True Security:

Rethinking American Social Insurance

ILLUSTRATIONS BY
TIMOTHY COOK

The big social-spending programs for the elderly have become the primary focus of Federal budget politics. Last year, Democrats rejected altogether-sensible suggestions for limiting the growth of Medicare in hope, of making political hay in the next election. Meanwhile, Republicans have joined in the demagoguery, attempting to pit younger voters, who presumably favor tax cuts, against baby boomers, who are worried that current budget surpluses will be spent before they get their turn at the Social Security trough.

Policy wonks see chances here to marshal public anxieties in the name of reform. Accordingly, the public-policy establishment is bubbling with plans to make over individual programs. But Graetz and Mashaw, veteran public-policy analysts at the Yale Law School, are coming from a very different place. Too much effort, they say, has been invested in redesigning individual programs, and too little on rethinking the safety net as a whole.

Their book is an incredibly ambitious consideration of social insurance from first principles. We offer a sampling from early chapters that lay the groundwork. Those interested in Graetz' and Mashaw's grand conception will have to spend $16.95 for the paperback, due out in November. — *Peter Passell*

BY MICHAEL J. GRAETZ & JERRY L. MASHAW

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Recall our childhood friends, the Three Little Pigs, children sent out by their mothers to seek their fortunes. Each meets a man who, simply for their asking, offers them building materials for a house – the first, straw; the second, twigs; and the third, bricks. Potential calamity soon comes calling in the form of a large-lunged wolf bent on huffing and puffing their newly built houses to the ground and eating the pigs. The wolf easily blows down the straw house, and has only a bit more trouble with the one built of sticks. But the third pig, who had made his house wind-proof by building it out of bricks, ultimately triumphs by enticing the wolf down his chimney into a pot of boiling water.

In the way that we tell this story to our children and grandchildren – a way no doubt influenced by an upbeat Disney cartoon version – the practical third pig not only saves himself but also the provides refuge for his two siblings, who have managed to escape the wolf.

The original version is harsher. The little pigs left home not because "the time had come to go," but rather because their mother "had not enough to keep them." The wolf devours the first two little pigs, and in a macabre but perfectly retributive finale, the third pig lives happily ever after only after eating the boiled wolf for dinner.

Virtually nothing is said about the first two pigs – but wolves, it turns out, are more than a residential threat. The third pig goes apple picking and to a fair, with the wolf following; this pig ultimately escapes only by rolling home in a butter churn fortuitously found nearby.

As with all fairy tales, there is a morality lesson here. But there are many interpretations, as well as many versions. One interpreter is particularly sympathetic to the second pig; he regards him as having the sad luck to be "alone, small in a world filled with predators and not especially bright or industrious, just a Joe Sixpack adrift on a sea of fate without a paddle or enough sense to keep afloat." A modern, politically correct version has the wolf die from a heart attack from all his huffing and puffing coupled with a lifetime of eating food high in cholesterol.

Walt Disney, who told the most influential American version, used the story as a paean to cleverness, hard work and personal responsibility. Disney depicted the first two pigs as foolish and lazy, wanting only to sing and play all day. He even named them Fiddler and Fifer, in sharp contrast to their hardworking brother, Practical. But in Roald Dahl's version, the third pig is too clever by half and ends up as a pigskin purse for Little Red Riding Hood. Having a brick house is good wolf protection. Yet building a brick house may take too long, leaving the industrious (but too fastidious) builder without shelter when the wolf happens by.

The authors view these tales as a complex meditation on the question of true security, and as a strong suggestion that no single strategy for achieving it is foolproof. Pigs who seek opportunity in the world can come to grief, but stay-at-homes may find their resources are too meager to provide for their families. We all sometimes benefit from the generosity

of strangers, but how much their kindness adds to our security depends on what we do with what we are given. When planning our lives to maximize our own security, the long view may be prudent – or a formula for disaster. Individual responsibility is crucial, but it will not guard us against all hazards.

THE HOUSE THAT ROOSEVELT BUILT

When the Disney cartoon was released in 1933, the Big Bad Wolf was widely taken as a metaphor for the Depression. The finale, with all three pigs merrily singing "Who's Afraid of the Big Bad Wolf," was viewed as an appropriate and uplifting response to those hard times – a national rallying cry.

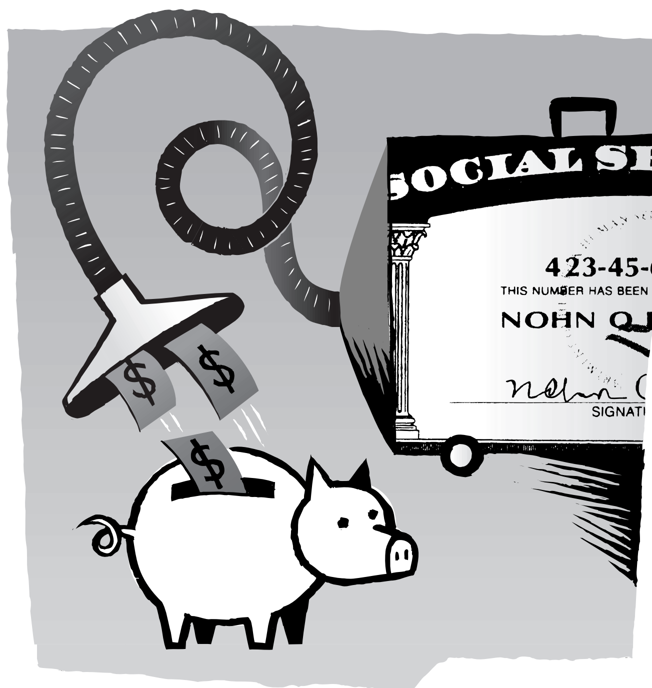
While the Disney cartoon was providing homiletic encouragement to a frightened populace, Franklin Roosevelt was trying to shape his own response to the Depression. He had no intention of rewarding laziness or inventing incentives for indolence. But he recognized that in modern America, true family security was both an individual and societal responsibility. Roosevelt's Committee on Economic Security produced a comprehensive blueprint for social insurance in the United States – a program that was designed to keep at bay the wolves of cyclical and structural unemployment, along with those that took the form of the absence, premature death, illness, disability or old age of the family's breadwinner.

Congress failed to deliver the full brick house Roosevelt desired, but he did get the Social Security Act. That law provided immediate aid to the elderly poor and to poor dependent children and their adult caregivers. It also began the program of retirement pensions that is now virtually synonymous with Social Security.

Congress amended Social Security in 1939, adding spousal benefits for retirees, and survivors' benefits for the dependents of contributors. Simultaneously, a variety of jobs programs were put in place, of which the Works Progress Administration is the best known. Disability insurance was added in the late 1950's. Health coverage for the elderly (Medicare) and the poor (Medicaid) were

enacted in the 1960's. In 1970 the Supplemental Security Income program replaced earlier Federal support for state aid to the poor who are blind, aged or disabled.

Anybody's list of the most successful laws ever enacted by Congress surely would include both Social Security and Medicare. For decades, Social Security has been known as the third rail of American politics – meaning that any politician who tries to change it courts grave political danger. Medicaid, which provides health insurance for the poor, enjoys almost as much support – as do unemployment and disability insurance. Together these programs provide crucial, but incomplete, social insurance against risks to family economic security.



CONTEMPORARY CONCERNS

Today the edifice of social insurance begun in the 1930's faces huffing and puffing from many critics, who are prompted principally by a vision of future fiscal difficulties. The aging of the baby-boomers, along with increasing life expectancy, means that both Social Security and Medicare must increase their funding and/or reduce benefits. Medicaid had become the 800-pound gorilla of state budget politics, putting financial stress on the states and crowding out opportunities for program innovation. "Entitlement" is rapidly becoming a political epithet, notwithstanding the popularity of these programs and the impossibility of assuring financial security without a legally enforceable promise to pay.

Influential economists have argued that, despite their popularity, social insurance programs are costly to the nation's economy. They believe that Social Security and Medicare contribute to the nation's low rate of savings and are thus a drag on economic growth. Whatever the truth of that charge, the growth of payroll taxes to finance Social Security and Medicare has been stunning.

Middle-income workers now routinely pay more in wage taxes than income taxes, and many argue that workers are not getting their money's worth. By contrast, others complain that cutbacks in programs for the poor have destroyed the safety net. To listen to the critics, then, our social insurance protections today have become simultaneously inadequate and unaffordable.

Ideological opponents delight in characterizing Social Security as a Ponzi scheme, while knowing full well that the government's power to meet its obligations by raising taxes makes such a label absurd. Behind the hyper-

bole, however, lie genuine problems and a real danger that the political support for social insurance could come unglued. America's young are said to doubt they will ever see their promised retirement benefits. And polls do reveal unprecedented levels of skepticism. At the same time, upper-income citizens are learning that they could achieve far greater financial returns from private investments than from Social Security. This threatens a political revolt of the haves like those that spurred popular state anti-tax measures such as Proposition 13 in California.

Fiscal and political stresses on social insurance programs are not unique to America. In Europe and Japan, the populations are older and aging faster that ours. And because of the greater ambitions of their social insurance, they already impose much higher payroll taxes than we do, leaving them much less room to maneuver. Hence both here and abroad a political battle is looming over the future shape of social insurance.

But the debate is seldom described in those terms. Discussions are instead crisis-driven and linked to the immediate problems of one program or another. Rather than asking how much of what forms of social insurance Americans need and can afford, policy makers lurch from crisis to crisis. Fearing the political fallout from reshaping popular policies, they put this or that program's future into the hands of an advisory board here, a bipartisan commission there.

These politically insulated, ad hoc groups often devise temporary fixes for the fiscal troubles in one or another program and then disappear until a crisis looms somewhere else. This process cannot address fundamental issues of program goals or the means of reaching them. We seem never to have a national conversation about social insurance as a whole.

Indeed, while individual social insurance programs often engage our attention, "social insurance" is not a familiar term to most Americans. We are inclined to talk about Social Security or Medicare, about workers' compensation or unemployment compensation, about welfare or the Earned Income Tax Credit. Public concern and debate are limited to particular programs – and are usually occasioned by claims of scandal or projections of fiscal calamity.

Social Security and Medicare contribute to the nation's low rate of savings.

Policy wonks do write jargon-filled essays about financing entitlements and about choices between universal and means-tested programs. But these limited exceptions prove the rule: Policy debates about social insurance are fragmented and seldom engage the fundamental question of how to provide Americans with effective and affordable protection.

This incomplete approach is a big mistake. We would think it foolish for a private household to debate whether it could afford a new winter coat for Grandma without considering whether the children need new shoes or whether the furnace is about to expire. Nor would it make much sense for a family to fret about the emptiness of Dad's pockets when Mom's wallet was stuffed with cash. But in the world of social insurance, we often fall into that sort of thinking.

For example, many have called attention to the nation's shocking childhood poverty statistics: One in four American children under the age of 6 lives in poverty. But this depressing

tale is seldom connected to other stories that help explain it – the irrelevance of Social Security survivors' insurance to the single-, divorced- and never-married-parent households that account for a substantial percentage of childhood poverty; the increasing numbers of low-wage workers cut off from employer-based health benefits; the precipitous decline in the coverage of unemployment insurance; the always-spotty public and private protection against loss of earnings from illness and disability.

More examples could be given, but the point is clear enough: It has been too long since Americans have considered broadly what sort of social insurance they want and how much they are willing to buy. There is a critical need to expand the conversation to ask how existing programs relate to the overarching purpose of cushioning economic risks in a capitalist society. What combination of individual and collective action will produce the true security that we all want?

THE COMPLEX WORLD OF SOCIAL INSURANCE

To pursue those questions, we must do more than look at connections among social insurance programs. We must distinguish between the goals of social insurance and the programs that promote income security. For much that is social insurance in the panoply of American income security programs is hardly recognized as such.

The popularity and success of big programs like Social Security and Medicare induce a sort of historical amnesia. Unless a program is structured like one of them, with wage tax contributions, trust funds, specific benefit packages, Federal administration and all the rest, we do not think of it as social insurance.

We forget that, like the Three Little Pigs, the 1930's architects of America's income protection programs used the materials that came to hand. They used general resources to deal with the most pressing problems of poverty in old age and to rescue the states' collapsing mothers'-pension programs. They engaged in massive public job creation, and they stimulated state unemployment insurance coverage by an almost comical Federal tax scheme that imposed a tax that was never meant to be collected.

In later years, private pension and health insurance was induced by massive tax subsidies to employment-based plans and to individual retirement savings. Disability coverage was begun through a grant-in-aid program that was partially financed and wholly administered by the states and limited to the needy.

But that program eventually became a supplement to the Federal disability insurance program put in place in the mid-1950's. A decade later, Medicare for the elderly was added.

But even Medicare flouts the conventional social insurance model. Hospital payments are financed by a payroll tax, but physicians' services are covered by voluntary private premiums that are subsidized by a massive infusion of Government funds. Health care coverage and pension savings for active workers have been subsidized by "tax expenditures" – that is, the failure to tax earnings received in the form of health insurance coverage or employer contributions to a pension plan. And income support for poor working families has also migrated to the tax code in the form of the Earned Income Tax Credit.

What combination of individual and collective action will produce the true security that we all want?

We ignore this history of multiple programs and heterogeneous techniques at our peril. For by failing to recognize and assess the full range of social insurance coverage now in place, we miss opportunities for making the arrangements more effective. Similarly, some of what we do recognize as social insurance could be abandoned or radically reshaped while maintaining – indeed, improving – current commitments. Conflating the defense of Social Security or Medicare with the defense of the broad idea of social insurance limits our possibilities.

THE FOUNDATIONS OF SOCIAL INSURANCE

Think about three pigs who are not simply fungible porkers, but who have instead lived complex and different lives. Bob Pig, for example, has a game leg and never did very well in school. Bob's participation in the labor force has been sporadic, and his best years have been spent at a large package-delivery company where he has a 30-hour-a-week job with no benefits. Bob has built his house from straw because straw was the only building material he could afford.

Betsy Pig did better in school and landed a pretty good job with an accounting firm. Betsy, however, had two kids who took her out of the labor market for a while. On her return, she needed a job that provided flexible hours, good benefits and a dependable paycheck. She managed to work this out with her employer and settled into a job with a steady, but unremarkable wage. A stick house, Betsy could afford; bricks were out of the question.

Bartholomew pig had well-to-do parents, went to Harvard Business School, became an investment banker and never married. Bartholomew could afford a brick house with ease – perhaps in a gated community.

THE NATURAL EVOLUTION OF PRIVATE INSURANCE

In this revisionist story of the Three Little Pigs, they must cope in varying environments and have radically different backgrounds. But each does face a threat from wolves and would be well advised to carry some insurance. How can they achieve a reasonable level of security? Will private markets permit them to do it on terms they will find acceptable?

A number of factors limit the private markets' ability to provide reliable and affordable wolf insurance. The threat from huffing and puffing lobos may be so difficult to predict that insurance company actuaries cannot make reliable estimates about exposure, even for large groups. Or, risks may co-vary – that is, rather than Bob's risk being independent of Betsy's and Bartholomew's, wolves may show up in packs that threaten all policyholders at once. If commitments to cover these risks cannot be diversified, private insurance may be impractical.

A pig who has insurance may change her behavior to increase the risk.

If pigs have much better information about their risks of wolf depredation than do insurance companies, the market will be characterized by an insurance demon called adverse selection – the tendency of those at high risk to be over-represented in the insurance pool. If insurance companies charge premiums based on average risks, they will go broke because most of their clients will in fact be porkers at high risk. And if they assume that all buyers are in the high-risk category, their premiums will be very steep – pricing the moderate-to-low-risk pigs, and perhaps many high-risk pigs as well, out of the market.

Finally, many insurance markets are infected by high moral hazard. A pig who has insurance may change her behavior to increase the risk. Thus, with good wolf insurance, Betsy might settle for a straw house, and the well-insured pig community might be inclined to disband the wolf patrol. Moral hazard is almost always present to some degree, but in certain forms of insurance it is so prevalent that private contracts can't be written.

Uncertainty, covariance of risks, adverse selection and moral hazard are the common causes of insurance market failure. The effects of such failure vary from the absence of insurance for certain kinds of risks to high prices and limited coverage for others. Private insurers have developed clever strategies for combating market failure, but such strategies do not always work.

Moreover, the mere existence of insurance does not mean that it will be available on terms or at prices that are satisfactory. The natural dynamic of private insurance is to segment risks in ways that society may well find unattractive. A private insurer cannot insure Bob, Betsy and Bartholomew at the same rate. If a company is so foolish as to try, it will find competitors offering both Bartholomew and Betsy lower rates because they pose lower risks. (Betsy's house was once blown down, but not every wolf will have lungs that strong.)

It is the nature of private insurance to segment the market into homogeneous risks. Indeed, private insurers compete with each other as much by their creativity in segmenting markets and charging differential rates (sometimes called underwriting) as by their service and other attributes of the insurance package.

For many purposes this market segmentation is efficient and desirable. To the extent that high insurance premiums force changes in behavior, such as making horrible drivers drive less or not at all, society is better off. But there is a wide range of circumstances in which mandatory insurance, effectively subsidizing bad risks with the premiums of good risks, also make perfect sense. In particular,

when the risk to be insured is being out of the labor force, voluntary private coverage has proved spotty and incomplete.

THE MANY REASONS FOR SOCIAL INSURANCE

Market Failure

If the wolf-insurance market is characterized by one or more of the features that cause private insurance markets to fail, but the pig community still wants wolf insurance, it may find that public action can remedy the market failure. Governments have the power to tax and to regulate; private insurance companies do not. Therein lies a world of difference.

In the case of highly uncertain risks, the government can pay compensation when the risks materialize and can impose taxes to pay the costs after they are known. This sort of after-the-fact assessment was the standard technique of the early English burial societies and remains a hallmark of the Lloyd's of London approach to reinsurance. But private attempts to use assessments in group insurance have generally failed.

The taxing (and borrowing) power of government is also critical to solving the problem of covering large risks. A widespread and prolonged wolf infestation can wipe out private insurers; governments are more permanent. They can borrow to meet current emergencies on the credible commitment to tax later to retire their debts. By contrast, private insurers cannot conscript new investors or new policyholders.

Regulation can combat adverse selection and moral hazard. Indeed, in the face of a government mandate that everyone be insured, adverse selection simply disappears. Moral hazard is not so easily solved, even with the power of government – but that power sometimes helps. For example, while the pig community may not wish to ban straw houses when providing wolf insurance, it can limit its exposure to insurance claims by requiring wolf alarms, zoning high-risk dwellings out of forests and increasing the effectiveness of the wolf police.

Market failure provides the fundamental rationale for collective action to tame important community risks. But social insurance also emerges where some forms of private insurance would be available. Here the need is not explained by the market failure, but by the wish to pursue broader social goals.

Solidarity

A society made up of Bob, Betsy and Bartholomew might well decide out of simple moral sentiment to treat wolf insurance as a collective good. As pigs facing ever-present wolf threats, they may see themselves as all in the same boat. It may be unacceptable for Bob, who needs wolf insurance most and can afford it least, to go uncovered.

This desire to treat everyone alike, although they are demonstrably different, is sometimes explained by a social contract metaphor. Think of the pigs as creating the contract about how their society is to be organized before their lives begin. Given little information about where they would start out or end up in the economic order, it may seem in everyone's interest to agree to the collective provision of affordable wolf insurance. And, of course, much of the information they will have in the future, such as Bob's game leg and Bartholomew's plentiful family resources, may seem a morally arbitrary basis upon which to decide who should be left to their own devices.

Obligation

Pigs with lower rates on their private wolf insurance might also feel that they have some

premiums Bob and Betsy face by increasing their risks, they all may feel that he has some special obligation to contribute to their protection.

Self-Regard

Bartholomew may also find that it is in his own interest to help Bob and Betsy buy insurance. After all, in Walt Disney's story of the Three Little Pigs, the pig with the brick house ended up with two long-term guests. Bartholomew may well believe that he will be unable to refuse Bob and Betsy's request for refuge. And he may prefer to contribute to their insurance premiums so that they can live independently, rather than risk having them camp out in his guest rooms.

Too much focus on security can stifle productivity.

obligation to assist their neighbors because their own behavior may actually increase the risks faced by others. Sensible wolves will not waste their time huffing and puffing at Bartholomew's brick house. They will move on to Betsy's, or better yet, Bob's, as likely candidates for producing a porcine meal. Bartholomew's choice of building material is thus not irrelevant to Bob or Betsy's risks.

In addition, the institutions of private property and free markets that produce Bartholomew's wealth – and thereby give him the freedom to build a brick house – also affect Betsy and Bob's situations. If Bartholomew's actions, and the institutions that produce his good fortune, increase the

Paternalism

This self-regarding motivation is closely connected to various forms of paternalism. Pigs at low risk may think those at higher risk should make some provision for a time when the wolf is at the door. But given the latter's low incomes and high private insurance rates, they are unlikely to do so. And given the natural piggy tendency not to value things they can't afford, Bob and Betsy are likely to underestimate the risk of carnivorous windbags as well. Even if they could afford some insurance, they might not buy any.

So if Bartholomew wants the Bob and Betsy Pigs of the world to have insurance and to make a contribution toward their own protection, his best recourse may be to participate in a community-wide social insurance pool. With social insurance, Bob and Betsy will be able to get back on their feet, and they

will make some contribution to their own protection. Without it, Bartholomew must witness his fellows' suffering and perhaps provide them with a humiliating handout. Or he may find himself stuck with tax bills for a public shelter for pigs whose houses have blown away.

Social Harmony and Productivity

Finally, the availability of insurance to protect against known risks may be an important determinant of the stability and productivity of society. Everybody is better off if Bob and Betsy devote their talents to tasks other than worrying about the wolves, or engaging in armed self-defense that puts others at risk. Moreover, at some level of insecurity, Bob and Betsy will simply be unwilling to support a system that makes Bartholomew fat, happy and safe while they are lean surly, and anxious.

In short, a guarantee of insurance against certain risks may not only free up human resources, it may make it possible to avoid various sorts of regulation – or even more fundamental changes in a society's political or economic organization – that stifle social productivity in general.

It is frequently said that social insurance began as capitalism's answer to Karl Marx. Marx famously believed that the insecurity characteristic of the capitalist means of production – its tendency to drive wage to subsistence levels, the inevitability of workers' losses of income through industrial accidents, unemployment and redundancy – would render capitalist society unstable and unsustainable. Marx thought workers, in the end, would seize the means of production in order to achieve reasonable levels of economic security.

But, as the conventional story goes, Germany's "Iron Chancellor," Otto von Bismarck, was too shrewd. By instituting workers' compensation, and then additional programs of social insurance and labor-market protection, Bismarck and his counterparts in other post-1848 European societies interrupted their capitalist economies' march off the precipice.

With the addition of protection against illness, old age, injury and unemployment, a regulated but relatively free market in labor became bearable for workers. The upside of the market system looked far more promising, once a floor on the downside had been constructed. Thus, Chancellor Bismarck did not pioneer social insurance because he was a softy. Rather, he recognized that in a very real sense the true security of the nation depended upon adequate social insurance for families.

We view all of these bases for social insurance as perfectly sensible – at least in principle. To be sure, paternalism can get out of hand. And social solidarity may be a treacherous foundation for long-term commitments in a changing world: Too much focus on security can stifle productivity, thereby undermining market capitalism rather than sustaining it.

It's worth remembering, too, that market failure justifies state intervention only if government failure is not the predictable alternative. But the possibility of excess should not blind us to the collective good sense of social insurance. Our contention here is just this: the many good reasons for social insurance overdetermine its existence. The primacy of family responsibility for economic well-being notwithstanding, the sensible debate in any society is be about how and how much social insurance to provide, not whether to have any.

Given the multiple motivations for particular security arrangements, we will not spend much energy attempting to unearth the true

bases of existing programs. For example, we embrace the American commitment to providing social insurance against the risk of impoverishment in old age. But we also believe that social insurance has a larger role here. Youth-poverty risks parallel the risks of destitution in old age. We propose, therefore, a much more active role for social insurance in protecting children's income security.

Nor do we shrink from requiring universal participation. Volunteerism – even highly subsidized volunteerism – will not produce true security. Moreover, putting the young and the old or the rich and the poor in separate insurance pools, as private marketers would, often limits coverage to low-risk populations. True security for all Americans demands that most social insurance programs treat everyone as sharing the same risk characteristics. This means that programs will skew benefits toward those who are unable to pay higher premiums.

The many good reasons for social insurance overdetermine its existence.

Rugged individualism and social insurance are not comfortable bedfellows, and we will not pretend that struggles between liberty and security, or individual and collective responsibility, are not at stake. Our task, therefore, is to convince you that our vision of social insurance puts these competing values into an appropriate balance. No society can have the cake of true security and eat from the full larder of pure individual responsibility.

Following Bismarck, it is also our view that too much is made of this conflict between the demands of the market and the need for security. High levels of economic insecurity do not make people free. And voters will not long support an economic system that relies on a devil-take-the-hindmost approach to those who lose out in the free-for-all of the labor market.

THE COMPLEX AND CONTESTED WORLD OF SOCIAL INSURANCE

We cannot charge ahead to consider possible social insurance arrangements before pausing to examine some more basic questions. What kinds of risks require public rather than private insurance? And what sorts of public action fit the general framework of social insurance?

Life is full of risks. Which are important enough to justify public concern? Where do we draw the line between private and public responsibility?

Viewed historically, the answers are not too difficult to provide. Social insurance in the United States is largely a product of the Great Depression. Before that, economic security was mostly a family responsibility. Family members who became too old to work were supposed to be cared for by the next generation; the pastoral image was grandpa at the fireside waiting to greet his hard-working children and grandchildren as they returned from the fields. Those who became disabled were cared for within the family. Private philanthropy provided assistance in a pinch.

Few private employers took responsibility for the economic security of their workers until workers' compensation legislation made them responsible for injuries on the job. The employer-based pension and health insurance systems that are commonplace today had not yet come into being before the Depression.

Government generally took responsibility only for its military and civilian employees. A number of states did provide cash assistance for widows and orphans. And a few large employers had introduced pension benefits before the 1930's. But anyone else without an income was supported by relatives or relegated to the metaphoric poorhouse.

Urbanization in late 19th-century America radically changed the reality of family-based security arrangements. But political action was largely postponed until the Depression, when nearly everyone's family income was at risk and no entity other than the national government had the capacity to respond.

President Roosevelt's Committee on Economic Security proposed a comprehensive social insurance to protect against life's major threats to family income. But that scheme was never implemented. Indeed, once history is left behind, getting a handle on the domain of social insurance is not easy. Social insurance has no essence. To define social insurance is thus to argue for a particular conception of it.

THE SOCIAL INSURANCE CONTRACT

Private insurance is usually thought of as a contract to pool common risks so that random economic losses will be experienced as small subtractions from all insured persons' wealth rather than as calamities for a few. Social insurance also pools risks. But social insurance is dependent on government action, directed at a particular class of risks and designed to pursue societal purposes that could not or would not be achieved through contracting in private markets.

Social insurance is not merely a variation on private insurance. But private and social insurance must address some common questions: What risks or events will be insurable? What level of protection will be provided? Who will be covered? How is the coverage to be paid for? And how can insurance protection be structured to limit behavioral adaptations that increase costs, or undermine other goals, or both?

RISKS COVERED BY THE SOCIAL INSURANCE CONTRACT

In a market economy, income is obtained in two ways: by providing labor, and by supplying capital. Most who have capital income have it because of savings from labor income. Thus, the distinctive risk that social insurance must address is the risk of inadequate labor income.

This risk emerges in many forms and in varying intensities. For some, loss of labor income may be complete and permanent. Others may lose income only temporarily, from unemployment or less-severe illnesses. For yet others, the risk occurs as part of the normal life cycle: Both youth and old age exclude one from the labor market.

A LIFE-CYCLE PERSPECTIVE ON RISKS

Indeed, risks to labor income change so substantially over a lifetime that most people view them as different in kind. Children are not expected to work. In early childhood they cannot work, and later they are often limited in the amount they are allowed to do. In childhood, therefore, the dominant threat to income security is the risk that one's parents have insufficient income. Hence, we usually think of the child's risk not as the risk of lacking labor income, but simply of being poor.

During the working years, our concern shifts. Anxieties typically relate to loss of income from illness or accident, loss of a job because of economic dislocation or family responsibilities, or inadequate income because of persistent low wages.

When we consider retirement years, we

think in yet different terms. In some ways, retirement in old age resembles leaving the workforce through disability or unemployment. Declines in personal physical and mental capacities or changes in the skills the market demands surely explain much retirement behavior. And because this decline happens to everyone who lives long enough, the risk of old age is similar to the risk of youth. Some retirements, of course, seem voluntary – the purchase of leisure time with the fruits of prior work effort.

Whatever the cause, we expect that virtually everyone will experience periods out of the labor force – first as a child, then as an elderly adult. In the latter case, we often conceive of the risk to economic well being not as lost labor income, but as having inadequate savings to support us in old age. But to glimpse how similar this risk is to that of children, remember that in an earlier era we might well have characterized the risk in old age as the risk that our children would be unable to support us.

Social insurance provides quite well for older and retired workers.

Because these risks are thought of differently, they are addressed in different ways and by different programs. Moreover, there are practical reasons for structuring social insurance differently when responding to risks at different stages in the life cycle. Nevertheless, a fundamental unity of purpose lies behind this multiplicity of policy initiatives. Social insurance, operating through direct transfers, subsidies or regulation, alters the distributive consequences that labor markets and private insurance would otherwise produce.

RISKS AND CURRENT REALITIES

While generally successful, American social insurance is a mixed bag. Looking over the life cycle, social insurance provides quite well for older and retired workers, reasonably well for workers in their middle years – but, as the childhood poverty statistics suggest, very poorly for children.

Indeed, looking just at the important cash-transfer programs, American social insurance is dramatically skewed toward protecting the elderly. It provides a relatively small amount to children, modest supports for people aged 18 to 60, and substantial payments to retirees. Inattention to children is not justified by the nature of the risks they face or the capacities of families to provide for their own security.

TIME AND SOCIAL INSURANCE

The categories of risk we have identified here were clearly recognized by President Roosevelt's Committee on Economic Security. But the society and the economy have changed since the 1930's. It is worth reflecting for a moment on how changing circumstances alter both the market risks that families face and the social insurance techniques that might be used to combat those old risks. It also allows us to glimpse how the concept of an insurable event differs in social and private insurance.

THE INCREASE OF WOMEN IN THE LABOR FORCE

Labor-force participation of women has more than doubled since the 1930's. And this massive increase in numbers, along with the impact of their earnings on family economic security, has sharply altered thinking about social insurance.

Two-earner families have higher incomes and a more diversified "portfolio" of workers than do single-earner families. This can translate into greater capacity to save for retirement or to ameliorate other risks to family income, such as unemployment, illness or death of one wage earner. On the other hand, even though the average incomes of two-earner families have increased, the wages of individual workers have fallen. Full-time workers averaged $440 a week in 1996. Twenty-five years earlier, they had averaged $517 a week in 1996 dollars.

Median family income in the United States in 1996 was $42,300. Twenty-five years earlier it was $40,100 – just 5 percent less.

But the averages masks important differences among families – especially the large differences between one-parent and two-parent families. In 1995, median family income for married-couple families was about $48,000, compared to $31,000 for single-parent families headed by a male and $20,000 for single-parent families headed by a female. The very slow growth in family income in recent decades has not only reduced the insurance effect of having two workers when one must leave the work force, but also has put single-earner families (particularly divorced or never-married single parents) at greater risk.

The importance of the second earner's income to the well being of low- and middle-income families has sharply escalated the opportunity costs of bearing and rearing children. Among other things, the confluence of these trends has made the absence of adequate and affordable child care one of the crucial concerns of late 20th-century American workers – a need that 1930's social insurance planners could hardly have anticipated. They believed that Social Security's Survivor's Insurance, buttressed by Federally subsidized state programs for low-income dependent children, would meet the income security needs of America's children. They were wrong.

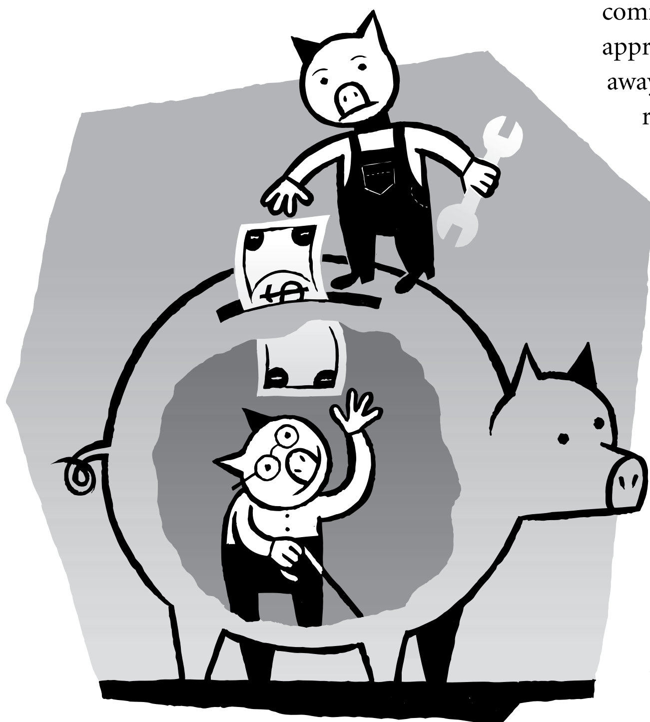
STAGNANT WAGES AND RISING RETURNS ON CAPITAL

Other changes of similar import are not difficult to identify. The flat wages resulting from shifts in the labor market have perhaps been reinforced by the globalization of production, and surely by the slump in unionized labor. Meanwhile, returns on capital have escalated.

Given these developments, conceiving of family security as turning exclusively on job holding and wage replacement makes ever less sense. Workers need some way to supplement low wages and to connect their long-term security to the performance of both labor and capital markets. Thus social insurance benefits financed solely by wage taxes and calibrated to prior earnings are not effective tools for coping with the risk and reward structures of the contemporary economy.

THE CHANGING NATURE OF EMPLOYMENT

In an era when one wage could support an entire family and workers could realistically expect to stay with a single employer for a decade or more, organizing social insurance around jobs made more sense that it does today. Yet voluntary, tax-subsidized, employment-based insurance has always failed to cover all workers, particularly those most in need of protection. Very few workers have spent their entire working lives with only one employer, and even fewer will do so in the years ahead.



DEMOGRAPHIC SHIFTS

Demography may not be destiny, but it sure sets the agenda. The baby boom, followed by the birth dearth, now influences everyone's thinking about how to cope with an aging population. Add increased longevity to the shift in fertility, and the promises made through Social Security retirement pensions and Medicare look very difficult to keep.

The ratio of the population over age 65 to the working population will increase dramatically beginning in the year 2010. The question is whether private financial markets can provide opportunities to maintain these commitments through alternative financing mechanisms – or, as some have argued, whether changing private financial markets offer reasons to abandon social insurance commitments in favor of radically different approaches. At a minimum, some movement away from pay-as-you-go financing (where retiree benefits are financed by taxes on current workers) toward more pre-funding (where workers put aside amounts to be vested and fund subsequent benefits) seems attractive.

But whatever the effects of changing demographics and family composition on social programs, their effects on families' capacities to provide intergenerational security have been enormous. True security once resided in having a large and closely linked family that could orchestrate transfers – not only from parents or grandparents to children when young, but also from children to their parents when old. Those transfers are still cru-

cially important, particularly for children. But existing family structures, themselves a response to changing economic demands and social aspirations, have altered our perceptions of how much we can reasonably rely on families.

As birth rates have fallen and divorce rates have risen, average family size has plummeted. Urbanization, industrialization and demands for workers' mobility have sharply reduced the percentage of the population living in extended families – a percentage that throughout American history has been much smaller than popular mythology made it out to be. But whatever the realities of the past, mom is now at work, and grandma is not home to care for the kiddies. More problematic yet, many children must look to the fragile capacities of the law to enforce the support obligations of absent parents.

PRICE INCREASES FOR NECESSITIES

The escalation of the cost of some perceived necessities also changes the way we should think about income security. Because of skyrocketing health care costs, Medicare faces enormous financial problems. Accelerating health care costs will burden the non-aged as well. The result is a combination of increased risk and steadily shrinking private insurance coverage.

The Committee on Economic Security recognized in 1935 that protection against health care expenses was important, but no action was taken. In 1965 Congress provided universal protection for the aged and the very poor by establishing Medicare and Medicaid, but left most working families with whatever protection was available through tax-subsidized, employer-based insurance. At century's close, the non-aged middle class remains the group most in need of relief from potentially devastating health care costs.

Nor is health care the only arena in which family incomes have failed to keep pace with costs. Child care and, for some groups, housing, are big problems. That explains the popularity of subsidies to help fund specific necessities that the social insurance pioneers of 1935 could scarcely have imagined. Current programs offer food stamps and Medicaid for low-income populations, along with a melange of housing and child-care subsidies for the rest of us. The time has come to recognize the common features in these social supports and to ask explicitly what subsidies are really necessary to produce true security for Americans.

WHO SHOULD BE COVERED BY SOCIAL INSURANCE?

Social insurance's aspiration to universalism most distinguishes it from private insurance. The goal of income security applies to the whole of society and across each citizen's whole life. What's more, social insurance is a contract across generations. Universalism in social insurance carries with it some important practical advantages. One is the saving that results from avoiding adverse selection, a dynamic we often see at work in private insurance.

Individual disability insurance, for example, is very expensive because those who purchase it often know things that they conceal from the insurer. Disability insurance becomes much more affordable if it is group insurance organized by a large employer. While buying the insurance is voluntary on the employer's part, once the group policy is purchased, coverage is usually mandatory. This guarantees the insurer that it is not getting a group of self-selected, high-risk individuals.

Universal participation can also limit moral hazard. For example, for many years

Australia had only a means-tested public pension system. The idea was that most Australians would provide for their own retirement, but some would be needy in old age and participate in the public program. As it turned out, though, most Australian workers found that the annuities they could buy with their private retirement savings provided little more than the means-tested program's benefit. The result was a pattern of spending down savings near retirement, so that the vast majority of retired Australians became eligible for the means-tested program.

The economic well-being of children continues to be left to their parents...a serious but remediable gap in social insurance coverage.

The aspiration to universalism in social insurance has significant implications for our critique of existing programs and our proposals for new ones. First, current reliance on employer-based protection has not produced universal coverage. And, as the changing nature of employment suggests, these arrangements are likely to produce even spottier coverage in the future. In a nutshell, we favor rearranging social insurance expenditures by removing the tax-based subsidies that now support employer-based income security and devoting those funds to mandatory, universal programs.

This need not mean that all employment-based income security arrangements disappear. We would leave the tax subsidies for pensions in place because private pensions supplement the mandatory public pension program (which we would bolster with an additional level of mandatory individual retirement savings). In addition, we favor a tax system friendly to private family savings. But as a general matter, we believe Americans have received a bad bargain from tax subsidies to employer-sponsored insurance.

We have similar objections to programs that leave the financing to the states. Given diverse state political cultures, one could imagine different social contracts in different jurisdictions. But this is generally an inefficient and inequitable approach in a national economy.

After all, most of the policy instruments that affect the performance of the economy are within the exclusive control of the Federal government. The states cannot regulate interstate or foreign commerce, modify the money supply or control migration. Yet all of these bear on the level of economic risk experienced by citizens. And unlike a private insurance company, states that create good social insurance cannot protect themselves from ruinous cost by preventing high-risk populations from moving in.

While the effect of welfare magnets may be oversold in the popular imagination, there clearly are some such effects between neighboring states. Moreover, perceptions matter: Fear of migration can fuel races to the bottom in which the safety net is unraveled in the name of improving a state's business climate.

In short, we believe that devolution of financial responsibility for social insurance is generally a bad idea. Our proposals, therefore, systematically nationalize finance and coverage requirements, but do not necessarily nationalize administration. And when the issue is services (such as job training or vocational rehabilitation) rather than income

security, localities are often superior providers.

Finally, universalism requires emphasis on the social contract features of social insurance. Promises of income security must be both intragenerational and intergenerational. The returns to the productivity of today's workers must be shared between today's haves and have-nots, as well as between those who are in the labor force and those who are either too young or too old to work.

This is hardly a novel idea. But, surprisingly, it is an idea that has never been systematically applied to the needs of children. Social Security operates on the belief that it is more effective to make all of today's workers responsible for the security of all the previous generation's workers than to make each family responsible for the support of its own elderly relatives. Recognizing the needs of children in the social insurance system requires a parallel shift from believing that the income security of children is solely the responsibility of blood relatives to the belief that the risks to children can, in part, be spread across all families.

HOW MUCH IS ENOUGH?

Clearly, this question cannot be answered once for all time. A society's need for social insurance will change with economic and social circumstances. For example, demographic shifts affect people's need for social insurance. Likewise, how much social insurance is affordable will depend on both national income and competing demands for resources.

Experience with private insurance offers limited insight into this question. In a private insurance contract, the level of insurance is a function of the purchaser's desire for security – for protection from the risks at issue, and the insurance company's concerns about adverse selection (the migration of bad risks toward insurance) and moral hazard (the likelihood that compensation will make the insured indifferent about whether the risk occurs). Private insurance contracts, therefore, rarely provide as much coverage as the insured can afford. Rather, they limit the insurers' potential losses, typically by putting a ceiling on the amount of coverage and by leaving some of the burden of loss on the insured person through deductibles or co-payments.

And in some circumstances, private insurance leaves people significantly underinsured. Individual disability-income policies, for example, seldom provide replacement for more than 50 to 60 percent of lost income.

Social insurance, in contrast, is designed to counteract the what-the-market-will-bear

limitations of private insurance. It insures people who could not otherwise afford it and it offers coverage in markets where moral hazard and adverse selection render private insurance of limited value. Social insurance can nevertheless face some of the same problems that pervade private insurance markets. Some levels of protection may be unaffordable collectively as well as individually. And because social insurance is directed to the problem of inadequate labor income, it suffers from a peculiar form of moral hazard: the tendency of social insurance to undermine work and savings incentives. Moral hazard in social insurance is a question that we come back to again and again. In our view, the issue explains much of the heterogeneity of existing programs and the need to pursue social insurance through a variety of avenues. But it should be remembered that moral hazard raise difficulties about how to gain true security through social insurance – not about the question of what should be insured.

Ultimately, the answer to the question of how much social insurance is enough turns not only on society's needs and desires, but also on how much we are willing to pay. A society's willingness to pay depends both on what it can afford and, more fundamentally, on how it draws the line between collective and family responsibility. Before the 1930's, Americans regarded the well-being of their elderly as a private family or charitable responsibility. Eventually, however, we came to regard keeping retirees off the streets as a societal obligation.

There is no turning back on that commitment. On the other hand, as we have explained, the economic well-being of children continues to be left to their parents. We view this as a serious but remediable gap in social insurance coverage.

Social insurance must ask how big a shock to current income families can tolerate. Presumably, families can defer larger amounts of current spending over short periods than over longer ones. Thus, we may want to replace higher levels of income for people who are permanently disabled than for those who are temporarily unemployed.

Similarly, we may want to use a lower replacement rate for retirement than for disability pensions because older workers have more time to amass personal savings. Indeed, we may want to require individuals to put aside some of their current wages in personal savings accounts to replace income during unemployment or retirement.

When considering social insurance across families, how much is enough tends to be addressed in terms of some social standard of adequacy and decency. And, of course, there is widespread dispute about what these terms mean. It should be emphasized, however, that social insurance is not judged solely by its capacity to prevent abject poverty. It should protect the incomes of all members of society, not just the poor.

In the end, affordability is a how-high-is-up question to which we offer no special insight. We sidestep the question by imposing a budget constraint on the total cost of our proposed system that is roughly equal to the cost of existing social insurance programs.

To guarantee all Americans true security without breaking the bank, we must be clear about our income-protection goals, and we must design social insurance programs that respond effectively when risks become reality. Much of the foundation for such a system is already in place. But as the third pig discovers to his misfortune in one modern retelling of the tale, a foundation without the house provides limited protection. Despite our nation's affluence, too many little pigs are still being gobbled up. M