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Author(s): Walter Block

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Comments on Thomason and Burton, Bruce and Atkins, Anderson and Meyer, and Green and Riddell

Walter Block, *College of the Holy Cross*

I. Introduction

This commentary will focus in large part on the economic rationales offered by the four sets of authors (Thomason and Burton; Bruce and Atkins; Anderson and Meyer; Green and Riddell; all in this issue) on behalf of public-sector unemployment insurance and workers' compensation. My thesis is that their explanations for the existence of these two programs are for the most part unsatisfactory, in that they give insufficient attention to the alternative hypothesis—rent seeking on the part of special interest groups—and that their accounts are problematic on logical and empirical grounds.

In an important sense, however, such criticism is rather harsh and unfair, at least when applied to these eight specific economists. This is because—under the provisions of the Fraser Institute–Donner Foundation project on income maintenance for which their articles have been written—they have been asked to render an account of the economic rationale for these programs, and this they have done in an entirely satisfactory and accurate manner. That is to say, theirs is indeed an unerring rendition of how these programs are actually explained and justified within the profession.

By taking on the responsibility for reporting on this state of affairs within the profession, they are not thereby committed to *accepting* these traditional justifications for workers' compensation and unemployment insurance. They may or they may not hold these views, but they are certainly

I would like to thank Gary M. Anderson and Reuben Gronau for numerous helpful suggestions. Any remaining errors and infelicities are of course my own responsibility.

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not obliged to do so merely for having written the articles now under discussion.¹

This article, then, insofar as economic rationales are concerned, is more of a criticism of the profession as a whole than of these four sets of authors. My comments utilize their renditions of the arguments, however, as cases in point.

II. Thomason and Burton

1. If we were to undertake a justification of the government's role in the workers' compensation system, how might we argue? We might begin as do Thomason and Burton (p. S6) with the claim—major premise—that as long as there is a “perfectly competitive world” (in this case, all firms are fully experience-rated) there is no case at all for government intervention. However—minor premise—it might be argued (curiously, they do not carry the argument through this step or make the case in any other way; on the contrary, after beginning the syllogism in this very traditional neoclassical manner, they allow the entire matter to drop) that we in fact do not live in a perfectly competitive world, in which these claims can be made unambiguously. Therefore—conclusion—it follows that government intervention is justified since the market has been shown to be “imperfect.”

There are a whole host of critics who have rejected this argument in other contexts (see, e.g., Demsetz 1968). The main point is that it does not logically follow from market imperfections that interventionism will work any better. On the contrary, there is the phenomenon of “government failure” studied by the public choice school (Buchanan and Tullock 1971; Buchanan 1975) and others. If markets fail, then so do governments. If there is to be an improvement in institutional arrangements, it must be predicated on state inefficiency being less than market shortfalls; it cannot be based on the mere demonstration of market imperfections. Everything known to man on this, the wrong side of the Garden of Eden, is imperfect: this applies to private enterprise as well as public. That the one is imperfect does not prove the preferability of the other.

The difficulty, in this case, is that it is not clear that anything less than all firms being fully experience-rated is sufficient to make the case for entrusting workers' compensation programs to the tender mercies of the public sector. As Thomason and Burton state, the riskier the occupation, other things being equal, the higher the risk premium that tends to be added to the wage. In the alternative scenario, the whole institution of

¹ This may be putting matters too strongly, in that there was no reason for not criticizing the traditional economic account, and, indeed, several of them on occasion have indulged in just that activity—e.g., Anderson and Meyer (in this issue), and Bruce and Atkins (in this issue).

compensation would be privatized; it would be left to the wage system, perhaps buttressed by a private insurance industry, to determine the occupational safety rate and compensation for accidents. This is the usual presumption among economists, and nothing uncovered by Thomason and Burton would appear to tip the balance in the other direction.²

Further, Thomason and Burton believe that the source of the market imperfection is a sort of externality: less than fully experience-rated firms “do not bear the complete cost of *ex post* compensation.” Rather, they are able to shift some of these costs onto “all firms within the rating class to which the firm belongs” (p. S7). The difficulty with this is that in a full free enterprise setting insurance companies would compete with one another to distinguish between (e.g., discriminate among) the high- and low-risk firms that have so far been included within the same rating class. If they can make such fine distinctions, they can profitably base their premiums on perceived risk.

At present, unfortunately, it is “politically incorrect” (particularly in Canada) to so “invidiously” discriminate between people, particularly if the high-risk firms have more than a proportionate share of women, blacks, “visible minorities,” native peoples, or “physically challenged” (e.g., handicapped) persons.³ Thus, part of the reason that the market cannot function as well as it might emanates, not from the private sector, but from the public.

2. Thomason and Burton describe the attempt of the insurance firms to transact business with the insurees as one of the former applying “pressure” to the latter. It is possible that this is just a matter of stylistic expression. However, based on the numerous occasions this terminology is employed, it may indicate a substantive normative point, namely, that these offers are improper, exploitative, immoral, or otherwise unjustified.

But it is an axiom of economic theory that all trades (at the very least

² Milton Friedman (1990, p. 15) claims that many people accept the following argument, which he has dubbed the “welfare state syllogism.” Here is the invariably accepted major premise:

A: Socialism has been an utter failure. (It’s been a failure in Russia, in China, in New Zealand, in Australia, in Britain, and even in Canada and the United States.)

The widely agreed upon minor premise:

B: Free market capitalism has been a great success. (It’s the only system which has been able to combine a relatively high degree of prosperity for the masses with a large degree of political and human freedom.)

And now for the conclusion, to which most people concur:

C: Therefore, we need more socialism.

This is then applied to medical care, welfare, etc., and is certainly apropos to our present concerns as well.

³ For a critique of this antidiscrimination philosophy, see Epstein (1992) and also Block (1992).

those between consenting adults) are mutually beneficial, if only in the *ex ante* sense (Rothbard 1977). That is, no one engages in trade unless he expects to gain thereby. In the present case, the insurance company makes an offer to the injured party to trade an uncertain future income stream for a lump sum payable immediately. If the accident victim has a preference for risk avoidance, we would expect him to accept even an offer that is worth less than the present discounted value of what he might otherwise have received. But no less is true in the case of the sale of a lottery ticket; the price is higher than the expected value of the gain. The same is true of many cases of gambling, buying insurance in the market, and other similar activities. These offers are not “mathematically fair,” at least not intentionally so, otherwise there would be no scope for administrative costs, profit, and so forth. Would we accept “pressure” as an accurate way of referring to all such offers? Hardly.

3. It is important to keep in mind the normative-positive distinction between equity and equality. In the view of Thomason and Burton, people who suffer from permanent partial disabilities (PPDs) are pressured by insurance companies to accept compromise and release agreements (C&R’s). As we have seen, the lump sum payments negotiated thereby are often of less worth than the present discounted value of the income stream they might otherwise have received had they gone on to adjudication. But the adjudication process costs time, money, and effort and is riskier than the acceptance of a compromise lump sum agreement. Presumably, the lump sum was worth more to the claimant *ex ante* than the package deal of the prospect of higher period payments, coupled with the attendant risks and initial costs. Otherwise, he would scarcely have agreed to it.

Let us contemplate a case, however, where this is for some reason not true. Where, for example, the claimant somehow unwittingly agreed to a less preferable deal than might otherwise have been available to him. Thomason and Burton characterize such a situation as “less equitable” (p. S12). With that, they slip almost imperceptibly from the relatively firm ground of positive analysis to the quicksands of the normative realm. Inequity implies injustice, and nowhere do Thomason and Burton offer any independent support for their claim. They state, “Obviously, unequal compensation is inequitable compensation only if the injuries are equally severe” (p. S12). But this is not as obvious as it might appear. Even if injuries are absolutely identical, it is not necessarily inequitable for compensation to be unequal. Perhaps premium payments were different. Perhaps the policies accentuated risk in a different manner. Perhaps the additional amount represents a voluntary gift from the insurance company to one of the injured workers.⁴ According to Robert Nozick’s (1974) en-

⁴ Would it be inequitable if two workers with identical marginal productivities were hired and the first was paid, as he must be in equilibrium, a wage equal to

titlement theory, all agreements are equitable, as long as no force or fraud is involved and as long as the property or wealth being traded is legitimately owned.

We can utilize the Stiglerian (1961) search model in this regard. Suppose that a poor man searches for a bargain for only 5 days, while a rich man searches for 10 days. The latter is able to hold out longer because he is wealthier. Now, it is one thing to conclude that the additional days of search might yield bargains that are more than offset by their expenditure and that therefore there is an advantage to being affluent. (This need not happen; it is entirely possible that the alternative cost of the additional time spent in searching might be less than the value of the additional bargains unearthed.) But it is quite another matter to label this situation as inequitable. Yes, greater wealth enables people to attain more command over all kinds of goods and services complementary to search, but to label this inequitable is tantamount to claiming that all divergences in affluence are themselves inequitable.⁵

If we want to consider a real case of inequity, we might contemplate the following. The New York State Workers' Compensation Board "will not permit agreements where medical treatment has been required. . . . Nor will the board approve compromise settlements when the worker is totally rather than partially disabled. All lump sum settlements must be approved by a member of the board" (Thomason and Burton, p. S14).

This is inequitable because it amounts to a taking (Epstein 1985) with no compensation on the part of the government. As we have seen, trade is mutually beneficial, at least in the *ex ante* sense. However, this applies not only to the more pedestrian cases of trade but to all commercial agreements as well, specifically, lump sum C&R's. On the assumption that claimants are not mentally but rather physically disabled,⁶ it is clear that these prohibitions are injurious to them. If a settlement must be approved of by a board member, this implies that at least some mutually beneficial

this level, while the second was paid 50% more? Hardly. Why is it necessarily inequitable to offer the second what is in effect a gift equal to 50% of his wage? The temptation to call this inequitable arises from a comparison of the situations of the two workers. This can be ameliorated by focusing instead on the boss and the favored employee. Surely, if the former offers the latter additional monies, on a completely gratuitous and voluntary basis, this cannot be judged inequitable.

⁵ Alternatively, it is possible that the rich man will engage in less search activity than the poor one. The rich man has higher opportunity costs and thus faces higher costs of search for the same item. As a result, he may search for fewer days. If so, a rich consumer is likely to pay a higher price for the same item. It is the rare person who would think this inequitable.

⁶ Strictly speaking, this would be inequitable even in the case of mental disability, unless we accepted the claim that the state is a better guardian than the claimant's friends or family.

transactions will be prohibited. Certainly this applies in the cases of total disability. The two parties have agreed to a settlement, one which, in their view, represents their best interests, and the board sets it aside. This is economically indistinguishable from a nontariff barrier to trade. In both cases, consumer sovereignty is set aside.

4. Thomason and Burton appear to take the view that there is something problematical about a "higher industrial accident rate experienced during the 1960s." They must see this as a difficulty in need of rectification, otherwise they could not characterize the commission's recommendation to make alterations in the workers' compensation program as being undertaken in order to "correct these problems" or that to make changes in the law would be to "improve" it (p. S2, n. 2).

But the view that a lower accident rate is necessarily an improvement cannot be sustained without recourse to unproven normative considerations. This assumption may accord well with the view that the man in the street is presumed to hold, but it is contrary to traditional economic theory. From that perspective, it is assumed that there is an optimal rate of industrial accidents, coupled with the strong expectation that this rate is larger than zero.

More specifically, the optimal rate is that at which the expected value of the cost of safeguarding against one more accident is just offset by the expected benefit of doing so, to wit, at the point at which the marginal revenue and marginal cost curves of accidents intersect. It is only if society were already past that point that the Thomason and Burton assumption would hold. But there is no evidence put forth by the authors to suggest that such a situation actually exists. Perhaps, on the contrary, workers' compensation benefits are already pegged at too generous a rate, and the amelioration of the misallocation of resources would be in the opposite direction from the one assumed to be the case by Thomason and Burton.

It is quite possible—perhaps because of excessive amounts of safety legislation, or as a result of an elasticity of accident prevention expenditures with respect to income that is higher for rent seekers than for the general populace—that we are now at a point of underinvestment in productive processes that are accident intensive. If so, the legal alterations of 1975 would not "improve" the situation but, rather, would worsen it.

5. Thomason and Burton state, "If insurers do use delays and other tactics to pressure claimants into smaller lump sum settlements, one would expect low income claimants to be more likely to settle with a lump sum than higher income claimants since low income claimants are less able to withstand insurance company delaying tactics" (p. S11).

This is indeed the implication of a positive income elasticity, the usual assumption in such cases. As well, in support of Thomason and Burton's point, there is another economic effect that works in the same direction; when both are considered together, their suggestion that there would be

a negative correlation between income and acceptance of the lump sum deal is even further strengthened. The other economic effect is that time preference rates are also negatively correlated with income (Banfield 1974, 1977); that is, the poor usually have higher time preference rates than the rich. So, on the one hand, as Thomason and Burton would have it, the richer one is, the easier it is to hold out against delaying tactics and to be able to refuse the lump sum settlement; on the other hand, the richer one is, the more likely one will prefer to wait in any case because, as a result of lighter discounting of future income streams, the more likely it is that the present discounted value of money receivable in the future will be greater than the lump sum payment.

III. Bruce and Atkins

Bruce and Atkins take great pains to establish, and correctly so, that several arguments in behalf of public sector worker's compensation cannot be considered definitive. For example, under their initial set of (perfectly competitive) assumptions, they conclude that "the socially optimal levels of employment, safety and risk spreading could be achieved without government intervention" (p. S44). As well, they refuse to accept the free-rider problem, and the existence of economies of scale in the purchase of insurance, as establishing a case for nationalization of this service.

However, when it comes to information asymmetries, Bruce and Atkins are no longer able to maintain this market-oriented public policy. Instead, they hold, "The presence of informational asymmetries may provide an argument for workers' compensation" (p. S46).

Why, in their view, should the fact that employers may know more about the riskiness of a job than employees call for governmental abrogation of commercial contracts between consenting adults? This is because "there will be underinvestment in safety if workers underestimate p_i (the probability of an injury taking place). The reason for this is that workers can only be expected to bargain for wage differentials which compensate them for the *expected* risks of employment. Thus, if workers underestimate the true risks of employment, the employer will have no incentive to provide either additional information or additional safety *unless* it has been made strictly liable for accident costs" (pp. S45-S46).

Let us ask whether it is really true that there will be underinvestment in safety in the absence of employer liability. We must start out by conceding that "the employer will have no incentive to provide either additional information or additional safety." But it by no means follows that no one else in a market situation will have such an incentive.

Who else, then? One possibility is for an outside agency to take it upon itself to rate the dangers of various occupations. Moody's and Standard and Poor's rate stocks and bonds; Consumer Reports describes the risks of hundreds of products and services; Freedom House (Gastil, various

years; McColm et al. 1989) and the Fraser Institute (Walker 1988a; Block 1991b) assess the risks to freedom from residing in different countries; while the Good Housekeeping Seal of Approval is not awarded to dangerous consumer goods. Closer to home, Underwriters' Laboratories assesses the safety of various consumer goods, and private commercial chemical, mechanical, and electrical laboratories certify the quality of industrial machinery. As well, the Insurance Institute publishes data regarding the relative riskiness of the various occupations.

In an era when we are accustomed to government sources accounting for some half of the gross national product, it may be difficult for most people to imagine market alternatives to government certification. This is a problem particularly besetting the newly capitalist countries on the other side of what used to be the Iron Curtain. But in the West, it ought not to be too onerous a challenge to envision a sort of Consumer Reports for industrial accidents.⁷

A second alternative resides in labor unions.⁸ Surely they embody sufficient physical and human capital necessary to ascertain the dangers of the jobs of their members. As well, they may be presumed to have a strong motivation to press for wages that fully capitalize these perils.

Then there are always other, competing, employers. If employer A is underpaying his work force, because he knows the true risks of laboring for him but his employees do not, then this is a golden opportunity for employer B, C, . . . to hire A's workers out from under him. Economists typically assume that wages tend to equal marginal revenue product in equilibrium. But this is only a first approximation. In point of fact, wages tend to equal the next best option available to the worker in question (Becker 1964). Why, after all, should the profit-maximizing employer agree to pay the marginal revenue product (MRP) of the worker? Out of the goodness of his heart? Hardly. No, the reason is based on the fear that, if he fails to do so, someone else will successfully bid away the underpaid worker. But this reasoning applies whether the wages paid by employer A are less than MRP out of inadvertence, because of sheer cussedness, or, in the present case, as a result of an informational imbalance.

It is of course true, as Bruce and Atkins assert, "that workers can only be expected to bargain for wage differentials which compensate them for the *expected* risks of employment" (p. S46). The point is, however, that competition from other employers will tend to ensure that employee ig-

⁷ I say "envision" what might be, rather than "appreciate" what already is, because in the last few decades the government has been so active in this field. Had the state not preempted the market by giving these services away for "free" (i.e., courtesy of the taxpayer), it is likely that private enterprise would now be playing a far larger role than at present.

⁸ For an account of the institutional arrangements that would render labor unions compatible with a market economy, see Block (1991a).

norance does not vitiate the market process. Laborers in general need not be aware of their own marginal productivities in order to be compensated at those levels; the same analysis applies in the present case.

Bruce and Atkins's rationale for compulsory government workers' compensation thus requires not only a knowledge asymmetry between employer and employee. Also needed is the assumption that this divergence applies to other employers as well, that is, that such information is totally firm specific. But this must be a rare occurrence indeed, applying only to monopolized industries. It has not been shown to be of sufficient incidence to be able to justify a public policy that applies to the entire economy.

Bruce and Atkins's position is also somewhat of a precarious one to defend because of the difficulty of generalizing. Informational asymmetries are ubiquitous in our society. If they can serve as the rationale for government intervention in this instance, they can do so in all others as well. For example, manufacturers and repair mechanics can be safely assumed to know more about the products they specialize in than do the consumers who purchase them; this applies to automobiles, refrigerators, toasters, lawn mowers, and to a whole host of other such products. Yet the case for generalization from workers' compensation to a call for government intervention in all these cases is hardly justified. There is no reason for such a public policy because commercial interactions in this regard are earmarked by a great deal of efficiency. Typically, in the market, these consumer durables come in a package deal with guarantees of various sorts; private insurance, in effect, thus addresses the problem at hand. Nor is there any reason to suppose that the incentives that lead to these arrangements would not also apply to the labor market.

Further, suppose the case where the informational asymmetry were the other way around. That is, the laborers have a clearer understanding of the hazards of the job than do the bosses.⁹ According to the logic of the Bruce-Atkins argument, there would still be a resource malinvestment. Only now it would be in the direction of too much protection, not too little. Would it make sense to inaugurate an "employers' compensation" program, to counteract the "exploitation" of employer by employee? Paraphrasing Bruce and Atkins, we could argue that, if "*employers* underestimate the true risks of employment, the *employee* will have no incentive to provide either additional information or *less* safety unless he has been made strictly liable for accident costs (in this case, the costs of unnecessary safety installations)." Bruce and Atkins provide no evidence as to how they would analyze such a case, but, unless they take the bull by the horns

⁹ For example, a restaurant owner hires an electrician to fix his wiring, or a bank engages an expert to put its operation on a computer basis. With regard to such particular specialties, the employer can be expected to be far less sophisticated than the employee.

in this dilemma and call for compensation of some sort from employee to employer, we cannot credit their original application of the principle.

The Stiglerian information search model may be utilized here as well.¹⁰ First of all, if employer information about safety is greater than that possessed by employees, it by no means follows that the former level is optimal and the latter substandard; it could as easily be the other way around. Namely, the search for safety information of the owners of the business could be excessive and that of their hirelings exactly right. Second, even if we assume for argument's sake that knowledge of safety conditions on the part of workers is insufficient, this does not necessarily indicate economic inefficiency. As Stigler has shown, this may well be a rational decision on their part.

Bruce and Atkins also briefly mention adverse selection as an argument in favor of government intervention. Yes, "if both insurers and employers are unable to distinguish among employees on the basis of their respective probabilities of injury" (p. S46), private safety insurance will not be offered by the market. But this is unlikely, and no evidence is adduced to the contrary. There is also the added complication that other statist interferences render the insurance task more difficult. For example, in some jurisdictions it is illegal to discriminate on the basis of physical disability, a phenomenon surely correlated with workplace risk. As well, there are now all sorts of legal constraints placed on the use of economical proxy variables, such as age, gender, and race.¹¹ But suppose that insurance fails to materialize for reasons unrelated to governmental barriers to entry. It is still not "welfare-improving to require that all employers offer a standard form of insurance—workers compensation" as claimed by Bruce and Atkins (p. S46), unless we indulge in heroic interpersonal comparisons of utility or ignore the welfare of those on whom these programs are enforced.

IV. Anderson and Meyer

There is little doubt that the unemployment insurance (UI) that was incorporated into the Social Security Act of 1935 "arose in response to the Great Depression and was motivated by a desire to stabilize the economy" (Anderson and Meyer, p. S71). As a historical account, this is unexceptionable. However, the task of the second section of the article under consideration is not historical exegesis but rather the development of an economic efficiency rationale for UI. As such, the benevolent motivations of the enactors of this legislation are as entirely beside the point as they are for any other aspect of the New Deal or any other governmental decision for that matter. What count for public policy analysis are economic effects, not intentions. Looking at matters from the perspective of the 1930s, the

¹⁰ For a critique, however, see Kirzner (1973).

¹¹ See n. 3 above.

task of public policy-making then was to address the cause of the Great Depression. But the economic malaise of the 1930s was due to poor monetary policy (Friedman and Schwartz 1963; Rothbard 1974), not to lack of an unemployment insurance program.

Since UI was not even used to address the monetary imbalances of the economy, it is unlikely that it could play any large ameliorative effect. True, the monetarist thesis was not well known or appreciated at that epoch in our history, but Anderson and Meyer are writing in the present, not the past. It is unlikely, then, that the Depression can serve as an efficiency interpretation for UI.

So they try again. In the view of Anderson and Meyer, “the main rationale for UI is that it provides insurance for workers who may lose their jobs” (p. S71). But this hardly accounts for the fact that the task has been assigned to the public, not the private, sector. The rationale for fire insurance is that it provides coverage for those who may lose their homes to a conflagration; but this by no means implies a nationalization of the industry that provides the protection.

“This rationale,” continue Anderson and Meyer, “is appropriate for workers whose unemployment is unexpected, but not for individuals with frequent and predictable spells of unemployment, say in seasonal jobs” (p. S71). But why should this be so? In ordinary marketplace provision of goods and services, entrepreneurs do not usually ignore any significant number of potential customers. If a person is engaged in seasonal employment, and is willing to pay premiums high enough to purchase UI, it is likely that some private firm would be willing to oblige. It would certainly not be Pareto efficient to forbid such transactions. Indeed, the usual assumption of risk avoidance offers a presumption in this direction. It is true that the worker could probably do better for himself financially by merely saving money from his time of employment to be used during his time of unemployment, but perhaps he does not trust himself to engage in such “rational” behavior. In such a case, private provision of UI may function as a way of voluntarily engaging in “forced” savings, a result for which the worker is willing to pay.

The point is, we can expect to have as much unemployment as the government is willing to pay for. It is a basic economic axiom that, *ceteris paribus*, the higher the reward offered, the greater the market response. That is, although individual supply curves may conceivably bend backward, the usual presumption is that the response of the entire market to greater remuneration is additional effort. Why this general law should not be seen to apply to UI must ever remain a mystery. Missing from the analysis is an appreciation for the fact that the more generous the unemployment compensation, the higher tends to be the resulting rate of unemployment.

Anderson and Meyer then cite adverse selection as a possible explanation for governmental provision of UI, at least on the firm level. But they

correctly undermine that argument by noting that private firms do offer medical and workers' compensation insurance.

Anderson and Meyer characterize the diversifiability argument as "perhaps the most compelling reason for publicly provided UI," noting that "claims for UI tend to be concentrated in recessions" (p. S71). At this point in the first version of their article Anderson and Meyer quickly and quite properly undermine any such notion on the grounds that "the counterargument here is that insurance companies should be able to borrow in a recession if their reserves are insufficient." As well, they noted in the version of their paper presented at the conference that the argument applies to earthquake insurance, and yet private companies typically offer this service, thus vitiating the diversifiability argument. Unfortunately, in their final version, the one that appears in the present volume, they have deleted this very insightful footnote.

Getting back on track, Anderson and Meyer do not accept UI on the ground that it increases societal welfare, in the absence of any "reason why the value of the job match is different for society than for the individual" (p. S72). They are agnostic on the stabilization argument, noting that, if the real business cycle (technological shocks) theorists are correct, UI will "reduce welfare by decreasing efficiency" (p. S72). Anderson and Meyer maintain that it is only if the Keynesians are correct that UI may be productive. However, one can argue that the existence of inflationary recession has all but destroyed the Keynesian system, at least from the neck up. As well, even on the assumption that this model is accurate, the private provision of UI can be expected to be every bit as countercyclical as the governmental counterpart.

The final rationale for UI considered by Anderson and Meyer is as a means of redistributing income. This rent-seeking explanation may well be the best one for why the program actually exists, but it by no means follows that UI is the most efficient means of attaining this end. Some experts (Friedman and Friedman 1980, chap. 4) maintain that the negative income tax may be a far more effective way of achieving this morally problematic (Rothbard 1973, 1982; Nozick 1974; Hoppe 1987, 1989; Friedman 1989, p. 189) goal. However, the Friedmans (1980, p. 122) state: "The negative income tax would be a satisfactory reform of our present welfare system only if it *replaces* the host of other specific programs that we now have. It would do more harm than good if it simply became another rag in the ragbag of welfare programs."

The problem with UI, at least from this point of view, is that this is just one of a "host of other specific programs that we now have." Income redistribution may be accomplished in this way and thus can serve as a justification for the program (at least for those who maintain that income redistribution is a worthwhile goal); but if the negative income tax is more efficient, only on condition that it *replaces* the other programs, then UI may actually be counterproductive to these ends.

To conclude our discussion of the public policy aspects of the Anderson and Meyer article, we now turn to a consideration of their proposals for UI reform. Anderson and Meyer put forth several options. One is to provide job training and offering cash bonuses for returning to work quickly. But evidence shows that this reform merely encourages temporary layoffs (the unemployed tend to return to their old firms.) One of the states experimenting with this policy even precluded returning workers from benefits on this ground. But it is easy to imagine the market response: firm A hires back firm B's layoffs, and B reciprocates in behalf of A. Another difficulty with this proposal is that it is merely a different way of providing UI payments and thus does not address itself to the crux of the matter: subsidizing unemployed people promotes incentives toward unemployment.

A second set of strategies is to more closely tailor a firm's UI tax payments to its layoff history. But there is a problem with these initiatives: they are not neutral with respect to the market. On the contrary, industries differ with regard to their layoff history in systematic ways, and any proposal that discriminates against those with heavy layoffs, and thus in favor of those with light layoffs, misallocates resources from the former to the latter.¹² Which are the industries that tend to engage more heavily in layoff activity? Generally, firms specializing in consumer goods tend to be more stable over the business cycle than companies involved in the production of capital goods (Hayek 1931; von Mises 1963); a similar analysis applies to seasonal versus nonseasonal careers and to general versus specific training (Becker 1964). Since this plan would not be neutral with respect to these sets of industries, it is to that extent resource misallocative.

Another set of approaches discussed by Anderson and Meyer involves the improvement of the safety net provisions of UI. These, then, are not addressed to the insurance aspects of UI but instead to this policy insofar as it is a part of the welfare system. The difficulty here is that, as a matter of pure welfare economics, as we have seen, the negative income tax (Friedman and Friedman 1980) may be a preferable means toward the end of erecting a social safety net. If so, then UI should be abolished and the negative income tax should be designed to take up whatever slack implied by that act.¹³

¹² If it can be shown that "society" somehow has an interest in unemployment over and above the totality of the private interests in this phenomenon, then an argument for making UI tax payments reflect layoff history can be fashioned on grounds of externalities. Unless and until this can be shown, however, the transfer of wealth from one set of industries to the other must be considered misallocative. Anderson and Meyer appear to be agnostic on this point, an interpretation that arises from their comments on p. S72, and thus quite properly this argument is not made use of.

¹³ For a critique of the welfare system—e.g., raising the social safety net—see Murray (1984, 1988) and also Anderson and Block (in this issue).

It is unfortunate that Anderson and Meyer did not address themselves to another type of UI reform: privatization. This is an initiative (sometimes called “private enterprise”) that has been tried (not with UI, unfortunately, but rather with regard to numerous other programs) very successfully, most notably in the West in England, Canada, Australia, and increasingly in the former Soviet Union and countries in Eastern Europe and elsewhere (Ohashi et al. 1980; Poole 1980; Walker 1988*b*). In this proposal, UI would be left to the market. Private insurance companies would provide explicit coverage if there arose a demand for it, and, if not, people would rely on the implicit UI now accomplished through the system of wage differentials. As well, governmentally imposed obstacles to such a market (e.g., anti-discrimination laws and price ceilings for premiums) would be rescinded.

V. Green and Riddell

Several years ago a popular magazine ran a full-page, exquisitely colored advertisement for an insurance corporation.¹⁴ It showed a gigantic mansion in the background, a large manicured field in the mid ground, and a luxurious yacht at anchor in the foreground. The caption of the ad stated: “Both the house and boat are insured with Chubb. Now, if only they’d insure my golf scores . . .”

This statement could have served as the motto of the Green-Riddell article as well. For both the ad copy for Chubb and the theoretical considerations offered by Green and Riddell maintain that there is something wrong with the marketplace if it does not supply insurance protecting against just about anything that anyone could conceivably claim ought to be covered. In the former case, it is golf scores; in the latter, it is unemployment. But in both instances the charge is that of “market failure.”

The insurance company’s advertising is of course meant as a wry joke, intended only to direct the reader’s attention to the commercial offering. Green and Riddell in contrast, appear to be entirely serious. What are their arguments?

Starting out with the indubitable premise that “individuals are generally believed to be risk averse,” they note that, while owners of capital can “reduce their income risk by holding a diversified portfolio,” “workers are generally unable to diversify their human capital wealth” (p. S98).

There are, however, several ways in which employees can largely escape income variations that result from unemployment, if their desire for a low-risk life is strong enough. For example, they can eschew employment in such risky endeavors as Broadway plays, wild-cat oil drilling, mineral exploration, and so forth, and instead focus on the civil service; the post office; utilities such as telephones and electricity; on large, long-existing

¹⁴ *Smithsonian* 20, no. 6 (September 1989): 101.

and well-established firms in the “blue chip” areas; or on conglomerates, where if things go bad in one division, a transfer to another may be economically advantageous.

Alternatively, they can work for the very owners of capital, pointed out by Green and Riddell, who “reduce their income risk by holding a diversified portfolio” (p. S98). As well, wages are likely to be higher for employees taking part in endeavors where the chances of losing their jobs are higher (capital goods, seasonal industries, specific training), and the differential between the compensation levels can be interpreted as the implicit market insurance premium paid for relatively secure employment.

Green and Riddell are fully aware of this market mechanism. They even remark on other “forms of self-insurance such as saving, career diversification, and family labor supply” (p. S101). Nevertheless, they conclude that “these private market responses are unlikely to obviate the need for comprehensive UI” (p. S101).¹⁵ Unfortunately, they give no justification for this contention,¹⁶ leaving the reader to wonder what criterion they are employing in order to reach their conclusion.

Green and Riddell (p. S98) also claim that “comprehensive private insurance markets that would enable most workers to purchase insurance against the risk of loss of labor market income . . . have generally failed to emerge . . . despite the demand that *evidently* exists for such insurance” (emphasis added).

But this is rather problematic. First, while it is perhaps conceivable that a demand can exist for a product not now being supplied on the market, one might maintain that the presumption is in the opposite direction. One can never close the door to the Green-Riddell thesis, but it would appear that the burden of proof rests on them.

Second, we have just seen that the market does indeed provide (implicit) unemployment insurance through the intermediation of wage differentials between risky and nonrisky employment. It is therefore somewhat hazardous to maintain that such institutions have “failed to emerge.”

Why are we to conclude that any demand for this service *evidently* exists, given the contention of Green and Riddell that little or none has been successfully supplied? In their view, this is because of the problems of moral hazard and adverse selection. But these obstacles occur with regard to several other instances where explicit insurance policies are commonly written. For example, persons insured against fire or motor vehicle accidents can affect the probability of the event against which they are protected from taking place, and both the owners of less fireproof dwellings and

¹⁵ That is to say, public-sector UI.

¹⁶ Apart from their critique that the “‘systemic risk’ associated with the business cycle is difficult to reduce through portfolio diversification” (p. S101), an argument to which we reply below.

dangerous drivers, other things being equal, are likely to most interested in purchasing such protection.¹⁷

To return to our previous example, there is at present no demand whatsoever for golf score insurance. But this “failure,” too, encounters the hurdle of moral hazard and adverse selection. For example, were they to be insured, golfers would be in a position to purposefully score badly, and such insurance, were it to be offered, would be of particular interest to duffers. But this is hardly why golf insurance is not explicitly offered on the market.¹⁸ The market has “failed” in this way because the demand for this service, at a price sufficient to defray the attendant costs, evidently does not exist. Moral hazard and adverse selection may thus be obstacles to the occurrence of formal insurance, but they are neither necessary nor sufficient conditions for its absence. If the demand for the requisite insurance is sufficiently strong, and if people are willing to pay high enough premiums, these obstacles can evidently be overcome, as in the cases of fire and accidents.

Why is it that the market offers only implicit unemployment insurance (through wage differentials) and not the explicit variety (where contracts are formally drawn up)? Although this is only speculative, the following considerations appear to be relevant. First, when government subsidizes a service, and, even more so, makes it compulsory, it is very difficult for private enterprise to earn a profit selling the same product. When people are forced by law to take part in the state’s UI program, this alone would tend to preclude operation of the market.

Second, the basic philosophy of insurance is everywhere under attack, particularly in the United States and Canada. A recent, popularly supported California ballot initiative would have placed a ceiling on premiums. In the Canadian provinces of British Columbia and Ontario, auto insurance has long been a monopoly of government (Grubel 1985). These institutional arrangements have not been upset by the recent trend toward privatization; in the opinion of many commentators, tax-financed insurance in this area has become somewhat of a sacred cow. Even if government were not providing “stiff competition” against private UI plans, this would be a particularly inopportune time to try to launch any such new initiative.

Third, as we have seen, there are now laws on the books in the area of discrimination that mitigate against the private provision of insurance in general; these would have especially strong ramifications in the area of UI. For example, in setting premium policy auto insurance companies

¹⁷ It is for these reasons that Anderson and Meyer (in this issue, p. S71) explicitly and properly reject the market failure argument on the basis of moral hazard and adverse selection.

¹⁸ There are however informal market mechanisms that can help “insure” against bad golf scores: private lessons, self-monitoring through video techniques, investment of time and green fees in putting practice, driving ranges, etc.

have come under attack for “discriminating against” young males merely because they have worse driving records than females and older males; life insurance companies have been similarly criticized for demanding higher payments of women, merely because they tend to live longer than men. It is only to be expected that severe restrictions would be placed on any insurance company attempting to deal with the problems of moral hazard and adverse selection by trying to distinguish, that is, discriminate, among potential clients on this basis. It is likely that endeavors to ascertain past employment histories would run afoul of “privacy” provisions. Nor would any attempt to attain and apply psychological profiles to prospective customers likely be tolerated in these “politically correct” times.

The only way to determine if private formal UI is viable is to repeal governmental UI and also other such laws that may have the effect of restricting private provision. Then, if the demand for the market variety of UI is strong enough, the creation and patronage of private sources of supply will occur.¹⁹ If not, not. In neither case, however, would we be entitled to argue for government intervention on the ground of market failure. For if successful market operation occurs, even Green and Riddell will have to retract their claim.²⁰ If it does not, it still will not have been shown by them that the informal market insurance provisions (through wage differentials) are insufficient.

The failure of the Career Guard scheme is also not evidence of the market's inability to provide this service (p. S99). This is no more true than that the failure of the Edsel or the Studebaker shows that private commercial arrangements cannot provide automobiles. Green and Riddell quite correctly point to the efforts of insurance firms to deal with moral hazard in life insurance by refusing to pay in the case of suicide or murder by beneficiary and by declining the business of high-risk persons such as sky divers. But if allowed to by law, private insurance firms would likely avail themselves of similar options in the case of UI. For example, they could arrange matters so as not to be responsible for payouts to unemployed clients unless the overall unemployment rate in an industry or in the economy reached a specific level. Green and Riddell seem to accept this point when they state, “consequently, private companies are unlikely to offer insurance against the risk of unemployment except under very narrowly specified circumstances” (p. S99).

Next, consider their comments on nondiversifiability (p. S99): “An additional reason why private insurance companies would be reluctant to

¹⁹ It will occur, i.e., if people are willing to pay premiums high enough to offset those aspects of moral hazard and adverse selection not overcome by the insurance industry's attempt to discriminate on this basis and to encourage coinsurance through deductibles, less than 100% coverage, etc.

²⁰ Although they could still argue that in the market there would be less than the optimal amount of resources invested in UI.

provide UI is that the risk of cyclical unemployment is largely nondiversifiable except over time. That is, the risk of unemployment due to the business cycle is positively correlated across members of the labor force so that pooling many insureds does not substantially reduce the aggregate risk."

But how could the alternative to private provision, namely, government-organized UI, overcome this problem? If we interpret Green and Riddell literally on this issue, society is in no better circumstance with regard to diversifiability under socialized UI. If the problem stems from something intrinsic to the cycle, unless it can be shown that the public sector has a comparative advantage in dealing with this challenge—an issue Green and Riddell fail to address—it does not follow that governmental provision of UI will be an improvement over market alternatives.

Their argument, moreover, proves too much. For there are other negative occurrences besides unemployment that tend to affect large numbers of people all at the same time, where private provision of service has long been in operation. Examples include hurricanes, firestorms, and earthquakes. In any case, a multinational firm (such as Lloyds of London) that provided private UI might be able to overcome this problem, at least to the extent that the business cycle is not uniform over the entire globe.

As well there is the problem that government itself, in the view of many commentators, is either the cause of the business cycle, and/or its attempts to ameliorate this condition tend to exacerbate this problem instead of solving it (Friedman and Schwartz 1963; Rothbard 1974). If this is so, then Green and Riddell argue in a curious fashion. The government causes/exacerbates the business cycle; the business cycle decreases the diversifiability of insurance, rendering private provision problematical; therefore, this industry should be placed in the hands of the initial causal agent of the harm, for example, the government. One might as well argue that the fox should be put in charge of the chicken coop because he has already gnawed half way through the protective wire fence surrounding it.

Next, consider their treatment of the efficiency rationale for UI. Green and Riddell assert that "the probable failure of private insurance markets to exist on a comprehensive basis provides the fundamental efficiency rationale for a publicly provided UI scheme" (p. S99). According to Pareto optimality conditions, however, a governmental program may be implemented on efficiency grounds if no one is made worse off and the welfare of at least one person is improved. Yet in this case it is easy to point to not one but several groups of individuals who will be made worse off by tax-financed UI: all of those who would not otherwise have been willing to pay taxes for this purpose; risk preferrers, whose welfare *ex ante* is worsened by insurance; and those entrepreneurs who would have earned profits in a privatized UI industry. Green and Riddell call for "compulsory participation" for those "who believe themselves to be low risk from opting

out of insurance coverage" (p. S100). By their own admission, then, there are people who will be made worse off by such a policy.

There is of course a weak sense of this argument in which it is not necessary that there be no people harmed by a policy in order for it to be efficient in the Kaldor-Hicks sense. All that is necessary, in this case, is that the gains of the winners more than offset the harms to the losers, so that the former, at least in principle, are able to compensate the latter for accepting the new program. Green and Riddell, unfortunately, provide no evidence on this issue. In any case, because of the subjectivity of costs (Buchanan 1969; Buchanan and Thirlby 1981), and the theoretical dangers of utilizing interpersonal comparisons of utility (Rothbard 1977), this argument rests on somewhat shaky grounds.

Green and Riddell set a difficult task for themselves: deriving normative conclusions (government should set up a UI program; a tax-financed UI program is justified; there exists a rationale for compulsory UI) from premises that do not contain a normative dimension (UI programs generated in the market will be less comprehensive than alternatives, mainly because of moral hazard and adverse selection). That they have not entirely succeeded in generating that conclusion from these premises does not undercut the fact that they have used all of the relevant tools of modern economic analysis in a competent and creative manner. There is another way to characterize the problem faced by Green and Riddell. As Harold Demsetz's "The Grass is Greener" (1988) fallacy has shown, even if the market were "imperfect," it does not logically follow that supplanting government for private institutions will improve matters. Green and Riddell have indeed indicated that private insurance markets are imperfect (e.g., through adverse selection and moral hazard). But they have failed to show that government bureaucrats would enhance economic welfare.

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