Economic Policy Papers

Insuring Against Adverse Outcomes at Birth

Policy should focus on the insurance motives of parents

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EXECUTIVE SUMMARY

To what extent should government policy try to equalize economic outcomes due to differences among individuals in their most basic, innate circumstances: the kind of family they're born into, their level of intelligence, their marketable talents, their health? Should policy tilt economic resources away from "genetic winners" and toward less fortunate newborns?

This paper points to the usefulness of considering different *perspectives* regarding at-birth risks. It argues that law and policy need to focus on allowing tools for *parents* to mitigate the real risk to *themselves* associated with having children of possibly different birth circumstances.

Specific policies would (a) allow deeper insurance markets (provided by private market or government) where parents-to-be would, in return for an insurance premium, receive a payment if their child is born with an expensive medical condition or disability, and (b) allow parents maximum discretion in formulating estate plans so as to provide for that child's future needs.

Michael Jordan and I were born on exactly the same day, month and year. Yet he was born with otherworldly athletic talent (along with a huge mental drive to develop that innate talent), while I was born with, well, less talent and drive. As a result of these differences at birth, he is immensely wealthy while I am … less so.

This—and far more serious cases—raises a question: To what extent should government policy try to equalize economic outcomes due to differences among individuals in their most basic or innate circumstances: the kind of family they are born into, their intelligence, their marketable talents, their health? Should policy tilt economic resources away from "genetic winners" (a term used by MIT economist Jonathan Gruber in a discussion over the Affordable Care Act) in favor of those born with a higher likelihood of needing expensive medical care? Should tax law, especially over inheritances and bequests, try to level out the life outcomes of those born into poor families and those born into rich?

An often-used justification for such policies is that they provide a form of *insurance*. As economists Emmanuel Farhi of Harvard and Iván Werning of MIT have put it: "One of the biggest *risks* in life is the family one is born into" (emphasis

added).[1] And when people face risks, economists typically suggest policies to mitigate or insure against those risks for the simple reason that most people are risk-averse and value insurance. Further, if markets are providing too little insurance, economists often consider whether governments should provide it.

A crucial distinction

But is risk regarding circumstances at birth like other life risks? Not necessarily. From the perspective of the child, policies that transfer resources from those with favorable birth circumstances to those with less-favorable circumstances are not insurance at all. No inherently healthy person worries about being born with an expensive medical condition: This person already *knows* he or she was born healthy. Michael Jordan doesn't worry about being born talentless. He already knows he was born with his skills and not mine.

From the perspective of *parents*, however, the birth circumstances of their potential children is a genuine risk. Parents do worry, quite naturally, about their children being born with a learning disability, for instance, or other unfavorable birth circumstances. The distinction between the perspective of the *parents* and that of the *child* matters deeply, and it should inform policy discussions regarding social insurance for risk at birth.[2]

Consider a simple world that exists for only two dates in time (our paper analyzes this more generally): At the first date, there are a large number of individual *parents*. At the second date, there are an equal number of *children*, each associated with a parent from the first date. Some fraction of these parents have inherently *low productivity* (they produce little for each hour worked), while the rest will have inherently *high productivity*. Further, each of these children themselves will be low- or high-productivity, with some known probability of each outcome. Finally, the society has a way of saving or storing some of what is produced in the first period for consumption in the second period.

Our research investigates two key questions: Is it possible to look abstractly at an economic arrangement to see if it is what economists call Pareto *efficient*, meaning an arrangement where it's impossible to make anyone better off without making someone else worse off? Further, is it possible to characterize what policies are necessary in this simple world to ensure such efficiency?

Necessary and sufficient

What conditions are necessary and sufficient to achieve Pareto efficiency? Our analysis finds that where parent and child productivity is easily observable and verifiable, these conditions point to a straightforward policy recommendation: Governments need to ensure that parents have sufficient opportunities (using either insurance markets or government policies) to transfer wealth to their children, depending on their children's birth circumstances.

In families with large numbers of children, parents can partially achieve this simply by giving differential gifts and inheritances to their children.[3] In a family with one or two children, however, the ability to make such conditional gifts is more constrained. One policy recommendation then is that insurance regulators allow fuller prenatal (or preconception) insurance markets where potential parents, in return for an insurance premium, receive a payment if their child is born with, say, an expensive medical condition or disability (with restrictions that the money actually go toward supporting the child). A second policy recommendation is that inheritance laws in all nations should fully allow differential gifts to children. This is the case in the United States, but parents in Europe are severely restricted in making differential gifts to their children.

When productivity is not observable

A second policy implication comes into play when we make the more realistic assumption that a child's productivity is known only to the child. In this situation, incentives matter. For instance, if parents cannot easily distinguish between a child whose labor market earnings are low because he or she truly isn't capable of earning more and a child who is simply not working to his or her potential, it becomes impossible for the parent to make gifts or bequests conditional on the child's true innate productivity.

Instead, the parent has to make gifts or bequests conditional on what the parent (or the estate executors) can actually observe, such as the child's wealth or labor market earnings. But once a parent makes gifts or bequests conditional on the child's wealth or earnings, this affects the child's incentives to accumulate wealth or earn more.

Our main insight in this more complicated and realistic situation is that government policy or law should give parents flexibility in designing enforceable arrangements regarding gifts or bequests to their children. Arrangements that may appear to the unknowing outsider as if venal parents are trying to selfishly control their children may instead be efficient reactions of altruistic parents who want to differentiate gifts to their children based on their innate characteristics, but need to worry about incentives.

Policy conclusion

Overall, our analysis points to a different approach regarding risks of birth with adverse outcomes—an approach that recognizes that the parents' perspective differs substantially from the child's. Law and policy need to focus on allowing tools for *parents* to mitigate the real risk to *themselves* associated with having children of possibly different birth circumstances, rather than the fictional risk to Michael Jordan that he could have been born with my basketball skills.

Endnotes

[1] See Farhi and Werning (2010).

[2] This discussion is based on the formal mathematical proofs in Phelan and Rustichini (2015).

[3] On another personal note, my grandparents did this by giving all of their lifetime and at-death gifts to my two developmentally challenged uncles and none to their other six children (who did not object).

References

Farhi, Emmanuel, and Iván Werning. 2010. "Progressive Estate Taxation." *Quarterly Journal of Economics* 125 (2): 635–73.

Phelan, Christopher, and Aldo Rustichini. 2015. "Pareto Efficiency and Identity." Working Paper 20883. National Bureau of Economic Research.