

by Jason Furman

MARKETS ARE THE CENTRAL INSTITUTION OF THE ECONOMY, allowing people to buy and sell goods and services in a manner that potentially makes everyone better off. Markets can also play a role in reducing the risks that individuals face by allowing them to purchase insurance such as health insurance, life insurance, or property insurance. Through insurance markets, households and communities can reduce the risks they face by pooling them, or sell these risks to entities that are better able to bear them.

MISSING MARKETS: Why Markets That Can Reduce Risks Are Missing and What Can Be Done About It

But in certain situations, markets that could potentially help to mitigate or reduce the risks faced by society and individuals are underutilized or even nonexistent, leaving households to face some of the largest risks without any protection. For example, while most Americans want to own a home, such a purchase comes inextricably linked to taking a major financial gamble on the value of the house. New ways of financing houses or insuring against lost property values could reduce this risk. Another major risk families face is outliving their assets in retirement and then being forced to have a dramatically lower standard of living in the final years of life—a problem that can in principle be addressed by the development of lifetime income products aimed at providing a long-term, reliable stream of income for retirees.

The absence of markets to address societal risks can exacerbate these problems as well. For example, terrorist attacks, hurricanes, and other catastrophic events create major financial risks for individuals, businesses, local governments, and the economy as a whole. In principle, these risks should be insurable, but today many or most of them are not. Similarly, many communities face substantial risk as a result of shocks to local tax revenue, which can send them into a downward spiral of reduced revenue, spending cuts, outward migration, and further reduced revenue. Without adequate protection, the entire community becomes vulnerable to economic hardship.

The ways in which markets can but often do not help people and communities have been a thread running through many of the discussion papers released by The Hamilton Project. These papers identify a range of missing markets for both societal and individual risk, highlighting three specific reasons for the absence of these markets and proposing solutions to enable private markets to flourish or public markets to play a role.

Missing markets can reduce the major risks a household faces, from purchasing a home to saving for retirement.

First, laws or regulations could tilt the playing field against a market that might otherwise come into existence. Laws or regulations, either deliberately or inadvertently, can favor certain products or financial instruments, making it harder for alternative and potentially more attractive markets to develop. One example, according to a forthcoming Hamilton Project paper by Andrew Caplin, Noel Cunningham, Mitchell Engler, and Frederick Pollock, is the way the households finance their house purchases. Caplin and coauthors argue that an attractive way to finance a house is through “shared-equity mortgages,” a product that would allow families to mitigate some of the financial risk associated with buying a home by having to repay the bank less money in the event that the house falls in value. But shared-equity mortgages are virtually nonexistent today, in part because they have a hard time competing against the tax benefits that are reserved exclusively for traditional, pure-debt mortgages. Caplin and coauthors propose leveling the playing field in the mortgage market by allowing tax deductions for shared-equity mortgages and other regulatory reforms that they believe would allow the private market to alleviate some of the risks of home ownership.

Similarly, Kent Smetters and David Torregrosa are concerned that families and communities are left too exposed to the financial risks associated with catastrophic events like hurricanes and terrorist attacks. They point out that insurance is often expensive, incomplete or unavailable. Moreover, after these catastrophic events, taxpayers often end up paying in a manner that is uncertain, at times unfair in providing disproportionate help to favored groups, and sometimes perverse in encouraging people to take more risks. Smetters and Torregrosa argue that many of these problems could be solved if insurance companies could tap into broader capital markets to spread the risks associated with catastrophes, allowing them to pass on the savings in the form of more affordable insurance products

for consumers. But insurance regulations and tax rules make it more expensive or even impossible for insurance companies to purchase reinsurance for their risks. Eliminating these regulations, leveling the playing field, and possibly establishing more direct government involvement in the provision of reinsurance could potentially help markets step in to reduce some of the major financial risks that individuals and businesses face.

Risks are faced not only by individuals but also by communities and even states. One of the major risks that a state can face is a negative economic shock that lowers tax revenues and requires the state to raise taxes or cut services. In theory, states and communities could purchase insurance against this risk to help them through difficult times. In practice, however, such insurance does not exist. States and localities might be deterred from purchasing insurance if they think that it would decrease their chances of receiving support from the federal government. In a new Hamilton Project discussion paper, Akash Deep and Robert Lawrence propose making such relief more predictable and regular by delivering it through an insurance market. They offer a proposal for state and local tax-base insurance, in which states and localities would pay premiums into a federal insurance fund and would qualify for payouts from the fund if they experienced a drop in their tax base.

Second, market failures could impede the creation of a market. A number of such failures exist. The classic market failure in insurance markets is “adverse selection,” a phenomenon that occurs when individuals know more about their own risks than the insurer does. Those individuals with the lowest level of risk may decide it is not worth buying insurance. When they drop out, people with higher levels of risk remain in the pool and drive up insurance prices, leading even more people to drop out and driving prices still higher. The result can be to eliminate potentially valuable markets.

Adverse selection is a major issue in health insurance, but it is one that can potentially be overcome with the right government policies. For example, a Hamilton Project discussion paper by Ezekiel Emanuel and Victor Fuchs proposed giving individuals risk-adjusted vouchers to buy health insurance from private firms, a process that would enable private market competition to focus on improving quality rather than just attracting the healthiest workers. Adverse selection also stands

Government can play a critical role in fostering missing markets.

in the way of private markets for wage-loss insurance—a system that cushions some of the blow for workers who lose their jobs and are re-employed at lower wages—because workers facing the most risk would flood the program and drive up premiums. That is why Hamilton Project discussion papers by Jeffrey Kling and by Lori Kletzer and Howard Rosen proposed setting up mandatory, government-run programs for wage-loss insurance.

A new Hamilton Project discussion paper by William Gale, Mark Iwry, David John, and Lina Walker also identifies adverse selection as one of the major problems impeding the development of lifetime income products, a market that could reduce the risk of workers outliving their assets and spending their final years in financial hardship. The problem is that lifetime income products are most attractive to the people who realize they are the healthiest and will live the longest, meaning that financial institutions must cut back on the monthly payout to retirees. These lower payouts make lifetime income even less attractive to the average consumer. To overcome this problem, Gale and coauthors propose an automatic two-year trial of monthly income for all workers, predicting that inertia would lead a wider group of people to invest in these risk-reducing products, thereby helping the market overcome adverse selection challenges.

Market failure also occurs if there are external benefits or costs to an activity that are not fully captured by the participants. For example, today most individuals and businesses do not take into account how carbon emissions contribute to global climate change. The Hamilton Project has released two discussion papers and one strategy paper that propose market-based solutions to remedy this problem, either through carbon taxes or through a cap-and-trade system that limits carbon emissions. Forthcoming papers also discuss how the government can foster markets for pay-as-you-drive auto insurance or use price signals to ease traffic congestion.

Finally, behavioral obstacles might impede the creation of valuable markets. This problem may particularly afflict markets designed to reduce risks and provide financial services since people may have predictable biases that lead them to avoid purchasing particular products. Indeed, Gale and his coauthors identify behavioral biases as another

impediment to the development of the market for lifetime income products. Individuals may be reluctant to turn a large sum of money into a series of smaller monthly payouts, despite the many benefits of this system. One way to help overcome these behavioral obstacles is through institutional mechanisms that default people into trial lifetime income payments, and through inertial decision-making, encourage them to stay with the product.

The paper by Gale and coauthors builds on an earlier paper by Gale, Jonathan Gruber, and Peter Orszag that identified behavioral obstacles that prevent families from saving adequately for retirement. A key part of their solution was to require all businesses to automatically enroll their employees in a retirement plan. Like the proposal for lifetime income products, this proposal would set the default to saving more, which evidence shows would lead to substantially higher savings.

While health analysts have traditionally focused on the problem of adverse selection, behavioral obstacles are also an important reason that the market for health insurance fails to provide universal insurance. These behavioral biases, combined with practices like the provision of uncompensated care, can impede the functioning of insurance markets. Gruber's forthcoming paper proposes to make insurance markets function better not just by providing subsidies but also by using effective pooling mechanisms and mandates to overcome the behavioral obstacles to purchasing insurance.

In conclusion, market-based or market-like solutions can be an attractive way to help solve a number of social problems and reduce the risks faced by individuals and communities. In some cases this is just a matter of eliminating the obstacles to these markets. But in many other cases market failures and behavioral obstacles make a “free-market” solution untenable, leaving a critical role for an effective government to help create the conditions for sound markets to flourish. Market-based solutions are a useful complement to the traditional and critical role of an effective government in fostering broad-based economic growth and economic security.

The Hamilton Project seeks to advance America's promise of opportunity, prosperity, and growth. The Project's economic strategy reflects a judgment that long-term prosperity is best achieved by making economic growth broad-based, by enhancing individual economic security, and by embracing a role for effective government in making needed public investments. Our strategy—strikingly different from the theories driving economic policy in recent years—calls for fiscal discipline and for increased



public investment in key growth-enhancing areas. The Project will put forward innovative policy ideas from leading economic thinkers throughout the United States—ideas based on experience and evidence, not ideology and doctrine—to introduce new, sometimes controversial, policy options into the national debate with the goal of improving our country's economic policy.

The Hamilton Project Update

A periodic newsletter from The Hamilton Project is available for e-mail delivery. Subscribe at www.hamiltonproject.org.

The Project is named after Alexander Hamilton, the nation's first treasury secretary, who laid the foundation for the modern American economy. Consistent with the guiding principles of the Project, Hamilton stood for sound fiscal policy, believed that broad-based opportunity for advancement would drive American economic growth, and recognized that "prudent aids and encouragements on the part of government" are necessary to enhance and guide market forces.

THE BROOKINGS INSTITUTION

1775 Massachusetts Avenue NW, Washington, DC 20036
info@hamiltonproject.org ■ 202.797.6279

Copyright © 2008 The Brookings Institution

THE HAMILTON PROJECT ADVISORY COUNCIL

GEORGE A. AKERLOF
Koshland Professor of
Economics, University of
California, Berkeley
2001 Nobel Laureate in
Economics

ROGER C. ALTMAN
Chairman, Evercore Partners

HOWARD P. BERKOWITZ
Managing Director, BlackRock
Chief Executive Officer,
BlackRock HPB Management

ALAN S. BLINDER
Gordon S. Rentschler
Memorial Professor of
Economics,
Princeton University

TIMOTHY C. COLLINS
Senior Managing Director
and Chief Executive Officer,
Ripplewood Holdings, LLC

ROBERT E. CUMBY
Professor of Economics,
School of Foreign Service,
Georgetown University

PETER A. DIAMOND
Institute Professor,
Massachusetts Institute
of Technology

JOHN DOERR
Partner, Kleiner Perkins
Caufield & Byers

CHRISTOPHER EDLEY, JR.
Dean and Professor, Boalt
School of Law – University
of California, Berkeley

BLAIR W. EFFRON
Partner, Centerview
Partners, LLC

JUDY FEDER
Dean and Professor,
Georgetown Public Policy
Institute

HAROLD FORD
Vice Chairman,
Merrill Lynch

MARK T. GALLOGLY
Managing Principal,
Centerbridge Partners

MICHAEL D. GRANOFF
Chief Executive Officer,
Pomona Capital

GLENN H. HUTCHINS
Founder and Managing
Director, Silver Lake

JAMES A. JOHNSON
Vice Chairman, Perseus, LLC
and Former Chair, Brookings
Board of Trustees

NANCY KILLEFER
Senior Director,
McKinsey & Co.

JACOB J. LEW
Managing Director and
Chief Operating Officer,
Citigroup Global Wealth
Management

ERIC MINDICH
Chief Executive Officer,
Eton Park Capital
Management

SUZANNE NORA JOHNSON
Senior Director and
Former Vice Chairman,
The Goldman Sachs
Group, Inc.

RICHARD PERRY
Chief Executive Officer,
Perry Capital

STEVEN RATTNER
Managing Principal,
Quadrangle Group, LLC

ROBERT REISCHAUER
President, Urban Institute

ALICE M. RIVLIN
Senior Fellow,
The Brookings Institution
and Director of the
Brookings Washington
Research Program

CECILIA E. ROUSE
Professor of Economics
and Public Affairs,
Princeton University

ROBERT E. RUBIN
Director and Chairman of
the Executive Committee,
Citigroup, Inc.

RALPH L. SCHLOSSTEIN
President,
BlackRock, Inc.

GENE SPERLING
Senior Fellow for
Economic Policy, Center
for American Progress

THOMAS F. STEYER
Senior Managing Partner,
Farallon Capital
Management

LAWRENCE H. SUMMERS
Charles W. Eliot University
Professor, Harvard University

LAURA D'ANDREA TYSON
Professor, Haas School
of Business, University of
California, Berkeley

DANIEL B. ZWIRN
Managing Partner,
D.B. Zwirn & Co.

JASON FURMAN
Director