Next Social Contract Initiative and Economic Growth Program

No Discount: Comparing the Public Option to the Coupon Welfare State

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The fundamental ideological conflict surrounding the Welfare State in the U.S. is no longer over the scope of government, but instead how the government carries out its responsibilities and delivers services. The conservative and neoliberal vision is one of a government that provides a comparable range of benefits as conventional liberals, but rather than designing and delivering the services directly, it provides coupons for citizens. Coupons – whether by that name or more anodyne terms such as "vouchers" or "premium support" or tax subsidies – could then be used to purchase the services in the private market. Whenever neoliberals have sought to expand the scope of the welfare state or conservatives have tried to fundamentally shrink it, both have come bearing coupons.

This is a vision of the government as a giant coupon machine, whose primary responsibility is passing out coupons to discount and subsidize private education, health-care, old-age pensions and a wide variety of other primary goods. Over the past 30 years, efforts to privatize what government does and replace it with vouchers have taken hold in elite policy circles. But recent popular pushback against the privatization of Social Security, the use of private military contractors, and the voucher-ization of Medicare in Paul Ryan's budget shows that the proper method of provisioning of government services is still a point of contention.

Beyond that, there's an increased realization that public options are capable of creating better outcomes while taking advantage of both democracy and markets when used under the right circumstances. But when should public options be used? What guidelines should be used to understand when the state should provide a good directly versus subsidizing the private market through subsidies?

There have not been many clear guides on which is a more preferable outcome for goods the government wants to provide: public allocation or public subsidies for private allocation. This paper seeks to outline a theory of when public provisioning of goods is a superior solution to the approach of subsidizing private goods with vouchers.

There are many advantages that the government has when it comes to providing goods itself, especially when vouchers prove problematic. When the government itself produces a good it can contain costs in markets where supply is constrained, standardize products to solve information problems, ensure basic levels of quality and use scale and compulsion to efficiently provide social insurance. Publicly produced goods move choices in the marketplace to choices democratically made, emphasizing democratic accountability and access. This can give it an advantage over many problems with vouchers, including distributional effects, visibility and control over intermediation.

Table 1 outlines the two different approaches of vouchers and public provisioning.[1] Direct public provisioning is when the government directly administers and allocates the good in question. The government chooses both the quality and quantity of the good in question. It handles the production, administration and supervision of the good in question.

Table 1:

	Public Provision	Vouchers
Explanation	Provide good directly through either transfer or production.	Encourage the private provision or purchase of a good through subsidies and inducements.
Common instruments	Government production, cash payments.	Tax breaks, subsidized credit, vouchers, cash payment.
Examples	Social Security, Veterans Health System.	Tax exclusion of fringe benefits, food stamps.

Vouchers can refer to many different things, but in general a voucher is a subsidy that grants an individual limited purchasing power for a specific range of goods and services in private markets. In this sense it provides a medium level of choice by both prescribing and proscribing the good in question. A voucher places restrictions on the types of goods and services that can be provided but allows for a large amount of choice within these goods. Beyond choice, vouchers are flexible in design. The subsidy they provide can be given to the consumer or the provider, and it can take the form of an expenditure or a tax subsidy.

Of course, the contrast should not be overstated. The relationship between direct, public provisioning and vouchers should be thought of as existing along a continuum. Many programs of direct provisioning already involve private contracts, outsourcing and public-private partnerships. And public provisioning has many distinctions, ranging from where the public monopolizes the good or service, like defense, to public options that are in competition with private options, such as K-12 schools and universities. (This paper will focus more on the public option than a single public provider, though distinctions will be discussed when necessary.) However, there is an ultimate distinct split between public provision and vouchers.

Advantages of Vouchers

The advantages associated with vouchers are ones of choice, efficiency, competition, budget control and incentive management. In allowing individuals to choose among market competitors, they can best satisfy their own preferences, elevating the best products. In return, competitive markets respond by increasing the quality and quantity of a good for a given price, bringing efficiency to bear on the product. This unleashes the full advantages of market competition while still allowing the government a role in helping with the allocation of certain goods.

Since the commitment of a voucher isn't open-ended, but instead capped by the amount of the voucher itself, it can allow for better budget control by the state than a publicly provisioned program based on need. The capped nature of vouchers manages incentives: there is an incentive to spend the full voucher but the marginal cost beyond it is transferred to the person in question. Vouchers can also be easily targeted to those most in need of a good, giving them equitable and distributional potentials as well.[2]

What are the Problems with Vouchers?

Though there are advantages to using vouchers to provide government services, there are also drawbacks. As the political scientist Jacob Hacker notes, we shouldn't think of private provisioning as a "mere substitute" to public production, but instead note that there are three big differences: "distribution, visibility and control."[3]

The distributional impacts of vouchers will often skew upward. Using vouchers requires having the information and resources to find and utilize them. For instance, the benefits of vouchers as public policy are often delivered through the tax code. People get certain deductions for the specific practices that the government wants to support, from housing to health care savings accounts. However, deductions for taxes disproportionately benefit those with higher incomes.[4] Taxes are higher up the income ladder under progressive taxation, so the richest have the most to gain from tax deductions. People with more income are also more likely and more able to put additional resources towards taking advantage of all the hidden welfare state mechanisms like tax deductions. If fully utilizing the private welfare state requires a team of tax attorneys, only people who can afford a team of tax attorneys will take advantage. The private welfare system is thus less progressive in its redistribution than the normal mechanisms of the traditional, public welfare state.

Privately provisioned aid programs are frequently less visible than publicly provided programs. A private welfare state hides the mechanisms of choices and distribution. As Cornell University professor Suzanne Mettler has shown, a large number of people who take advantage of the voucherized, or what she refers to as the "submerged," welfare state, don't believe they are using a government resource. For example, over 60% of those who use college tuition subsidies and over 50% of those who claim a mortgage interest deduction or take out a student loan don't see themselves as using a government program.[5] This creates the impression that private provisioning is more "natural" while hiding the public nature and government role in setting up these markets. It also leads to under-provision of goods and services because people do not want to pay for the programs that they do not realize they are benefiting from.

Beyond citizens, it isn't clear that lawmakers always see deductions in the tax code as part of a private welfare system or fully understand the mechanisms at play. Thus a private welfare system can be even less subject to democratic control and accountability, either from citizens or lawmakers.

Meanwhile, control over the allocation of these public goods is in the hands of private intermediaries who actually produce the goods. As a result of providing public goods through vouchers, new political coalitions will be created. Some argue that using vouchers will reduce the size of the government. Libertarians such as Milton Friedman have been aggressive in arguing that vouchers are a good first step in reducing the size of the government, while others like Stuart Butler have argued that privatization more broadly will break up "public spending coalitions" that advocate for a larger government. However, both of these thinkers miss that a private welfare state will create new coalitions of business interests, providers, middlemen and conservatives to defend this welfare state with just as much vigor.[6]

Vouchers can create spending coalitions that are difficult to change. The fact that public authority and resources are being used to validate the private provisioning of the state gives these coalitions even more power than they would normally have as a lobbying group.

To take one example, many commentators have argued that the home mortgage interest deduction, a tax code subsidy voucher that is nominally designed to encourage homeownership, should be phased out. However, this voucher brings together realtors, construction companies, the financial industry and homeowners themselves as a new coalition group in a way that public housing never did. Homeowners don't see the tax deduction as part of the welfare state and do not engage with it as a form of "welfare" as they normally would. And the mortgage-interest tax deduction is highly regressive, mostly benefitting people making well over six figures, and only those that itemize their returns.[7]

Democratic Choice and Market Choice

Those are obvious problems with running public goods through a private system. But it is important to critically discuss what is considered the best benefit of vouchers – the notion of "choice." Most proponents of vouchers say that it will expand choices. Instead of citizens relying on a single option provided by the government, there would be many options in a competitive marketplace. But what vouchers really do is replace one set of choices, made through democratic action, with another set of choices, made through the market.

In a democracy, governmental actions are responsive to citizens through voting. Vouchers take citizens democratically finding solutions to problems and turn them into consumers bidding on goods in a market. Finding solutions in a public space emphasizes accountability, voice, transparency, rules and claims through reasoning that goes beyond the self. The private market emphasizes cost-benefit thinking, exit, closed proprietary profit-seeking strategies, bargaining and the satiation of individual wants. The locus of government action moves away from providing for the commonwealth towards encouraging entrepreneurial activities. Instead of a role in directly providing certain goods or a baseline of security – economic or otherwise – in a voucher system, the role of the government is to provide a baseline of market participation. Though the limits of and strains on the democratic process are well known, that does not negate the clear limits of the marketplace. The democratic problems are simply turned into a new set of constraints in the market.

The solutions for these constraints are also different. Democracy enables citizens to demand accountability and agitate for change through action and expressing their voices. But the equivalent form of action in a market for consumers is either spending or not spending. This turns democratic action into something where agency and votes are conditional on income, and thus fundamentally unequal. Vouchers encourage what the economist Albert O. Hirschman called "exit," as vouchers can only be spent or not spent, while public options encourage "voice."

A public option amplifies private options. It provides cost-control in cases where firms have monopolistic price-setting powers. It helps reduce informational problems, by creating a long-term, stable baseline for private providers to innovate and expand against. In some markets, notably insurance ones, it is more efficient because of compulsion and size.

More generally, public options working with private-market vouchers combine the strengths and weaknesses of democracy and market-based capitalism. Democracy and accountability are essential to the social goods the government provides, as the items we want the government to ensure citizens have, from education to health care to retirement in old age, aren't just narrow consumer goods but the basis of our civic society and form the promise to the future of our country.[8]

This element of democratic accountability will shape the provisioning of public goods, with citizens arguing for more or less of a good, and with the possibility of exit to the private market making the voice of the democratic process more effective. In turn, if consumers feel a lack of accountability or voice in the private market, or if they feel private providers are exploiting them, they are more likely to return to the public option. This in turn makes private providers more accountable to the democratic process.

Beyond allowing citizens to have a democratic say, what are the other advantages of public allocation? What characteristics of goods make it more attractive for them to be provided by the government, and are these features generalizable? Table 2 gives an overview of when public allocation has an edge over the coupon government, and the rest of the paper will expand on these.

Table 2:

	Advantages to Public Provisioning	Concerns about Coupon Government
Choice	Democratic choices as citizens encourage accountability, voice, transparency, rules and claims through reasoning that goes beyond the self.	Market choices as consumers encourage cost-benefit thinking, exit, closed proprietary profit-seeking strategies, bargaining and the satiation of individual wants.
When Markets Fail, and Providers Have Pricing Power	Full allocation goes towards the good in question, while also reducing costs and rent-seeking powers of private providers.	Private providers can capture subsidies. Increased demand raises prices for all consumers.
When Standardization and a Baseline of Quality is at Stake	Public options can function as check and balance by providing baseline quality of a good. Reduces need for subsequent regulation. Encourages competition on price and higher quality.	Often difficult to tell the difference between efficiency gains and lower quality of a good. Very important when baseline quality is important for the good in question.
Providing Social Insurance	Compulsion, scale, long timeframe, strong negotiations make government provisioning of insurance efficient.	Cream skimming and market segmentation. Vouchers work poorly when needs is very unequal.

Uncompetitive Markets: Firms that Don't Lower Prices in Response to Demand

Given that the case for vouchers relies on theories of economics in which markets are functioning well, what happens when markets don't behave perfectly? What about situations where firms won't increase supply in response to demand, either because they are monopolists, oligopolists or otherwise have market power to set prices?

In these cases, incumbent firms are likely to capture a large part of the value of a voucher through increasing prices on the services they deliver. Vouchers are designed to increase demand, which, if not met with an appropriate amount of increase in supply, will raise the price. Not only will this blunt how much beneficiaries from vouchers will benefit, it will also raise the price for consumers not benefiting from the voucher. If the firm has market power, this effect will allow them to capture part of the voucher in profits.

But what if the state, instead of providing vouchers for private firms, uses those resources to reduce the cost of the good by providing it themselves? First, all those resources will directly go to the services necessary to be funded. Second, a dollar spent producing the good doesn't just lower the cost for the direct consumer. It also lowers costs from private providers, who have to compete with the public option.

In these cases, vouchers get less bang-for-the-buck than public options directly funded with the same amount of resources. Vouchers, in the presence of firms with market power, will be partially captured and prices will increase for all. With public options, the resources will be adequately allocated and prices will decline for all.[9]

Take the example of higher education. Since the 1970s the government has created several voucher mechanisms to fund access to private colleges and universities, including Pell Grants, government-subsidized student loans and tax-subsidized savings vehicles. Meanwhile, public funding is being lowered and tuition raised at the equivalent public option, state public colleges and universities.[10]

There's a set of arguments stating that private institutions of higher education largely capture these vouchers by raising tuition in order to compensate for the extra demand vouchers produce.[11] If this logic is flipped, directly reducing the price of a college degree through public education will also reduce the tuition costs at the private institutions, as they are forced to reduce margins in order to compete. So in these instances, money spent on providing cheaper public options will amplify their effect throughout the market, while money spent through vouchers is simply captured by incumbent institutions and prices rise across the board.

When Standardization and Quality Are an Issue

A public option also standardizes a product, which is especially important for markets where there are information inequalities between buyers and sellers. This not only gives consumers an advantage in expecting what they'll get, but it also allows competitors to more explicitly compete on both quality and price. This is necessary when the government requires that a bare minimum of a good be allocated to each citizen.

A major problem with providing vouchers for a good is that it can be difficult for the government to completely monitor the quality of goods that qualify for vouchers when the private market produces them. If consumers themselves also have difficulty monitoring or understanding the full variety of goods, the market can lead to stratification and competition on reducing quality.

If prices are lowered, it can be difficult for the government and citizens to tell if it is because market innovations have allowed for lower cost production or because they are providing services of a cheaper quality. When there is a baseline quality necessary for the good this becomes very important.[12]

This extends to situations in which there is already a large market for private goods. Public options can set standards against which private plans can compete. The private market is then more incentivized to provide new benefit options and offer greater flexibility. Public options thus provide an institutional check and balance, which encourages private plans to have higher standards of quality and affordability.

This is true in the case of consumer finance. A 30-year, prepay-able fixed-rate mortgage with a down payment is, in part, a creation of Fannie Mae and Freddie Mac of the immediate post-War era. Consumers know what they are getting with these mortgages, and because they are standardized banks are able to compete on rates without deterring quality. The standardized nature of these mortgages created a large secondary market. Many states and academics have pushed for additional so-called "vanilla option" packages to be mandated for sale by banks or officials, ranging from a checking account with no hidden fees to a system of banking accounts to be run by the postal service.

It is worth noting that these vanilla options reduce the need for excessive regulation of private options that come with subsidies. For instance, private prisons have extensive regulations associated with them, because the baseline of what should be done to prisoners shouldn't be left to market forces. These private systems can lead to an increase in the importance of regulations, because monitoring of private agents can become quite costly. Rather than creating regulations to try and mold a basic quality level, the government creates, runs, and subsidizes such an option and lets the private market innovate in response to it.

Social Insurance

In many cases, especially in regards to social insurance, the government will be a more efficient provider of services than the private market. For markets where adverse selection plays a major role, the unique ability of the government to use compulsion to require purchase of a service makes public options more effective. People can choose not to spend vouchers, but being required to take advantage of a program can't be easily avoided. This allows insurance to work best through expanding risk pools and distributing risks more widely. This particular bargaining leverage gives the government the ability to gain volume discounts and restrain total spending.

As public options can often innovate and do research that acts as a public good, improvements in the system can be spread more widely. And due to the timeframe of the government relative to private firms, public options are better incentivized to make long-term investments in their clients that deliver benefits further down the road.

The lack of a profit margin and the scale at which governments can perform help explain these cost-control advantages, especially in the insurance markets. Information is a public good that private firms have no desire to share, yet it directly impacts quality control, improvements and costs. The size of the government gives it an advantage as a negotiator, and lower administrative overhead contributes to these cost-control advantages. We see this when the good is health care, as public insurance has proven more stable and capable of controlling costs, especially for the most vulnerable populations.

To take one example, public health insurance has been shown, through a range of studies, to be better at providing a given level of benefits for less than it would cost on the private market. Comparisons between Medicare and private insurance spending show that Medicare spending per enrollee has grown substantially slower than private plan spending.[13]

Social insurance is particularly important because needs aren't equally distributed among people or known in advance. Vouchers particularly work well when needs are roughly equal across people. People need roughly the same amount of food to survive, so food stamps allow individuals to buy the food bundles best suited to their needs. In these cases, giving people coupons to purchase the specific good that best suits their preferences is sufficient.

However, there are many situations in which needs vary greatly among people for reasons outside their control. In these cases, needs are unequally distributed and thus having equal access to a subsidy won't be enough for people who need the good the most. This is most obvious in health issues, where pre-existing conditions and the randomness of brute luck can cause people to need a large amount of health care.[14]

Indeed, "cream-skimming" and other forms of adverse selection, in which providers pick the most advantageous clients and leave other potential clients on the sidelines, are problems that can only be solved with compulsion available with certain types of public options. Both health care and Social Security can be available to those that would normally be denied it by creating a single-risk pool.

A form of social insurance that it is worth spotlighting is income maintenance. The government has shown itself to be particularly capable of supporting incomes for populations during specific age spans or life circumstances. As with health care, because of its size and lack of profit motive the government can lower administrative costs. Cash transfer programs where income is taken in through taxes and then sent out to targeted individuals is highly efficient as a technical matter: Social Security's administrative costs are in the range of less than 1%.[15] Beyond this, the long, intergenerational timeframe of the government's horizon allows for efficient, long-term insurance.

Providing people a level of income X under conditions Y is something the government has turned out to be very efficient at doing. Determining both the level of income and the circumstances of income maintenance requires a democratic debate, but once determined the government is well-positioned to carry these actions out.

Social insurance combines with the priority of providing for a bare minimum. Many social insurance goods are designed to compensate for bad luck, keep people out of hunger or poverty, or prevent certain undesirable states from being reached. Because these goals are part of the core of the welfare state, they should not be contingent on a relative lack of success in marketplace transactions. Preserving social insurance policy outside of the market emphasizes the importance of this minimum.

Case Study: Unemployment Insurance Accounts

With the broad outlines provided here it might be helpful to use a specific example to illustrate these principles in practice. Let's look at the example of unemployment insurance. Several commentators and policymakers have suggested replacing the unemployment insurance program, created in law as part of the 1935 Social Security Act, with a system of private, personal accounts for unemployment insurance. Former presidential candidate Mitt Romney told an Iowa debate in 2011 that he "would far rather see a reform of our unemployment system, to allow people to have a personal account which they're able to draw from as opposed to having endless unemployment benefits….if I were president right now, I would go to Congress with a new system for unemployment, which would have specific accounts from which people could withdraw their own funds."[16]

Under this private system, instead of contributing to a public trust fund for unemployment insurance, employees would create a savings account while working that has money automatically channeled into it tax-free that could then be drawn down during periods of unemployment. How does this system stack up against traditional unemployment insurance?

Unemployment insurance is strong all the advantages that we've outlined above and also manages to have the disadvantages of the private sector welfare state. To start, unemployment insurance falls under the broad definition of income maintenance and social insurance. It is easy for the government to provide people with a stipend of money under the conditions that they've been unemployed for a certain period of time and meet a few other obligations. The innovation and competition that comes from the market won't further this in the way it does for many other industries.

Between compulsion and the spreading of risks unemployment insurance also falls into social insurance, playing to the strengths of the government as a provider. Unemployment insurance savings accounts aren't actually social insurance – there's no risk pooling or sharing risks among large populations in order to take advantages of the traditional benefits of insurance. With individual savings accounts isolated, atomized individuals absorb the entirety of their unemployment risks by themselves.

The base minimum that comes with standardization is also key for unemployment benefits. Unemployment benefits are easy to scale up in difficult times like recessions. Unemployment savings accounts would be difficult to expand, thus taking a crucial "automatic stabilizer" of macroeconomic policy out of commission. Publicly-provided unemployment insurance is not isolated from choice, either – the expansion and contraction is subject to a democratic process, making the expansion in rough times visible and thus accountable.

Unemployment insurance savings accounts also encounter many of the pitfalls of a private welfare state. Redistribution in this private welfare state is quietly upwards, towards the richest, instead of toward those in need. Like any welfare spending through the tax system, unemployment insurance savings accounts benefit those who pay the most in taxes and those who have the ability and means to take advantage through disposable income and tax sophistication.

Unemployment insurance, like the best of social insurance, is something that works well in the background. People pay into it during good times automatically and then withdraw from it in bad. An unemployment insurance savings account transfers the risk from the public to the household, but it also transfers the management and execution to the individual as well. It is even more likely that citizens see that "submerged" welfare benefit not as a government executed item but as something they do themselves.

Conclusion

In the wake of the Great Recession, people from across the ideological spectrum are looking to remake the welfare state. As a result of the deregulation and privatization of the past 30 years, the default stance for many policy intellectuals is to support using private means to carry out the government's responsibilities as an end in and of itself.

This should be resisted. The public allocation of goods has many advantages that are unique to the government itself. These include compulsion, standardization, democratic input and rectification of market imperfections. Meanwhile, the private allocation of goods has additional problems that often amplify generic concerns about the government, ranging from distributional to control concerns. Reexamining the role of the government with these guidelines in mind will shed new light on where the market tends to fail and where the government can provide better by itself.

Notes

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About the Project

The Next Social Contract Initiative *aims to rethink our inherited social contract, the system of institutions and policies designed to empower and support citizens from childhood through work and retirement. Inspired by the premise that economic security and opportunity are mutually reinforcing, a new social contract should foster innovation and openness, encourage long-term growth and broadly shared prosperity, and engage individuals and families not only as participants in the economy but also as citizens.*

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