those responsible for administering Canada's unemployment insurance program.

However, in my view, the size and cost of outright cheating in dwarfed by the rational adjustment to the availability of unemployment insurance undertaken by both individuals and provincial govern-

[2] For a major, early effort to consider the theory and empirical evidence of the effect of unemployment insurance on the rate of unemployment see Grubel and Walker (1978). The thesis of this study was very contentious during the 1970s, especially among academics in the social sciences other than economics.

ments. The adjustment takes many forms. Individual recipients of benefits often are unwilling to accept jobs offered on the grounds that they require too much travel, retraining or other costs. Such objections to taking jobs cannot be policed because they involve personal decisions and values. It is well known that jobs previously spurned, often become acceptable once eligibility for benefits ceases. The same enforcement problems exist when workers quit jobs voluntarily. By law they are ineligible for benefits, but employers are only too happy to certify that the job loss was involuntary. These employers have nothing to lose by doing so while their refusal brings them a damaging reputation in the labor market and makes it more difficult to find suitable workers.

Governments in the Atlantic Provinces have added to the size of the moral hazard phenomenon through programs of public employment. These programs offer jobs lasting just long enough to qualify workers for the insurance benefits. One of these programs involves subsidies to the construction of fish processing plants, which are designed to offer only seasonal employment.

The federal government has added to unemployment by a very special deal for fishermen in the Atlantic Provinces. In the rest of the economy, the owners and operators of trucks, farms, retail stores and other small businesses are considered to be self-employed entrepreneurs, and therefore, are ineligible to receive insurance benefits. Not so the fishermen in these provinces. After just a few weeks of fishing, they can claim benefits for many weeks—incidentally regardless how much money they have earned through their fishing.

Moral hazard behavior in response to unemployment insurance also has affected private industry. Before the existence of the unemployment insurance system, seasonal workers in forestry, tourism and construction insisted on pay levels sufficiently high to enable them to live off their earnings once the season ended and they were out of work. When unemployment insurance was introduced, these workers became willing to work for less and used the insurance benefits to pay their living expenses after they lost their jobs. These lower wages resulted in an expansion of the seasonal industries because they could charge lower prices to their customers and increase sales. In addition, another effect operated. The lower wages reduced the incentive to introduce labor saving technologies and capital, which in turn increased even more the demand for seasonal labor and the resultant annual rate of unemployment.

Canada's public unemployment insurance system uses methods for limiting moral hazard adjustment of the sort just described. Much like the private sector, there are deductibles and coinsurance: There is a waiting period between the start of unemployment and the receipt of benefits. The percentage of the wage replaced by benefits, the so-called replacement ratio, is only around one half. However, the system does not use experience rating in the premiums charged employers and employees. This practice is used widely in the private sector and in the US unemployment insurance system. Its absence in Canada has been criticized by many economists and is responsible for a large part of the overexpansion of seasonal industries noted above.

The use of deductibles, coinsurance and experience rating is restrained by the political process and explained by the theory of public choice. Workers benefiting from short waiting periods and high replacement ratios are politically active because their concentrated benefits encourage them to do so. Employers in seasonal industries enjoy the low wages they are able to pay seasonal workers and the fact that their repeat claims do not result in higher premiums. Politicians react favorably to the demands of the beneficiaries. On the other hand, the costs of these benefits are relatively small, widely diffused and do not merit political activism. Therefore, politicians do not have to fear punishment at the polls or through reduced donations from those who pay for these excessive amounts of benefits.

The relevance of this model is illustrated by a recent episode. During the fiscal crisis in the middle 1990s the Liberal government in Ottawa reduced benefits to habitual users by a modest amount. The effects of this policy were felt especially hard in the Atlantic Provinces. During the elections following these reductions in benefits, the voters severely punished the Liberal party through reduced votes and seats in the House of Commons. The reductions in benefits were rescinded promptly before the following election.

Finally, it should be noted that moral hazard is also determined by public attitudes towards the receipt of unemployment insurance benefits. Before the introduction of the scheme in the Atlantic Provinces, being on the dole or accepting benefits from the government came with a public stigma. There was a widespread sense that hard working, honest and responsible citizens did not accept such benefits. After the introduction of the unemployment insurance scheme, slowly this stigma eroded.

Importantly this change in attitudes occurred because people were encouraged by their governments and social activists, who argued that receipt of these benefits was a right of citizenship and a legitimate return to the premiums they had paid. This change in public moral values is equivalent to the depreciation of a social asset, which in the future it may be difficult to reestablish. This change in moral standards can also explain why moral hazard effects have persisted even after the government had increased coinsurance by requiring longer waiting periods and reducing the size of the replacement ratio on a number of occasions during the 1980s and 1990s.

Section 4
Moral Hazard and Government-to-Government Transfers

In recent years, it has become obvious that moral hazard has also impacted the behavior of the Provincial Governments of the Atlantic Provinces through both the unemployment insurance and the transfer payments paid by the federal government. The latter payments were designed to permit the relatively poorer provinces of Canada to offer government services of equal quality to those offered in the rest of the country. The program represents a form of social insurance akin to unemployment insurance because it is available to all provinces which for some reason fall on bad times and have the lowest incomes in Canada.

In a constantly changing world where anything can happen, at some time in the future, the Atlantic and other relatively poor provinces may become so rich that they will pay analogous transfers to other Canadian provinces, which by then, by definition, will have reached the bottom of the ladder. The realism of this scenario is illustrated by the fact that British Columbia, long one of the main payers of equalization funds, in recent years has gone through some rough economic times and, if trends continue, may soon become a recipient of transfers.

Nobel laureate James Buchanan first presented a sophisticated economic rationale for the policy of regional equalization payments in the 1960s.[3] He believed it to be necessary to prevent inefficient migration between rich and poor provinces. The pre-condition for such migration exist when persons with relatively high incomes and high tax obligations live in a poor province, where they pay proportionately more than others for their government services. Such high-income earners can be induced to move to a richer province because there they may have to pay the same amount of taxes, but because everyone else in province is richer; they receive more or better government services. The economically justifiable rationale, higher productivity and incomes do not cause such migration. It is caused solely by the existence of taxation and government spending.

Buchanan's argument was that transfers of income from the rich to the poor provinces are required to prevent this kind of migration. The additional funds available to the governments in the poor provinces

[3] For a longer discussion of Buchanan's model and his own comments on it during the Montreal conference where a first draft of this paper was presented, see Crowley, Holle and Kelly-Gagnon (2001), Watson (2001) and Kappler (2001)

allow the delivery of the same level of government services as exist in the rest of the country. This equality of services removes the incentives for non-economic migration between provinces.

Professor Buchanan's analysis is logically rigorous and was written as his doctoral dissertation at the University of Chicago in the 1960s. As he said in a recent speech and interview, his own development as an economist has made him aware of the fact that this analysis neglects the political and public choice consequences of government transfers. In particular, money made available to politicians through these transfers are subjected to lobbying by special interest groups. The funds end up being spent on lobby groups assuring the reelection of the politicians rather than on the kind of government services needed to prevent non-economic migration.

Evidence on this political and public choice process has been analyzed and publicized by professional economists working at the Atlantic Institute for Market Studies. In particular, the Institute's Brian Lee Crowley has published several papers in the media and has made them available at the institute's website.[4] Fred McMahon[5] has written two books detailing the same issues. His books have been recognized through awards for excellence granted by an association of conservative think tanks in North America.

One of the most important moral hazard effects takes the form of delayed natural resource development in Newfoundland-Labrador. As is well known, very large, economic deposits of Nickel have been discovered at Voisey's Bay. The Premier of Newfoundland, Brian Tobin, did not allow this development to proceed unless the developing company built a large smelting facility in the province.

The company refused to develop this facility because its location made it non-economic, given the world prices for nickel and the availability of superior alternative sites. Tobin insisted on his demands for two main reasons. First, the way in which the size of the transfer payments from Ottawa are calculated, for every dollar of resource revenues obtained by the government, the federal government reduces its payments by 70 to 90 cents. Second, workers constructing the facility at Voisey's Bay will be employed and pay taxes to the provincial government. Once the construction period will be completed, the redundant workers will be eligible for unemployment insurance benefits and bring substantial flows of net funds into the province.

Tom Courchene (1998) and Fred McMahon have pointed out other important moral hazard effects of the equalization payments. The existence of the transfers reduces the impact of socially and economically inefficient policies on the provinces' economies and its taxpayers. For example, the public does not care, or actively encourages its politicians, to pass excessively high minimum wages and build wasteful public facilities. This wasteful spending is paid for essentially with tax money raised elsewhere.

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[4] See Crowley (2000a), (2000b) and (2001).

[5] See McMahon (2000a) and (2000b).

Brian Lee Crowley, Peter Holle and Michel Kelly-Gagnon (2001) have pointed out that the easy transfer money has induced Newfoundland to adopt the best pupil/teacher ratio in Canada, a policy choice unlikely to have been made by a relatively poor province paying the full cost out of its own taxpayers' funds. The authors also question whether Nova Scotians would have chosen to keep operating a steel mill losing huge amounts of money for as long as they did if the money would have come out of their own pockets. The authors illustrate the point made by Buchanan by identifying powerful bureaucratic interests, public sector unions, teachers and others, whose special interest group lobbying is more successful because the funds they demand come from the federal government, not local taxpayers.

SECTION 5
THE COST OF MORAL HAZARD BEHAVIOR

It is tempting to argue that money transferred from the employed to the unemployed is not an economic waste but simply a desirable redistribution of income, which makes Canada a better and more civilized place to live. Similarly, the money paid by citizens of rich provinces to the governments of the poor provinces do not use up resources but simply create a more equal distribution of income in Canada.

This favorable view about the merit of social insurance spending has undergone some significant change in public attitudes in recent times. First, there is the concept of optimum taxation, which shows theoretically and empirically that taxation results in large economic waste as the taxed engage in policies designed to avoid the taxes. It has been estimated, for example, that a dollar raised through a tax on corporate profits leads to a loss of output of $1.55.[6] In other words, the money raised to pay for unemployment insurance benefits and equalization payments costs results in outright losses of output much in excess of the funds transferred between payers and recipients.

The moral hazard behavior outlined above shows that the spending of the money itself results in further losses. The unemployed workers are unproductive. Capital used in seasonal industries expanded excessively has better uses elsewhere. The efficiency of the entire fishing industry in the Atlantic Provinces is damaged by the use of none-economic practices, which a fully private industry would never engage in.

The workers employed in the public service and private firms subsidized by public funds demand and receive higher wages than they would if either the industries were totally private or taxpayers had to pay them out of their own funds. Unfortunately, these higher wage payments are not just income transfers; they have other important economic implications. The high wages discourage new firms to establish themselves as they are forced to pay wages in excess of the workers' productivity or cost in other parts of Canada. Workers lose the opportunity to start at low wages, learn by doing and get onto the normal career path enjoyed by most workers.

One of the most serious problems associated with social insurance programs is that they create dependency, or the welfare trap. These tragic conditions arise because all public insurance programs require that eligibility and the quantity of money paid to recipients decrease as they earn more in the private

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[6] See Grubel (2000), p. 60 for a table giving values for other taxes and providing the source of the data (OECD and Department of Finance)

sector. In all cases, there is a level of earnings at which benefits cease altogether. These requirements are necessary because otherwise the demand for benefits would rise to unsustainable levels as more and more normally working people insist on getting public benefits just like their neighbors. For this reason, not even the most ideologically committed governments in Western countries have benefits that are not diminished or terminated as beneficiaries return to normal work and earnings.

As a result of these regulations, the recipients of social insurance benefits face very harsh incentives, which are often illustrated in the context of welfare benefits. Thus, a welfare recipient can earn only \$100 a week without losing any public benefits. Sums above this amount lead to the clawback of benefits at an increasing rate. In addition, at some level of income, the recipient may have to pay taxes and typically loses other government benefits like medical care, child-care subsidies and public housing. It is easy to see that under these conditions, it is possible that an increased earning of \$1,000 results in a *net reduction* in total income, cash and in kind. Welfare recipients facing these problems lose their incentives to seek and accept work. As a result, their personal and professional skills deteriorate and future employment opportunities shrink even further.

People in these conditions are considered to being caught in the “welfare trap”. This trap is a very serious personal tragedy, often destroying what otherwise might have been productive and satisfying lives. No government in the world has been able to design welfare programs that can avoid the existence of welfare traps, even if some are less severe than others.

The equalization payments received by the Atlantic Provinces have created the equivalent of a welfare trap for its government, as Crowley points out. If it allows the development of Voisey’s Bay, the future expected net revenues from the deposits shrinks by around 80 percent. It should not come as a surprise to anyone that the government of Newfoundland holds out for better conditions. It believes that it has nothing to lose.

But it is losing, just like the person trapped in welfare. Potential development is stopped. Skilled workers are unemployed and lose their productivity or emigrate. Tax revenues are lost and with it opportunities for public investment or tax reductions that would spur private investment.

Fred McMahon has assembled strong evidence suggesting that these economic costs of moral hazard behavior have been substantial. He shows that the gap in per capita income between the Atlantic Provinces and Ontario had been closing since the end of the Second World War, in a pattern of convergence of incomes between the center and outlying regions found in many industrial countries. This convergence pattern ceased around the time the government of Canada increased the generosity of its unemployment insurance benefits and the transfers for regional income equalization was introduced.

Section 6
What should be Done?

Canada's economic performance during the last two decades of the 20th century has been much below that of the United States and several other prosperous countries. The performance of the Atlantic Provinces has been worse than that of the country as a whole. This poor Canadian record of economic performance undoubtedly has many causes, some are undoubtedly external, but many are due to domestic policies that have stifled incentives to work, invest and take risks.

This study suggests that one of the causes of this relatively poor performance has been the generosity of social insurance programs going to people, like unemployment insurance and going to provincial governments, like regional equalization payments.

It will not be easy to reverse these generous policies. There are many who believe that the cost of these programs and the accompanying poorer economic performance are worth the price of living in a more caring and egalitarian society. The programs have created powerful interest groups whose well being depends on the continuation, if not growth of these programs. Public choice theory explains why it is so difficult to overcome opposition from these interest groups and their political allies.

However, the analysis in this paper and in other studies cited shows that the costs of these policies are significant in economic terms. They are also detrimental to the people of a region, which is caught in the welfare trap that so diminishes the dignity and prospects of its victims.

For the reasons outlined, it would be very much in the longer run interest of the people of the Atlantic Provinces if the federal government used more of the principles used in the private insurance industry to limit moral hazard. The benefits of the unemployment insurance system can be made less generous and less accessible to repeat and habitual users, to whom it has become a way of life. The introduction of experience rating would do much to achieve this goal in a process relatively free from interest group lobbying. At the same time would increase the system's efficiency in the rest of Canada.

The transfer payments from the federal to the provincial government need a complete overhaul, possibly with the aim of phasing them out. The most important overhaul suggested by Crowley is to remove the incentive to hoard natural resources, and thus exclude them from the tax base which determines the size of the transfers. The federal government can also redesign the formula for the allocation of transfers so that they fund deliberately the closing of only a smaller gap in government services than is aimed for under present conditions.

If Canada wants to maximize the income of all, it must not prevent efficiency increasing adjustment from taking place. The present system says in essence “You people with low incomes in the Atlantic Provinces need not move elsewhere or do much to improve your lot because, as long as you stay where you are and remain poor, we will make sure you have a decent income.”

None of us offer equivalent incentives to our children as they grow up, even if we have enough income or wealth to finance such promises. We do not want them to become dependent and neglect the development of their skills. Our goal rather, is to see them grow into self-respecting citizens, standing on their own feet. Even though they might ask us to shelter them from the hard life, we exercise tough love because we know what is best for them in the longer run.

It is time for Canada to treat the Atlantic Provinces with some tough love, develop a definite plan that leads to the elimination of all subsidies and transfers in 10 or 20 years. Such a policy may well mean that the region will lose more people to emigration. But these emigrants will improve their own lot and the future of their children. Those left behind will find their incomes increasing as fewer are working a given stock of natural resources and capital. From all the evidence, these emigrants will be very successful in other parts of Canada and the world. Simple economic principles make it certain that the benefits to those remaining behind will be strong and lasting.

But I am not hopeful that these ideas will be translated into policy because interest groups and the political process have too much power. Elections are always around the corner for the politicians. In the long run, they are long retired or dead. And surely no one will erect a statue to a leader who slowed the gravy train from Ottawa.

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