THE CURRENT LIFE INSURANCE CRISIS

Kyle D. Logue

UNIVERSITY OF MICHIGAN
LAW SCHOOL

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by

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Introduction

In 1997 Americans paid $115 billion in premiums to life insurance companies.¹ By the end of 1997, the total amount of life insurance in force was roughly $13.2 trillion.² The per-household average amount of life insurance (for those households who had some type of life insurance policy) was $165,800, or roughly 2.85 years worth of annual disposable income.³ In addition, the federal government in 1998 spent approximately $15.5 billion in tax subsidies to encourage the private purchase of life insurance. Those subsidies consisted of the income-tax exclusion for investment earnings on cash-value life insurance policies (a $13.5 billion tax expenditure in 1998) and the exclusion

² Id. at 2, table 1.1.
³ Id. at 12, table 1.6.

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** Professor of Law, University of Michigan. I appreciate helpful comments from participants at the 1999 Harvard Law School Seminar on Current Research in Tax Policy and the Michigan Law and Economics Workshop.
for employer-provided group-term insurance (a $2 billion tax expenditure).\textsuperscript{4} And then there are the enormous amounts (tens of billions of dollars) of life insurance proceeds that get paid out every year by the U.S. government directly to widows, widowers, and children of deceased workers in the form of social security survivorship benefits.\textsuperscript{5}

Despite the substantial resources being devoted to the provision of life insurance, this Article argues that there are reasons–both empirical and theoretical–to worry that existing levels of life insurance are inadequate, such that some additional form of government intervention (besides those summarized above) might be called for. It does not argue that the time has clearly come to make drastic changes in survivorship benefits or the tax treatment of life insurance, but rather that the time has come, finally, for life insurance to become a serious topic of conversation among policy commentators–and not just with their life insurance agents. In that spirit, the Article also surveys an array of alternative policy responses, identifying their main strengths and weaknesses, should the underinsurance problem, upon further theoretical and empirical investigation, prove to be real.

Part I of the Article focuses on the initial (and central) normative question implicit in the empirical claim of life-insurance inadequacy–the question of what is the “right” (or “optimal” or “rational”) amount of life insurance. That question turns out to have no definitive answer, which may

\textsuperscript{4} Tax Expenditure Budget (1998) Table 5-1.

explain the paucity of research on the subject. Interestingly, however, the same conceptual problem exists in other areas such as retirement savings, where scholars and policy makers do not hesitate to make policy recommendations, as if the optimal amount of retirement savings were common knowledge.

Next, section A of Part II reviews the existing empirical research on life-insurance purchasing patterns, which finds substantial and widespread underinsurance. The scholars conducting those studies, however, take pains to avoid making any normative conclusions based on their findings, precisely because of the difficulty of specifying the optimal amount of life insurance coverage. In section B of Part II, however, I review a number of theoretical reasons why the empirical evidence should be given a normative slant, that is, why the evidence probably does suggest true underinsurance and why, therefore, further government intervention may indeed be appropriate.

Part III, building on Parts I and II, assumes the reader has been sufficiently persuaded of the existence of a problem to consider what the possible policy responses might be. For those acquainted with the standard debates regarding the funding and administration of social insurance programs, this

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framework will be familiar. For example, Part III compares and contrasts the standard types of policy tools that are available to deal with this sort of problem, such as direct government provision, government mandates, or government subsidies. The purpose of Part III, which draws heavily from the existing literature on optimal subsidy design, is not to provide a comprehensive legislative proposal, but rather to suggest avenues of further inquiry. This Part concludes that a promising approach would involve either (a) a combination of some minimal amount of government provided term insurance (along the lines of what is currently provided through social security survivorship benefits, although perhaps made more widely available and with somewhat more generous benefits) and a demand-side subsidy either in the form of a deduction, a credit, or a voucher, or (b) a more generous level of government-provided or government-mandated coverage, but with the possibility for households to opt for less coverage. Part III also looks at the existing tax-subsidies for life insurance—the exclusion for employer-provided term insurance and the exclusion for investment earnings in cash-value life insurance policies—as discusses who those rules might be expanded to enhance the existing subsidy for life insurance purchases.

I. The Problem of Defining “Adequate” Life Insurance

A. Explaining Insurance Demand Generally

To evaluate the question whether households are purchasing adequate amounts of life insurance, we need to understand why they purchase life insurance in the first place. And that inquiry can begin with a review of the standard explanation of insurance markets more generally. According to the economist’s traditional account, insurance markets arise because of differences in attitudes toward
risk. Specifically, individuals are often believed to be risk averse, at least with respect to the possibility of large losses of the sort that insurance policies typically cover, and insurers are less so. What is meant by the assertion that individuals are risk averse is that individuals would rather experience a certain loss than an uncertain prospect of equal expected value. This intuition generally is traced back to Nicholas Bernoulli’s *St. Petersburg Paradox* posed in 1728:

Suppose someone offers to toss a fair coin repeatedly until it comes up heads, and to pay you $1 if this happens on the first toss, $2 if it takes two tosses to land a head, $4 if it takes three tosses, $8 if it takes four tosses, etc. What is the largest sure gain you would be willing to forgo in order to undertake a single play of this game?  

The expected value of this game is infinite. Therefore, if an individual were indifferent to risk, if she were concerned only with expected value (the sum of the probability-weighted outcomes, irrespective of the variance), she would be willing to pay a huge sum (everything she has) to play such a game. However, the conventional wisdom is that most people would pay only a modest amount (maybe a few dollars) to play such a game only once, which suggests some general applicability of the risk-aversion assumption.

The assumption underlying Bernoulli’s observation was subsequently formalized and modeled by von Neumann-Morgenstern. The von Neumann-Morgenstern [VNM] utility function produces the

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8 Machina, supra note __ (“Since this gamble offers a ½ chance of winning $1, a 1/4 chance of winning $2, etc., its expected value is $(1/2) \cdot $1 + (1/4) \cdot $2 + (1/8) \cdot $4 + \cdots = $1/2 + $1/2 + $1/2 + \cdots = $\infty$, so it should be preferred to any finite sure gain.”).

concave marginal-utility-of-income curve (denoting risk aversion)\textsuperscript{10} that is well known to students of introductory microeconomics. The intuition underlying that concave curve is that, although individuals derive some utility from each new dollar received, they derive less utility with each succeeding dollar, an intuition that seems especially plausible for low-probability/large-loss events and that is consistent with the existence of insurance markets for catastrophic losses.\textsuperscript{11} In such a situation, the relatively few dollars that go to pay the insurance premium are plausibly “less costly”–less painful–for the individuals to lose (on a per-expected-dollar basis) than the much larger number of dollars that would be lost in the event of an uninsured catastrophic loss.\textsuperscript{12}

In other words, the insurance contract provides a mechanism for satisfying the relative differences in taste for risk between individuals and insurance companies. By purchasing an insurance policy, a risk-averse individual can pay a certain premium (which approximates the individuals expected loss for the period plus some loading charge) to an insurance company who agrees to cover the loss in

\textsuperscript{10} As well as and the convex curve (denoting risk preference).

\textsuperscript{11} We also, however, observe individuals (by the millions) purchasing lottery tickets and gambling in other ways, which suggests some applicability for the convex, risk-preferring curve as well. Applying the VNM model, Friedman and Savage showed that a utility function which is concave at low levels of wealth and convex at high levels of wealth can explain why the same individual might buy both an insurance policy and a lottery ticket. Milton Friedman & Leonard J. Savage, \textit{The Utility Analysis of Choices Involving Risk}, 56 J. POL. ECON. 279 (1948).

\textsuperscript{12} In a sense, the idea of risk aversion is that not all dollars are created equal: Some of the dollars that go to pay an uninsured catastrophic loss would have otherwise gone to purchase “necessities” whereas all of the dollars that go to purchase insurance come “off the top.” A similar rationale is used to justify redistributive taxation; that is, the policy of progressive taxation is sometimes defended by reference to a hypothetical concave social marginal-utility-of-income curve. See, e.g., Joseph Bankman & Thomas Griffith, \textit{Social Welfare and the Rate Structure: A New Look at Progressive Taxation}, 75 CALIF. L. REV. 1905, 1916-18 (1987) (explaining welfarist, utilitarian defense of progressivity).
question if it occurs. The insurer in turn a) spreads some of the risk of that loss over a large number of other individuals, all of whom pay premiums to the insurer and b) shifts some of the risk to reinsurers.

And this is what we observe.\(^\text{13}\)

How much insurance will a rational individual demand? That is a question that economists have explored in great detail, and even the standard economic models—which rely on a common set of methodologies as well as assumptions about human rationality—produce varying outcomes.\(^\text{14}\) In general, under the standard models, the purchase of “full” insurance coverage for a particular loss—coverage with no deductibles or coinsurance or caps—would only be rational under a limited set of conditions—such as the absence of loading costs, moral hazard, and adverse selection. Given the prevalence of loading costs, moral hazard, and adverse selection, the standard models suggest that rational insurance policies would include something short of full coverage for monetary losses.\(^\text{15}\)

\(^{13}\) As will be discussed further below, there is a strange circularity in the economic study of insurance: Economists explain insurance markets on the grounds that individuals are risk averse; however, they defend their risk-aversion assumption by referring to the existence of insurance markets. In fact, this circularity is largely benign. When we get to the question of how much insurance rational individuals would demand for a given type of loss, however, reference to market outcomes becomes more problematic. [cross reference]

\(^{14}\) By “standard” models I am referring to those based on the von Neumann-Morgenstern utility function. For a review of the growing experimental-psychology literature that calls into question some of the key assumptions underlying the VNM model (such as the transitivity of preferences and the absence of framing effects), see Machina, supra note __.

\(^{15}\) For example, applying the VNM model, it has been shown that 1) if the insurer is risk averse (and hence charges a disproportionately large loading charge), the insured would prefer a policy that includes some element of coinsurance; and 2) if the insurer is risk neutral (so that the loading charge is proportional to the actuarial value of the risk), the insured would prefer a policy with full coverage over some deductible. KENNETH J. ARROW, ESSAYS IN THE THEORY OF RISK BEARING (1971).
An important refinement of the economist’s standard analysis of insurance demand takes into account the possibility that some events cause not only monetary losses (that is, losses for which there is a ready monetary equivalent) but also nonmonetary losses (that is, losses for which there is no ready monetary equivalent). For example, if an individual loses an arm or a leg or, worse, a child in an accident, that individual would obviously suffer a catastrophic nonmonetary loss as well whatever monetary losses may be associated with such tragedies. Indeed, in such cases, the nonmonetary loss will constitute the majority, in some instances all, of the actual harm.

Whether individuals demand insurance against the possibility of such a nonmonetary harm turns out to be an interesting and difficult question. Applying a variant of the standard model, scholars have concluded that the answer turns on whether (and the extent to which) the event in question is expected to alter the individual’s marginal utility of money. On one hand, if the event is expected to have no effect on the individual’s marginal-utility-of-money (that is, the next dollar in the “accident state of the

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16 In the literature, the terms “pecuniary” and “nonpecuniary” are often used to describe what I am calling monetary and nonmonetary losses. See generally Steven P. Croley & Jon D. Hanson, The Nonpecuniary Costs of Accidents: Pain-and-Suffering Damages in Tort Law 108 HARV. L. REV. 1785 (1995).

17 With loss of a limb, there would be medical expenses and possibly lost income. But there would clearly be a large nonmonetary element as well. That is, the individual would, assuming he could get the money, certainly be willing to pay more than the discounted present value of the future earnings associated with the limb to avoid the accident. With the loss of a child, there may in fact be no substantial monetary loss. Rather, the entire loss may be of nonmonetary nature. Croley & Hanson, supra note __, at __.

18 If an individual’s utility function (the marginal utility of dollars) changes as a result of particular type of event (here, a nonmonetary loss of some sort), that individual’s utility function is said to be “state dependent.” Philip J. Cook & Daniel A. Graham, The Demand for Insurance and Protection: The Case of Irreplaceable Commodities, 91 Q. J. ECON. 143 (1977).
world” is equal in value to the next dollar in the “no-accident state of the world”), the individual would ex ante demand full insurance against monetary losses (again, assuming no loading costs) but no insurance against nonmonetary losses. On the other hand, if the event is expected to increase the individual’s marginal-utility-of-money (all else equal), she would demand more than full monetary-loss insurance coverage. Finally, to complete the picture, if the event is expected to reduce the individual’s marginal-utility-of-money, less than full monetary-loss insurance would be demanded.19

In sum, risk-averse individuals will demand insurance to cover them against an (uncertain) possibility of harm; and the amount of coverage (the fraction of the total potential loss that will be covered) will depend on, among other things, whether there are severe moral hazard and adverse selection problems (which suggest the rationality of less-than-full coverage) and the effect of the potential harm on the individuals’ marginal utility of money (which can go either way).

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19 Steven Shavell, Economic Analysis of Accident Law 229-30 (1987). The scholars who have studied this question often develop simply hypothetical examples to illustrate the point. For example, one scholar offers the following illustration:

Consider a business executive who runs recreationally and who loses a foot in an accident. . . . [T]he injury could increase the marginal utility of money for this consumer if it caused her to substitute travel or the symphony for running because these activities are more expensive. Here marginal utility could fall, however, if she substitutes reading for reading.

Alan Schwartz, Proposals for Products Liability Reform: A Theoretical Synthesis, 97 Yale L.J. 353, 364 (1988). Thus, in the former case, the executive would ex ante demand insurance for the loss of her foot in order to shift income (via the insurance premium) from the non-injured state of the world to the injured state of the world in which travel (which is an expensive pastime compared to running) has become relatively attractive; whereas, in the latter case, she would not demand insurance for the loss of her foot, but might in fact demand some form of “disinsurance” (for example, less than full medical insurance for amputation accidents) in order to keep more of her dollars in the non-injured state of the world where they are relatively valuable. For a discussion of the concept of, and a survey of the literature on, disinsurance, see generally Croley & Hanson, supra note __, at 1800 n.47.
B. The Demand for Life Insurance

1. The Life Insurance Policy

Before embarking on a theoretical exploration of life-insurance demand, however, let us review some practical aspects of the life-insurance market as it currently exists. The simplest form of life insurance is the term policy. A term life insurance policy is a contract in which the insurance company agrees to pay a predetermined amount of money—called the “face amount” or the “death benefit”—to the beneficiary named in the policy if the insured dies during the policy period. In return for this promise, the insured pays periodic premiums to the insurer, which the insurer, of course, invests. A more complicated type of life insurance is cash-value life insurance, which, in effect, is two products bundled together: term life insurance and an investment vehicle. In cash value policies, it is often, though not always, the case that as the investment side of the policy increases over time, the term side of the policy decreases. This would be true, for example, if the death benefit were kept fixed over the life of the policy. Sometimes, however, the death benefit in a cash value policy is increased over time. In those cases, if the term-insurance portion of the policy remains relatively constant over time, then the investment portion of the policy grows.

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20 The “insured” is the person who’s death triggers the payment of the death benefit to the beneficiary. The “policy owner” is the person with the power to designate the beneficiary under the policy and, with cash value policies, the right to receive the cash surrender value. I will generally use the terms insured and policy owner synonymously, although they need not always be the same person. “Cash value” life insurance is a product that combines term insurance with an investment account.

21 In Part __ below, I provide a fuller discussion of cash value insurance and the federal tax subsidy that it enjoys.
In this country all insurance companies, including life-insurance companies, are regulated heavily at the state level.\textsuperscript{22} To differing degrees, state insurance regulators monitor insurer solvency (both assets and liabilities), insurance prices, policy terms, and agent conduct. According to the law in every state, the party taking out a life-insurance policy on someone else’s life must be someone who stands to lose financially if the insured dies; that is, the policy owner must have an “insurable interest” in the life of the insured.\textsuperscript{23} In addition, the face amount of life insurance that can be purchased on someone’s life cannot exceed the policyowner’s insurable interest. An insurable interest is presumed to exist when one is seeking to insure one’s own life or that of a family member and, in theory, is presumed to be infinite.\textsuperscript{24}

2. \textit{The Conceptual Difficulty of Modeling Life-Insurance Demand}

But why do people buy life insurance in particular? With some life-insurance contracts, the standard model of insurance demand, discussed in Part \_\_ above, would seem to apply rather nicely. Think of the person on whose life the policy is purchased (whose death will trigger the payment of the death benefit) as an income-generating asset and the beneficiary of the policy as someone who has a financial interest in the insured’s continuing to live and who, if risk averse, would therefore demand insurance against the possibility of the insured’s premature death. This property-insurance analogy is

\textsuperscript{22} \textsc{Robert H. Jerry II, Understanding Insurance Law} 84-95 (2d ed. 1996).

\textsuperscript{23} \textsc{Keeton, Insurance Law} (xxx). This paper will focus on intra-family life insurance, since it is with respect to that type of life insurance that the theory and evidence suggest a problem of inadequate coverage.

\textsuperscript{24} Although there are no legal limits on the amount of life insurance a person can buy on his own life or that of a family member, there are limits in practice. The most obvious is the budget constraint; that is, the insured must be able to pay the premium. In addition, insurance companies may, as a matter of practice, impose upper limits.
almost perfect, for example, in situations involving the purchase of life insurance by one business partner on the life of another. However, when life insurance is purchased on the life of the breadwinner or breadwinners in a household, and the beneficiaries of the policy are the members of those members of household who are dependent on the breadwinner(s)’ income, the analogy to property insurance weakens and the analysis becomes more complex.25

For one thing, it is the breadwinner who generally purchases and maintains the life insurance policy on his or her own life. And, of course, if the loss event occurs, the breadwinner-insured is no longer in the picture; hence, the demand for life insurance in such settings cannot simply be understood as a risk averse party seeking to shift a risk of loss from him or herself to an insurance company. If the risk-shifting rationale is to be used, it must be that the risk in question—the premature death of the breadwinner—is faced by the dependent members of the household. Thus, to explain the breadwinner’s decision to purchase life insurance, one must adopt some theory of household dynamics, such as an exchange theory (under which the breadwinner receives something of value in exchange for devoting some of his or her income to insurance on his or her life) or an altruistic-head-of-household theory (under which the breadwinner insures his or her life out of love or charity).26

25 There can be, and often is, more than one breadwinner within a household. And each breadwinner can be viewed as a dependent to some extent of the other breadwinner, in which case each might want insurance on the other’s life, even without children in the picture. It is also true that in households with children whose primary caregiver is a stay-at-home parent (or other family member who does not charge for the services), insurance might be demanded on the life of that person even if that person is not also a breadwinner.

26 When children are the primary beneficiaries under the policy, the altruistic model seems clearly more appropriate, especially where term insurance is involved. In the vast majority of cases, the insured does not die during the term of the policy and eventually allows the policy to lapse after the need for the insurance has passed. Thus, it seems likely that the children never even know that their
The difficulty with all such theories, however, is that, although they might explain why households would purchase some life insurance on a breadwinner’s life, they do not provide an obvious means of specifying the precise amount of insurance that a rational household (that is, a household composed of rational individuals) would demand. As a first approximation, one might try to apply the standard insurance-demand model to this context in a straightforward way. Thus, for example, if we could identify the dependent-beneficiaries’ expectation interest in the life of the breadwinner, and if we assume that those dependent-beneficiaries’ are risk averse in the traditional sense (and that the breadwinner is a perfect purchasing agent for the beneficiaries), then, putting aside loading costs and nonmonetary losses for the moment, the standard model might be used to determine the amount of coverage that would be demanded.27

But the analysis is not that simple. For example, what is the dependent-beneficiaries’ expectation interest? And what would amount to full coverage of that interest? Moreover, what is the effect of the breadwinner’s death on the utility derived by the household from income? To answer these questions, a long list of prior questions must be addressed: Is the ex ante expectation of the household that, if the breadwinner should die, the dependent-beneficiaries will find other sources of income? For example, in a household in which one spouse is the primary breadwinner and the other has elected to stay home (either to rear the children or otherwise to maintain the household), it might be

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assumed that the homemaker will get a job upon the death of the breadwinner. Likewise in such cases, it might be assumed that the stay-at-home spouse will remarry, thus bringing a new breadwinner into the household. Alternatively, it might be assumed that the household will purchase enough coverage on the life of the breadwinner to enable the dependent-beneficiaries to continue with their existing, pre-loss standard of living—without having to go back to the “market” (the job market or the spouse market) to provide a substitute source of income. Or it might be assumed that implicit, informal types of life insurance will be relied upon, such as assistance from charitable organizations, friends, and family.

Also, how long are children expected to be members or dependents of the household? Until age 18? 22? How long is the breadwinner expected to work? How much of an inheritance is anticipated? What portion of that inheritance is expected to go to charity and how much to survivors? In addition to all of these considerations, would the members of the household wish to include an extra amount of insurance (over and above the amount necessary, for example, to maintain the household’s standard of living), to help compensate for the survivor’s feelings of bereavement.

All of these questions bear on the choice of the right amount of life insurance. And different households obviously can answer these questions in different ways, which presents a profound difficulty for any investigation of life-insurance adequacy. That is, if insurance theory does not even provide a determinant answer to the question of the optimal amount of coverage for any given household, how can we know whether the existing levels of life insurance are adequate or not? In one sense, we cannot know. It is entirely possible that whatever empirical results we find can be explained as reflecting rational, well-informed, unbiased household decision making. On the other hand, it is equally possible (and, in my view, more likely) that the empirical results reflect an underlying problem in the life insurance
market. Before exploring the reasons for my interpretation of the data, and for my worries about life-insurance markets generally, consider first the data.

II. Defending the Claim of Life-Insurance Inadequacy

A. Empirical Research on Life-Insurance Adequacy

By far the most sophisticated study of life-insurance adequacy ever done is the most recent one, authored by B. Douglas Bernheim, Lorenzo Forni, Jagadeesh Gokhale, and Laurence J. Kotlikoff, the results of which have been made available in a working paper entitled “The Adequacy of Life Insurance: Evidence from the Health and Retirement Survey.” That article builds on a model of life-insurance adequacy developed by Alan Auerbach and Laurence Kotlikoff in a series of papers in the late 80s and early 90s. According to this approach, “life insurance is defined to be adequate if the survivor’s highest sustainable standard of living after the death of a spouse is equal to or greater than the couple’s highest sustainable standard of living if both survive.” If the household’s standard of living would decrease when a spouse dies, that household would be considered underinsured.

28 Bernheim et al., supra note __.

29 Auerbach & Kotlikoff, Life Insurance of the Elderly, supra note __; and Auerbach & Kotlikoff, Adequacy of Life Insurance, supra note __.

30 Bernheim et al., supra note __, at 6; see also id. at 2 (“[W]e consider the level of life insurance to be adequate if it allows an individual and his or her children to sustain his or her living standard upon the death of a spouse.”). By adopting a standard-of-living baseline, the authors have simply relied on their own intuitions as to the choice of a useful benchmark and have not attempted to rely on some derivation of the VNM utility function.
Although this basic approach is the same as the earlier studies, there are two important differences: First, the Bernheim et al study examines much more recent data.  

Second, the Bernheim et al study is that it adjusts for a number of important factors that prior studies did not, including liquidity constraints and changes in household composition over time (including the presence of children). In addition, the authors make a number of assumptions to make the enterprise tractable. First, they define the “household” to include husbands and wives until their deaths and children until they reach age 18.

Second, they make assumptions about the household utility function that allows them to make predictions about how the death of a breadwinner will affect household consumption patterns. Along the same lines, they treat certain types of expenditures—such as housing costs, college tuition and wedding expenses for children, and funeral costs—as being fixed, by which they mean that those expenses would not be reduced or eliminated in the event of a death of an adult in the household.

Finally, the software package the authors use employs a sophisticated approach to measuring social security benefits (including survivorship benefits), income and payroll taxes, and tax-deferred retirement savings.  

31 Whereas the prior studies were based on data from the 60s and 70s, this study looks as data from the 1992 wave of the Health and Retirement Survey (HRS).

32 Id. at 10-11. The study also leaves out a few things. For example, it does not attempt to take account of the possibility that a surviving spouse may remarry. They justify this assumption on the theory that “the economic well-being of a remarried individual may be determined by his or her financial status prior to remarriage, insofar as this affects bargaining power within the new marriage.” Id. at 12 (citing Shelly Lundberg, Family Bargaining and Retirement Behavior, in Henry Aaron (ed.), Behavioral Economics and Retirement Policy, Brookings Institutions (forthcoming 1999)).
For a more detailed discussion of the study’s methodology, data, and findings, I refer the reader to the paper itself.\textsuperscript{33} Here I will only summarize some of the most noteworthy results. The most general conclusion is that underinsurance is indeed widespread— for husbands and wives, for primary earners and secondary earners, for the relatively young and the relatively old, and for high income and low income households.\textsuperscript{34} However, the prevalence and severity of underinsurance does exhibit some patterns; the problem is much more concentrated in some areas than in others. For example, a higher percentage of households are underinsured on the husband’s life than on the wife’s life.\textsuperscript{35} Moreover, the discrepancy in adequacy is even greater as between the lives of primary earners\textsuperscript{36} and those of secondary earners.\textsuperscript{37} Also, in households with single earners, the underinsurance problem on the life of the sole earner is quite pronounced.\textsuperscript{38} One clear message comes from all of these numbers:

\textsuperscript{33} This paper can be found at \url{http://www.nber.org/papers/w7372}.

\textsuperscript{34} Three categories of underinsurance were defined: If the death of a spouse would reduce a household’s standard of living at all, the household was said to be merely “underinsured” with respect to that spouse. If the reduction would be between 20\% and 40\%, the household was “significantly underinsured.” And if the reduction would be greater than 40\%, the household was “severely underinsured.”

\textsuperscript{35} In terms of mere underinsurance, 51\% of households were underinsured on the husband’s life, and 24\% on the wife’s life. With respect to severe or significant underinsurance, the numbers are 30\% (for husbands) and 12\% (for wives).

\textsuperscript{36} 55\% of households underinsured; 34\% significantly or severely so.

\textsuperscript{37} 21\% of households underinsured; 8\% severely so. The reason for the greater discrepancy with respect to primary and secondary earners is, of course, that some wives are primary earners within their households.

\textsuperscript{38} In such households, roughly 21 percent are severely underinsured, and another 14 percent are significantly underinsured, on the life of the primary earner.
When the households are arranged according to income, other interesting patterns emerge. For example, underinsurance tends to fall as income rises at the lower levels of income; and then it levels off (that is, underinsurance tends to remain constant as income rises) at moderate levels of income. However, when it comes to significant and severe underinsurance, the tendency is the reverse. Both significant and severe underinsurance tend to decrease with income at low levels of income and to rise with income at high levels of income. What explains this result? The authors suggest, I think rightly, that significant and severe underinsurance on the lives of primary earners in the highest-earning households is to be expected, because “these households are more likely to have a single high earner, and because Social Security survivor benefits replace a much smaller fraction of income.”

For example, in households with husbands and wives who are in their 40s, 71 percent of households are underinsured, and 49 percent are significantly or severely underinsured, on primary earners.

In households without children present, for example, there was considerably less underinsurance (52 percent) and significant and severe underinsurance (31 percent) than in households with children present (69 percent and 47 percent, respectively).
reduction in their living standards had their husbands died during the survey year. They predicted greater insurance shortfalls for younger widows. They reached similar results in another study, this time of data compiled from surveys of a cross-section of U.S. households consisting of married couples with husbands between the ages of 35 and 55. In that study, too, they found that a significant minority of households were underinsured with respect to the lives of the husbands. The underinsurance problem was most pronounced in the households in which women were considered “at risk” in the following sense: over half of the household’s total life-contingent assets were attributable to the husband’s life.

All of those findings, the authors concluded, probably understate the extent of the underinsurance problem, for several reasons. First, the authors’ calculations assumed no economies of scale in shared living arrangements. If there were such economies—that is, if “two can live cheaper than one”—then a larger amount of insurance would be needed to maintain a given standard of living. For simplicity, they assumed no such economies. Second, the SRI surveys included little data on private pension benefits. Because most private pensions at the time were defined-benefit rather than defined-contribution plans, and because such plans at the time did not typically offer joint-survivorship benefits, this omission probably caused the underinsurance problem to be understated. Third, Auerbach & Kotlikoff made no effort to take account of the consumption requirements of small children in the household. Adding children to the mix would almost certainly increase the amount of coverage on a

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42 Roughly 25 to 30 percent of the households in the survey would have suffered a reduction in standard of living of at least 30 percent; and 15 percent would have suffered at least a reduction of 50 percent had the husbands died.

43 In those households, 20 percent of wives would lose 50 percent or more of their standard of living, and 41 percent would lose 30 percent or more, if the husband were to die in the survey year.
breadwinner’s life necessary to prevent a drop in consumption power in the event of his or her death.

Fourth, when calculating the value of each spouse’s human capital, Auerbach & Kotlikoff assumed zero growth in the real rate of earnings. Of course, it is possible that real earnings could stay the same over time, or even decrease, but it is most likely that real earnings would increase with age, especially between the ages of 35 and 55. Thus, an assumption of zero growth would tend to understate the underinsurance problem.44

In sum, all of the academic studies of life-insurance adequacy have concluded that life-insurance “inadequacy” is pervasive and in some cases severe. Additional (albeit weak) support for the claim of underinsurance comes from insurance-industry lore and survey research. First, there is an industry rule of thumb that a “typical” household (one that includes two adults and two children) should have life-insurance coverage the equals between 5 and 7 times the its annual income. For whatever that rule of thumb is worth,45 there is industry research indicating that many households do not come close to

44 Because the Bernheim et al study addresses all of these shortcomings–it accounts for economies of scale, it incorporates a great deal of pension information, it includes the presence of children, and it accounts for earnings growth–it is unsurprising that their study finds underinsurance to be more prevalent and more severe than the Auerbach & Kotlikoff studies did. Another interesting finding in that particular Auerbach and Kotlikoff paper was that households rarely updated their coverage. That discovery is especially noteworthy because the survey was conducted during and after periods of rapid inflation, when theory would suggest that insurance coverage (which almost never is indexed for inflation) would need to be increased regularly. This failure to adjust one’s coverage over time could be responsible for at least some of the underinsurance problem.

45 Some life insurance experts contend that any life-insurance “rule of thumb” is basically worthless. JOSEPH BELTH, LIFE INSURANCE: A CONSUMER’S HANDBOOK (2d Ed. 1985). The claim is that an accurate determination of life insurance need is too contingent on various factors that differ significantly from one individual to the next for any rule of thumb to be of use. Cf. BLACK & SKIPPER, LIFE INSURANCE ch.12 (showing the detailed calculations necessary to determine life insurance adequacy).
meeting it. For example, according to one study, the average level of coverage was roughly 2.85 times the average annual household income for the sample.\footnote{American Council of Life Insurance, \textit{supra} note \_, at 64.}

\textbf{B. Reasons to Be Worried}

One might be tempted to conclude that the findings of insurance inadequacy summarized above are, by themselves and with no further justification, sufficient to warrant a call for swift government intervention. But that would be a mistake. Although the studies provide grounds for concern, there remains a considerable degree of uncertainty about how to interpret those results. Recall, for example, that the Bernheim et al study chose as its baseline of insurance adequacy the standard of living prior to the breadwinner’s death. That is certainly a defensible benchmark, even an admirable one. But it is clearly not the only plausible one. Moreover, although Bernheim et al themselves conclude that “underinsurance is widespread,” they nevertheless take great pains to emphasize the non-normative nature of their study. They make clear that their definitions of “inadequacy” and “underinsurance” are not meant to carry any normative implication. For example, in the introduction the authors say:

\begin{quote}
It is important to emphasize that we do not equate adequacy with rationality. A couple might purchase relatively little life insurance for a variety of economically legitimate reasons. For example, the household’s decision maker(s) may place relatively little weight on the well-being of the secondary earner, or may regard life insurance as excessively expensive. Thus, the current study is not intended to shed light on the rationality of life insurance purchases.\footnote{Id. at 2-3.}
\end{quote}

And at the beginning of their “Methodology” section, they state that the adequacy of a household’s life insurance is in the eyes of the beholder. Virtually any level of life insurance can be rationalized as reflecting the maximization of some intertemporal and state-specific preference function. Nevertheless, we think it possible to establish meaningful benchmarks and to
evaluate the adequacy of insurance in comparison to these benchmarks. In so doing, it is important to emphasize that significant deviations from the benchmarks do not necessarily reflect irrationality. Rather, they simply indicate the extent to which actual choices either fall short of or exceed some easily interpreted target.48

Finally, consistent with their non-normative approach, in the conclusion of the paper, although the authors report “widespread underinsurance,” they make no policy recommendations.49

Why do the Bernheim et al go to such lengths to emphasize the non-normative nature of their enterprise (despite the use of the term “adequacy” throughout their paper)? The reason is simple: Identifying definitively a single “optimal” or “adequate” amount of life insurance for a given household is impossible. What seems odd, however, is the implicit assumption that such indeterminacy precludes any normative judgment whatever. Since when? For example, a clever scholar could come up with a model to explain virtually any pattern of consumption over time, even one that entailed almost no retirement savings. And yet countless scholars and policymakers operate under the assumption that some level of government intervention, either a tax subsidy for retirement savings or some form of compulsory retirement savings, is appropriate.50

The reason, of course, is that we can easily envision all sorts of pathologies—ranging from standard externality stories to myopia stories—that would lead individuals to undersave for retirement.

48 Id. at 5-6.

49 The absence of a normative element and a policy recommendation is something of a departure from the earlier Auerbach & Kotlikoff studies, which concluded with recommendations of increased survivorship benefits.

50 See, e.g., HARVEY S. ROSEN, PUBLIC FINANCE 197 (1995) (“[I]t is popularly believed that in the absence of the Social Security program, most people would not accumulate enough assets to finance an adequate level of consumption during retirement.”).
In my view, a similar set of stories, as well as a few additional ones, can be offered at least as persuasively in support of government intervention in the life insurance market.

For starters, consider one of the most commonly offered justifications for social insurance regimes: the problem of adverse selection. In the life-insurance context, adverse selection occurs when some individuals are better informed about their own statistical life expectancy than insurers are. In such a situation, premiums will tend to be inefficiently high, as insurers will be compensating for the fact that the relatively high-risk individuals will tend to “adversely select” into the insurance pool. As a result, all other individuals will tend to purchase less than optimal life insurance coverage or perhaps even forgo coverage altogether.51

Next, consider how standard externality arguments might be applied to life insurance. The breadwinners in a household may anticipate that, if they die leaving survivors who are destitute, the extended family and friends of the survivors, as well as local charitable organizations, will step in to fill the breach. If so, an externality is created, which means a lower amount of life insurance would be

51 See generally ROSEN, supra note __, at 196-97 (summarizing the adverse selection justification of social insurance). For the seminal, albeit technical, article on adverse selection, see Michael Rothschild & Joseph E. Stiglitz, Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information, 90 Q. J. ECON. 629 (1976). Of course, insurance companies attempt to counteract adverse selection in several ways. For example, the development of employer-provided group life insurance may, in part, be attributable to the way in which group underwriting (in contrast with individual underwriting) responds to the adverse-selection effect. Moreover, even for life insurance policies sold to individuals, insurers have developed ways of combating the most egregious forms of adverse selection. For example, in addition to the usual battery of medical-history questions that are asked of every insurance applicant, there are advances in medical technology—such as new blood and urine tests—that help life insurers to segregate the high, medium, and low risk individuals into separate pools. Neither of these approaches, however, completely eliminates the problem. With group life insurance, there is still a greater tendency for high-risk individuals than for low-risk individuals to buy the group term coverage at any given price. And the blood tests and application process for individual policies are not perfect.
Indeed, it is difficult to imagine grandparents, aunts, uncles, cousins, and friends approaching an individual and suggesting that if he would increase his life insurance coverage they would all chip in and bear the extra cost in order to spare themselves the cost, ex post, of contributing to the support of the survivors. Of course, it could also be argued that relying on friends and family in this way is a desired form of insurance rather than a type of externality. Indeed, in one sense, reliance of family and friends is the original form of life insurance, and it may continue to be a type of life insurance that we want to encourage. That is, one might argue that society benefits—perhaps from an increased sense of community—when extended family and friends are expected to bear some of the load of a breadwinner’s death. That reasoning if persuasive would, of course, tend to cut against the finding of underinsurance. However, if we take that argument seriously here, we would need to do so elsewhere as well. For example, on similar reasoning, we might want to discourage retirement savings so as to encourage reliance by aging parents on their children’s resources.

Likewise, a similar sort of externality story can be told with respect to government-provided survivorship benefits. That is, it could be argued that households who underinsure externalize costs to all taxpayers because of the payroll-tax-funded social security survivorship benefits.

And what about the myopia argument? In the context of retirement savings, it is often argued that some type of compulsory savings or transfer system (such as the social security system) or at least some type of government subsidy for retirement savings (such as IRAs and 401(k) plans) is justified on

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52 Indeed, it is difficult to imagine grandparents, aunts, uncles, cousins, and friends approaching an individual and suggesting that if he would increase his life insurance coverage they would all chip in and bear the extra cost in order to spare themselves the cost, ex post, of contributing to the support of the survivors. Of course, it could also be argued that relying on friends and family in this way is a desired form of insurance rather than a type of externality. Indeed, in one sense, reliance of family and friends is the original form of life insurance, and it may continue to be a type of life insurance that we want to encourage. That is, one might argue that society benefits—perhaps from an increased sense of community—when extended family and friends are expected to bear some of the load of a breadwinner’s death. That reasoning if persuasive would, of course, tend to cut against the finding of underinsurance. However, if we take that argument seriously here, we would need to do so elsewhere as well. For example, on similar reasoning, we might want to discourage retirement savings so as to encourage reliance by aging parents on their children’s resources.


54 See, e.g., Treasury Report, supra note __, at 40 (Families [who purchase inadequate life insurance] may choose to rely on existing government welfare programs if premature death of the family provider occurs.”); and Summers at 178.
the theory that individuals, when they are young, do not adequately plan for the future. There are a number of possible reasons to suspect such myopic savings behavior: (a) people may lack the information necessary to judge their needs in retirement; (b) people may be unable to make effective decisions about long-term issues because they are unwilling to confront the aging process; and (c) they may simply apply an inappropriately high discount rate to the future. These arguments would seem to apply with at least as much strength in the context of life insurance purchases: (a) Households (or breadwinners as agents of households) really do not know what the households’ financial needs will be in the event of a breadwinner’s death; (b) individuals are almost certainly even more averse to thinking


56 Peter Diamond, A Framework for Social Security Analysis, 8 J. Pub. Econ. 275 (1977). For the views of one prominent economist who is sympathetic to proposition (A), see Martin Feldstein, The Optimal Level of Social Security Benefits, 10 Q. J. Econ 303 (1985). Of course, the argument can also run in the other direction— that is, that the existence of social security discourages retirement savings. See generally Rosen, supra note __, at 205-09.

57 Part of the problem lies with the difficulty of determining the full value of the household human capital. Not only should it include the value of the insured’s earning capacity but it should also include the value of his or her nonmonetary services to the household. Both of these are likely to be underestimated. Indeed, as far as I can tell, all of the various empirical studies of life-insurance adequacy have ignored the present value of household services. What’s more, even for the portion of human capital attributable to future earnings, one suspects that there would be substantial underestimation. For example, how likely is it that individuals will think to take into account future real pay increases when assessing life-insurance needs? And it seems almost certain that the purchaser of life insurance will underestimate the cost that the household will incur to hire someone to do all of the things that the insured used to do around the house. (For example, will they know, when calculating the discounted present value of the insured’s future services to the household, to take into account that buying replacement services—childcare or household chores—will come out of after-tax dollars whereas the services themselves came out of pre-tax dollars?)
about dying than about aging; and (c) individuals may apply an irrationally high discount rate when considering the future state of the world in which the breadwinner might be dead.

This last concern, of overweighting the present in comparison to the future, deserves special emphasis. It is commonly argued, for example, that smokers place an irrationally high value on the current pleasure of smoking as compared with the value they place on the harmful health effects that smoking will bring ten, twenty, or thirty years into the future. Indeed, there is a psychological literature on this issue which suggests that, where there is a substantial time gap between costs and benefits, individuals tend to use different discount rates—a higher rate for the distant cost or benefit and a lower rate for the more proximate one. The result is that, in the short run, the individual prefers the option that minimizes short-run costs or maximizes short-run benefits (for example, forgoing the purchase of life insurance) but that at some point, as the time draws closer for the benefit to be received (here, the insurance proceeds become more likely as the insured gets older), the individual’s preferences switch. This sort of dynamic inconsistency of preferences—or “myopia”—is considered to

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58 One of the principal difficulties trust and estate lawyers face in dealing with their clients is getting them to contemplate and plan for various “end of life” issues.


be quite common; and one could easily see how such a phenomenon might especially affect life insurance decisions.

Even if there are problems of myopia initially, one might expect the market (namely, insurance companies) to come to the rescue. That is, if consumers have a tendency to underestimate their life-insurance needs, insurance companies would have an incentive to educate them; and that, of course, is precisely what insurance companies try to do. The main job, for example, of the insurance agent is to convince the customers that they need income replacement (or human capital) insurance. For that reason, virtually every licensed life-insurance agent has access to a computer software program that will...
allow the agent to gather information from potential customers and then use the information to produce impressive and convincing “illustrations” of the customers life-insurance needs. Such services have long been available for those individuals willing to sit down with an insurance agent. A more recent phenomenon is the proliferation of insurance-needs calculators at various web sites sponsored by insurance companies and others. If a consumer were to take the time to visit one of those sites, and enter all the relevant data (such as annual income, net worth, number of children, and the like), she could get an estimate of her life insurance needs. And many of those needs-calculators will actually force consumers to think through just the sorts of questions posed in the earlier discussion of insurance adequacy: For example, one common question is whether the individual seeking to purchase insurance on his life wants enough coverage to pay off the mortgage on the families house, or to start a college fund, or to create an emergency fund.

But even the existence of these needs calculators (and of agents willing to assess a person’s life insurance needs) may not be enough. Both require time and effort. And if consumers are not inclined to give much thought to life insurance in the first place, it seems unlikely that many will go to the trouble to find a reliable insurance-needs calculators. What’s more, consumers may well be inclined to distrust any needs assessments made by life-insurance agents, on the theory that those agents stand to gain (in sales commissions) by overestimating the household’s life-insurance need. The combination of all of these factors create an expectation that households would purchase too little life insurance coverage.

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64 For example, consider the following insurance-need calculators, which were up and running as of the date of this Article:  [http://www.life-line.org/life/index.html](http://www.life-line.org/life/index.html); [http://www.tiaa-cref.org/lins/howmuch.html](http://www.tiaa-cref.org/lins/howmuch.html); [http://www.worldwidewebinc.net/family/calculator.html](http://www.worldwidewebinc.net/family/calculator.html).
A final reason why life insurance may be suboptimally consumed involves the way that economic decisions are made within households. Traditionally, it has been assumed that there is joint and equal control over and consumption of household resources between spouses in a marriage. This assumption derives from the prevailing economic model of the household, pioneered by Gary Becker.

On this model, the household is assumed to have a single, unitary utility function; and household resources are distributed by an altruistic head. More recently, however, scholars have begun to question this model and have suggested alternative models. Further, there is some evidence suggesting that household consumption decisions depend to some extent on who—the husband or the wife—has the initial control over the resources. For example, consumption patterns appear to vary depending on the relative share of the household’s income that is earned by each spouse. Studies show, for example, that “increases in the wife’s income relative to that of the husband are associated with an increase in expenditures on restaurant meals, child care, and women’s clothing, and with decreases in expenditures on alcohol and tobacco.” How this dynamic might apply to life insurance purchases has not been studied. Still, one can tell a story along these lines that might help to explain part of the underinsurance problem. That is, for the most part, it will be the primary earner (still, more

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66 See, e.g., Martin Browning et al., Income and Outcomes: A Structural Model of Intrahousehold Allocation, 102 J. Pol. Econ. 1067, 169-70 (1994) (“What recent empirical analysis points toward is that multiperson households cannot be treated as single decision makers and that household allocations should probably rather be considered as the outcome of some interaction between household members with different preferences.”);

often the husband) in the household who ends up making the decision regarding life-insurance coverage.

Why? Because insurance agents tend to focus their efforts on the primary earner; moreover, if employer-provided group insurance is purchased, it will typically be through the employer of the primary earner. In any event, the purchase of life-insurance coverage on the life of the primary earner may be a sort of household expenditure that gets neglected precisely because the primary earner exercises disproportionate control over household financial decisions. Why might this happen? For one thing, it might perhaps be easier for a primary earner to conclude that, in the event of his or her death, the other spouse will be expected to remarry or to get a paying job or a higher paying job, or to conclude that consumption needs will be reduced as the family will be expected to move to a smaller house. For now, of course, these are just speculations; further empirical research is necessary to pin down the relationship between life-insurance adequacy and relative income within the household. However, there is one relevant finding in the Bernheim et al. study. There the authors found that the degree of underinsurance was strongly correlated with the disparity between the income of the primary earner and that of the secondary earner—that is, the greater the share of income attributable to the primary earner, the greater was the shortfall in the insurance on the primary earner’s life.68 This finding seems consistent with both the idea that the primary earner tends to exercise disproportionate control over the income that he or she brings into the house and the idea that the primary earner is inadequately altruistic with respect to the rest of the household’s needs.

C. Summary

68 Bernheim et al., supra note __, at 30 & 49 Table 13.
It is not my view that either the theoretical arguments just reviewed or the findings summarized in section A above, taken separately or together, amount to a definitive case for immediate implementation of some new government program designed to increase the level of life insurance coverage. Rather, it is my view that the preceding sections should merely be sufficient to put the issue of life-insurance adequacy squarely on the policymaking agenda, as well as on the agenda for future theoretical and empirical research, and should be sufficient to prompt an initial, exploratory examination of possible policy responses. It is this latter project that will occupy the remainder of this Article.

II. Designing the Optimal Life Insurance Subsidy

A. Brief Note on Choosing the Optimal Policy Design

If we are persuaded that the problem of underconsumption of life insurance is real and significant, the next task is to determine the appropriate government response. As mentioned above, Auerbach and Kotlikoff end their initial studies with a sentence or two calling for either an expansion of social security survivorship benefits or an expansion of employer-provided group term coverage. However, any such recommendations are expressly rejected in the more recent Bernheim et al study. Therefore, no one has made any effort to elaborate on the policy implications of the underinsurance problem in the life insurance context. This Part begins to fill that gap in the literature.

Before launching into a discussion of the various regulatory approaches to the problem, consider first the least intrusive solution: disclosure. It may be that the principal reason people purchase insufficient life insurance is that they do not know how much is needed to sustain the household’s standard of living. And it may be that this problem cannot fully be corrected by the market alone because, as argued above, people distrust the recommendations about life-insurance needs given by
insurance agents. However, if these statements are true, the only policy response necessary is to develop some way of credibly informing households of their insurance needs should they want to purchase enough life insurance to maintain their household’s standard of living. We could use a public service announcement, paid for with tax dollars and endorsed by some agency of the government, perhaps the social security administration. Or it could be some joint initiative, funded by the life-insurance industry and certified by the government. One can imagine a moving television advertisement that explains the hardship a family can face if a primary earner dies and the household has inadequately insured—followed by a listing of websites that have insurance-needs calculators which have been endorsed by the federal government.

Although such a solution might be sufficient to overcome the problem, I will, for the remainder of the Article, focus on other regulatory alternatives. I will assume that—as with the problem of insufficient retirement savings—it is not enough just to remind people that they may need to set aside more money now to provide for the future. Rather, the following proposed solutions are based on the assumption that more direct (and, alas, more expensive) government involvement may be needed.

The following three categories represent a standard way of organizing the range of regulatory responses to the problem of an “underconsumed” good or service. Such a good or service can be provided by the government, mandated by the government, or subsidized by the government. Government provided life insurance would involve payments made directly by the government to the dependents after the death of the insured, and the source of funding would be either a payroll tax or income tax. (Although existing social insurance programs tend to be funded through payroll taxes, other funding regimes are possible.) With government provided insurance, government employees collect the
There are, of course, many ways to draw the lines between these categories; and no particular set of definitions is correct or incorrect—just more or less useful. For example, within the general category of government subsidies, there is a subcategory known as the “voucher,” which was given a clear and useful definition only recently. See David F. Bradford & Daniel V. Shaviro, The Economics of Vouchers (NBER Working Paper No. 7092) (1999) (defining a voucher as a demand-side subsidy which leaves the consumer with some level of choice among competing suppliers and which tends to display a “marginal rate of reimbursement” of the subsidized activity of 100% up to a given point and then 0% thereafter).

Each of these general categories of responses—government provision; government mandate; and government subsidy—has advantages and disadvantages, which will be summarized in the sections that follow. It is worth noting in advance, however, that in this country we rarely settle for only one of these approaches. Instead, almost every area of the economy that receives public funds does so through a combination of approaches to public spending. Take health care, for example. In addition to Medicaid and Medicare, which are types of government-provided health insurance, there are a number of healthcare tax-expenditures, the largest of which is the exclusion for employer-provided medical care and health insurance. Likewise with education, we have a mixture of government provision and
government subsidies: State and local governments directly provide public elementary and secondary education is to virtually all children from kindergarten to grade twelve; and there are state-funded and state-run universities in all fifty states. Nevertheless, there are a number of government-subsidy programs primarily for higher education, some of which are tax expenditures (such as the deduction for contributions to educational charities, the exclusion for qualified scholarships, and the treatment of education IRAs) and some of which are indirect expenditures (such as government guarantees for qualified student loans).

Life insurance is no different. To the extent the problem of underconsumption of life insurance has been addressed (apparently un成功fully), it has been through a combination of government provision and government subsidies in the form of tax expenditures. The government-provided life insurance consists of social security survivorship benefits that are available to the children, spouses, and dependent parents of qualified individuals. The principal tax expenditure is the deferral (and in some cases outright exemption) of taxation on the investment earnings inside of cash value life insurance. The substantially smaller in scale are the exclusion for employer-paid premiums on up to $50,000 of group-term life insurance and the various preferential tax rules for life insurance companies, mainly consisting of special reserve deductions not available to other firms.

In the next two sections, I discuss the theoretical pros and cons of these three general approaches. Section B briefly summarizes the principal strengths and weaknesses of government-

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70 In 1998 the amount spent on this tax expenditure was estimated to be $13.5 billion. Tax Expenditure Budget (1998) Table 5-1.

71 In 1998 the amount spent on this tax expenditure was estimated to be $2 billion. Id.
provided and government-mandated insurance and contrasts the two with each other. Section C
provides a separate discussion of a government-subsidy approach. I focus in that section on the use of
a demand-side price subsidy for term life-insurance premiums—either a tax deduction or credit or
perhaps a voucher for life-insurance premiums—and I try to highlight a few of the implementation issues
that such a subsidy would present. Although I believe there are a number of advantages a demand-side
price subsidy (when compared with government-provided or government-mandated insurance), I will
not argue that a deduction or credit should be the only response. Rather, as suggested above, probably
the best response is a combination of approaches. I will have more to say about that in the following
section.

B. Government Provision versus Government Mandate

Both government-provided and government-mandated insurance have one advantage over
government-subsidized insurance: They avoid the problem of adverse selection. As described in Part
above, adverse selection occurs relatively high risk individuals, knowing (or at least suspecting) that
they are relatively high risk, find insurance prices to be a relatively good deal, and therefore tend to self
select into insurance pools. As a result: premiums rise; low risk folks buy less insurance; and the
process tends to feed on itself and can result in some risk-averse individuals not being able to purchase
coverage that would have been available in the absence of adverse selection.72

Adverse selection is completely eliminated, however, if the insurance coverage is provided or
mandated by the government, to the extent that individual choice regarding the level of coverage is
eliminated. This argument has often been used in support of various universal health insurance

72 At the extreme, insurance pools can, in theory, unravel entirely, leaving everyone uninsured.
It is possible to imagine a government-provided life insurance program that provides a range of options. A person might be allowed to select different levels of coverage, which would carry different “premiums.” But such a regime would be a dramatic departure from the way in which government has always provided social insurance in this country. Likewise, it is also possible to imagine a mandatory insurance regime that left some degree of choice regarding the nature of the life insurance coverage to individuals. To the extent the mandatory regime preserves consumer choice in that way, it would be more like the government subsidy regime described in the next section.

But this reduction in choice is also at the heart of the criticisms of mandatory and government-provided insurance. With government-provided insurance, individuals or households would have no say in answering what might be considered highly personal and idiosyncratic questions: how much insurance is to be provided, whose life is to be insured, who are the beneficiaries of the insurance to be, how are the benefits to be paid out, how long will the coverage remain in force, and who will the insurance provider be. The only difference with mandatory insurance is that the choice among providers is preserved. Some might consider this inhibition of individual choice a reason itself to oppose such programs, because of the conflict with basic liberal notions of consumer sovereignty and individual autonomy.

At this point, the reader might understandably ask the following question: Was it not with respect to just those sorts of choices that we decided (in Part II above), because of myopia and externality concerns, that households’ unsubsidized decisions are not to be trusted? That is, if households have a tendency to purchase too little life insurance coverage, to allow those households

73 It is possible to imagine a government-provided life insurance program that provides a range of options. A person might be allowed to select different levels of coverage, which would carry different “premiums.” But such a regime would be a dramatic departure from the way in which government has always provided social insurance in this country. Likewise, it is also possible to imagine a mandatory insurance regime that left some degree of choice regarding the nature of the life insurance coverage to individuals. To the extent the mandatory regime preserves consumer choice in that way, it would be more like the government subsidy regime described in the next section.
broad discretion in choosing their level of life insurance may seem unwise. Put differently, it could be argued that the concern for preserving individual choice in insurance decision making necessarily contradicts this Article’s concern for the problem of underinsurance. That conclusion, however, is both true and false. It is true that, when we say there is a tendency to purchase “too little” life insurance, the amount and duration of coverage are precisely the sorts of consumption choices we have in mind. However, to say that something is underconsumed is not to say that individuals’ preferences regarding its consumption are irrelevant. As I have emphasized throughout, determining the “right” amount of life insurance is extremely difficult as a conceptual matter. (Indeed, that was the main conclusion of Part I.) And one way of incorporating a measure of policy-making humility with respect to the question would be to preserve a degree of consumer choice. Thus, although there may be reasons to encourage or even require households to purchase more life insurance than they would otherwise, we also want to preserve some element of individual or household choice in the matter.

As to the choice between mandatory insurance and government-provided insurance, a sizable literature has developed, though none of it speaks directly to the topic of life insurance. Perhaps the best known example is the recent debate over universal health care. In the late 80s and early 90s, there was much talk of providing health insurance coverage to all Americans; and among those pushing for universal coverage, there was a vigorous debate about how best to achieve that goal: government provision, in the form of a Canadian-style, single-payer regime, or government mandate, imposed on either employers or individuals.

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One potential benefit of mandated insurance over government-provided insurance is the element of competition among suppliers. With mandatory insurance, whether the mandate is imposed on employers or individuals, there remains some choice among suppliers. By contrast, such competition is believed to be especially important in the context of health care. With health insurance, there are numerous dimensions with respect to which competition can occur; and health insurance policies can differ significantly in terms of what medical expenses are covered, the degree of flexibility in choosing health-care providers, and so on. However, whether flexibility and competition among suppliers is as important a concern with life insurance as it is with, for example, health insurance is unclear. With pure term insurance, the policies tend to be fairly standardized with competition being primarily over the price rather than the terms of coverage.

Another reason often given for favoring employer mandates over direct provision is the claim that mandates create “fewer distortions of economic activity” than do government provided benefits funded by a payroll or income tax. The best way to understand this point is to compare the effect of a mandate with the effect of a payroll tax on equilibrium wages and employment. According to standard economic analysis, the introduction of a payroll tax, because it increases employer’s costs, will result in a decrease in employment, assuming some elasticity in the labor supply. But this effect will be mitigated by a reduction in wages, so long as labor supply is not perfectly elastic. As it turns out, evidence suggests that labor supply, in the short run, is fairly inelastic, meaning a payroll tax could theoretically

\[\text{See, e.g., Summers, supra note } \_\_, \text{ at } 181; \text{Gruber & Krueger, supra note } \_\_, \text{ at } 115-16.\]
cause considerable unemployment.\textsuperscript{76} An employer mandate, on the other hand, has a different effect from a payroll tax, insofar as the employees place a value on the benefit being provided. Because they value the benefit, employees are willing to accept a decrease in wages in exchange. (The supply curve shifts.) As a result, the reduction in employment caused by the mandate is not as severe as that caused by the payroll tax.\textsuperscript{77} This idea is sometimes called the theory of “compensating wage differentials.” Under this theory, the more that employees value the mandated benefit, the fewer will be the jobs lost as a result of that required benefit; whereas, the less that employees value the benefit, the more the mandate has the effect of pure payroll tax and the worse will be the employment effects.\textsuperscript{78}

Government mandates also have some disadvantages when compared with government provision. First, consider a few of the standard criticisms that have special application to employer mandates. For one thing, the job-protecting effects of employer mandates disappear if there are wage rigidities, such as a binding minimum wage, that prevent wages from falling to compensate employers for providing the mandated benefit.\textsuperscript{79} Second, mandating that employers provide life insurance to their

\textsuperscript{76} This whole analysis assumes, as is standard in public finance economics, that unemployment caused by taxation is worse than reduced wages caused by taxation.

\textsuperscript{77} Gruber & Krueger, supra note __, at 113.

\textsuperscript{78} Summers captures the point as follows: “In terms of their allocational effects on employment, mandated benefits represent a tax at a rate equal to the difference between the employer’s cost of providing the benefit and the employee’s valuation of it, not at a rate equal to the cost to the employer of providing the benefit.” Summers, supra note __, at 180-81.

\textsuperscript{79} Summers, supra note, at 181. It is possible that “wage rigidities” may be more prevalent than proponents of employer mandates would lead us to believe. Empirical research in labor economics has not been able consistently to document compensating wage differentials. Gruber & Kruger, supra note __, at 113. However, the problem may be with the nature of the data and the approaches taken by the researchers. In an analysis of workers’ compensation insurance data from all
employees does nothing for the self-employed or the temporarily unemployed. Thus, if universally provided life insurance is felt to be an important goal, perhaps government provision (or even individual mandates) would be preferable to employer mandates. Of course, an individual mandate would apply to nonemployees as well. In any event, whether a government mandate is imposed on employees or on individuals, if the goal is universal provision, there will necessary be a need for some additional subsidization of low-income individuals. For a recent analysis of the comparative distributional and efficiency effects of government mandated versus government provided health insurance, see Charles L. Ballard & John H. Goddeeris, Financing Universal Health Care in the United States: A General Equilibrium Analysis of Efficiency and Distributional Effects, 52 Nat. Tax J. 31 (1999).

Third, to the extent employer mandates provide an efficiency advantage (because of the compensating wage differentials), they inhibit the government’s ability to accomplish redistributive goals through the provision of the benefit. Finally, government mandates tend to be more hidden from public scrutiny and political accountability than are other ways of funding universal insurance, such as taxes.

An individual mandate— that is, a law that compelled individuals to purchase a given level of life insurance rather requiring their employers to provide it— would avoid some of the problems just listed, but would present problems of its own. For example, a truly universal mandatory insurance regime would require that some type of cash or tax subsidy be provided to low-income households. In fact, compulsory life insurance could not exist without some degree of government subsidy as well. Finally,

50 states, Gruber & Kruger found that substantial evidence of both cost shifting from employers to employees and little effect on employment. Id.

80 Of course, an individual mandate would apply to nonemployees as well. In any event, whether a government mandate is imposed on employees or on individuals, if the goal is universal provision, there will necessary be a need for some additional subsidization of low-income individuals. For a recent analysis of the comparative distributional and efficiency effects of government mandated versus government provided health insurance, see Charles L. Ballard & John H. Goddeeris, Financing Universal Health Care in the United States: A General Equilibrium Analysis of Efficiency and Distributional Effects, 52 Nat. Tax J. 31 (1999).

81 Indeed, it can be argued that the principal motivation behind the push for employer mandates in the health insurance context is not the pursuit of efficiency but a desire to hide the costs of healthcare reform.
and perhaps most significant, mandatory insurance–like government-provided insurance–would eliminate the element of individual choice as to the appropriate amount of life insurance.

Given the benefit of avoiding adverse selection, discussed above, an argument could be made that some form of government-mandated or government-provided life insurance would be an appropriate response to insufficient demand for life insurance. Moreover, because we already have a fairly well-developed system of government-provided life insurance–that is, the survivorship program–which would be extremely costly (and politically impossible) to replace, I will assume that a version of the survivorship program will be preserved. With that in mind, the next section briefly summarizes the level of coverage provided under the survivorship regime. Then, I turn to a discussion of how tax subsidies might be used to supplement that regime.


Although we currently have no program of government-mandated life insurance, we do have government-provided life insurance. The social security survivorship program gives a limited amount of coverage to the families of individuals who have worked and paid into the social security system for a sufficient period of time, provided that certain eligibility requirements are met by the beneficiaries. Survivorship benefits are part of the Old-Age, Survivors, and Disability Insurance (OASDI) Program contained in Title II of the Social Security Act. In general, spouses and dependent parents are eligible for survivorship benefits only if the deceased worker was “fully insured,” which depends on how long the worker worked and paid into the system. In addition to the fully-insured requirement, surviving spouses who are not taking care of young children must meet the following requirements to qualify for
benefits: they must be unmarried and either they must be 60 or older; or they must be between 50 and 59 and be disabled throughout a five-month waiting period.\textsuperscript{82} Surviving children under the age of 18, and surviving spouses who have not remarried and who are taking care of the breadwinner’s under-age-16 children, qualify for benefits even if the worker was not fully insured, so long as he was “currently insured,” which means that he needs to have worked and paid into the system for one and a half years during the three years before his death.\textsuperscript{83}

Even for individuals who qualify for survivorship benefits, the actual payments are meager, especially for middle- and upper-income families. The benefits are a function of the deceased worker’s “primary insurance amount” (PIA), which is the monthly benefit amount payable to the worker if he retires at full retirement age or becomes entitled to disability benefits. The PIA is based on the worker’s average earnings over his or her working lifetime. The PIA itself replaces only a fraction of the insured worker’s income; and the higher the worker’s average career income, the smaller the replacement ratio would be. Thus, for a worker born in 1935 who retires in 2000 at full retirement age after a full-time career with steady earnings, the PIA would replace 58\% of his earnings if he were a low-wage earner (defined as earning 45\% of the Social Security average wage index), 43\% of his earnings if he were an average-wage earner (defined as earning the Social Security average wage index), and only 25 percent if he earned the maximum wage taxable for social security purposes (which currently is in the neighborhood of $63,000).

\textsuperscript{82} Green book, supra note __, at 15.

\textsuperscript{83} There are also special rules for surviving children who are disabled. Id.
The relationship between the breadwinner’s PIA and the survivorship benefits that dependents received if the breadwinner dies is somewhat arbitrary. The breadwinner’s young children and surviving spouses taking care of young children each receive 75% of the deceased’s PIA. However, the surviving spouse’s benefit will be reduced if he or she earns above a certain amount and will be eliminated if he or she remarries. The total survivorship benefit payable on account of a given worker’s death, however, is capped at between 150% and 180% of the worker’s PIA.

The following example illustrates the annual survivorship benefits that would be received by a typical household in which a breadwinner has died. Assume that the hypothetical breadwinner worked full time and paid into the social security system for 22 years before dying in 1995 at the age of 40.

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84 To qualify for benefits, a surviving child must be under the age of 18 (or, if a full-time elementary or secondary student, under the age of 19). If the child is disabled before turning 22, she can received survivorship benefits beyond the age of 18. Id. at 15.

85 Oddly, for the spouse to qualify for these benefits, the child must be under 16 rather than under 18 or 19, the ages which determine the limits of the child’s benefits. Id.

86 Id. at 26. Surviving spouses can be eligible to receive survivorship benefits themselves—and not merely as the custodians of the worker’s young children—but only if the surviving spouse is disabled or over a given age. See supra text accompanying note __. For example, widows or widowers who are age 60 (or disabled and between 50 and 59) can received benefits equal to 71.5% of the deceased breadwinner’s PIA. Id.

87 SSA, Social Security: How Work Affects Your Benefits, Publication No.05–10069, Feb. 1999. In general, if the surviving spouse is under the age of 65, for every $2 he or she earns in excess of $9,600, $1 in survivorship benefits is lost. Id. at 1. The first $9,600 of earnings have no effect on the spouse’s survivorship benefits. None of the spouse’s earnings affects the surviving child’s survivorship benefits. SSA, Social Security: Survivors Benefits, Publication No. 05-10084, July 1998, p.6.

88 Green book, supra note __, at __.

89 SSA, supra note __, at
Assume further that the deceased worker is survived by a spouse and two young children. The annual survivorship benefits received by the household (so long as the children were under the age of 16 and assuming the surviving spouse earns no more than $9,600 per year and does not remarry) would have depended on the breadwinner’s yearly income as follows: 1) If the breadwinner had yearly earnings equal to the Federal minimum wage, the annual survivorship benefit would have been $9,912. 2) If the breadwinner had yearly earnings equal to the average wage (approximately $26,000), the survivorship benefit would have been $16,440. 3) And if the breadwinner had yearly earnings equal to or greater than the maximum wage taken into account for social security taxation purposes (approximately $63,000), the survivorship benefit would have been $26,304. These household benefits would continue to be paid until the children reached the relevant age limit and would be reduced if the surviving spouse earned above the $9,600 threshold or remarried.

Whether social security provides the ideal government-provided life-insurance program is open to question. First, the level of benefits may be inadequate. Although it makes sense to link the amount of benefits to the deceased worker’s income, tying the benefits to the worker’s PIA—which is based on the worker’s lifetime average earnings, adjusted for inflation—may be worth reconsidering. Arguably, a more accurate measure of the financial value of the worker to the household would be some measure of the worker’s income at time of death. Whereas the PIA seems an appropriate measure to use in determining a person’s social security retirement benefit (since, in retirement, most individuals can expect their living expenses to be lower than during their younger working years), the PIA seems the wrong amount on which to base a life-insurance calculation. In cases involving relatively young

90 Green book, supra note __, at Table 1-10.
families, living expenses will tend to be increasing rather than decreasing, especially if the children are expected to go to college.\textsuperscript{91}

Other aspects of the survivorship program involve hidden assumptions that are certainly defensible but that deserve careful scrutiny. For example, the program assumes that, if a surviving spouse who receiving survivorship benefits remarries, the spouse’s benefits will stop.\textsuperscript{92} In addition, if the surviving spouse takes a job, his or her survivorship benefits can be reduced. These rules imply a certain austerity in the program that may well be consistent with the majority’s view of the optimal life insurance contract, but it may not.\textsuperscript{93} The program also assumes that children will be self sufficient when they reach the age of 18–or, if full-time students, 19. Some might feel that the benefits should continue until the child reached the average age of college graduation, although the current assumption, again, is certainly defensible.\textsuperscript{94} And finally, that the current survivorship benefits are skewed to provide disproportionately large benefits to relatively low-income households seems consistent with this country’s historical preference for progressivity.\textsuperscript{95}

\textsuperscript{91} It could be argued that the survivorship program responds to this precise concern by allowing special benefits for young children of deceased workers and for surviving spouses who are taking care of those children and by awarding a maximum household benefit equal to 180% of the deceased’s PIA.

\textsuperscript{92} Id. at 15.

\textsuperscript{93} Not to mention the effect on the surviving spouse’s marginal income tax rate of the phaseout of benefit for earnings over $9600.

\textsuperscript{94} Recall that the same assumption–that children are part of the household until age 18–was also made by Bernheim et al. See supra note _ and accompanying text.

\textsuperscript{95} For the same reason, the relatively regressive way in which the survivorship benefits are funded–through a payroll tax–is vulnerable to criticism.
Obviously, much more could be said about the merits and demerits of the current survivorship program; however, the purpose of this section is not to offer a systematic assessment of that program. Rather, the point is just to start the discussion. For the remainder of this Article, however, I will assume that some version of the current survivorship program—one that continues to provide a modest amount of income replacement for a large number of households and a significant amount of income replacement for the very lowest-income households—will continue to exist. Seeing as how the existence of this regime has not thus far eliminated the underinsurance problem, I will turn my attention to possible ways of supplementing the survivorship program with additional government subsidies for life insurance.

D. Government Subsidized Life Insurance

Continuing with our assumption that life insurance tends to be underconsumed, this section explores the benefits and costs of using some sort of government subsidy to encourage households to purchase life insurance coverage on their primary earners (and perhaps on secondary earners and caregivers as well). I begin by exploring some of the advantages and disadvantages of government subsidies generally, of which tax preferences—such as special deductions, exclusions, and credits—are only one variety. Then I offer some thoughts about several issues of implementation: whether the price-subsidy should take the form of a tax expenditure or a direct expenditure; whether, if a tax expenditure is chosen, a deduction or a credit makes more sense; and whether (and to what extent) the subsidy should be targeted to achieve optimal effect.

1. The Advantages of Demand-Side Price Subsidies

Most of the advantages of government subsidy can be inferred from what was said above in criticism of government-provided and government-mandated insurance. The biggest comparative
advantage of the subsidy approach (as compared with the government-provision or government-mandate approaches) is the preservation of consumer choice and supplier competition. How important those two factors are to the efficient workings of the life insurance market will determine whether a government-subsidy approach should be adopted. But first, let us be sure we understand what we mean by a government subsidy. I have in mind a simple price subsidy; that is, the government pays part of the cost purchasing life insurance. But the individual or the household determines how much insurance coverage to purchase and from which insurance company.

Examples of price subsidies abound. A tax preference, such as a deduction or credit, is a species of price subsidy. If the taxpayer makes a tax-preferred expenditure, the government shares the cost by reducing taxpayer’s tax liability. In the case of a deduction, the price subsidy is equal to the taxpayer’s marginal tax rate (since the deduction reduces his or her tax liability by the amount of the deduction times the applicable marginal tax rate). In the case of a tax credit, the price subsidy is equal to the credit, which typically is a given percentage (usually less than 100%) of the expenditure up to some set maximum amount. Credits differ from deductions in that credits, unlike deductions do not reduce the tax base; rather, the amount of the credit is taken directly out of the taxpayer’s tax liability.96

Another type of price subsidy is the voucher, which usually reimburses 100% of the costs of the designated good or service up to a set amount and then none after that. Food Stamps are the quintessential example.97 A price subsidy can have both a substitution effect and an income effect. The

96 In theory, by use of refundable credits or something similar, this approach can even be applied to households that owe no taxes. In practice, refundable tax expenditures are relatively rare.

97 Bradford & Shaviro, supra note __, at __.
substitution effect is the increase in consumption of the good caused by the decrease in the relative price of the good (when compared with all non-subsidized substitute goods) due to the subsidy. The income effect is the change in the level of consumption in the good due solely to the taxpayer’s increased household income, owing to the subsidy. For goods called “normal goods,” increased household income leads to increased consumption.\(^98\) Thus, if the expenditure being subsidized is a normal good or service, the two effects—substitution and income—will cut in the same direction: towards increased consumption.\(^99\)

The price-subsidy approach has a number of potential advantages over direct government provision. First, consider one final word on behalf of “consumer choice” and “supplier competition.” It has long been a widely held view that individuals deciding how to invest their own resources are generally better cost monitors than government bureaucrats deciding how to invest tax dollars.\(^100\) Thus, for example, competition among charitable organizations for tax-deductible contributions from individual and institutional donors may induce a more efficient provision of the organizations’ various charitable functions than would, say, the competition for government grants, which are doled out by government

\(^98\) Rosen, supra note __, at __.

\(^99\) It is the substitution effect (caused by the change in relative prices) that is important from the perspective of correcting the underinsurance problem, insofar as the problem derives from myopia or externalities with respect to life insurance in particular. For a discussion of the complications that arise when the deduction or credit has a cap or a floor, see Charles T. Clotfelter, Federal Tax Policy and Charitable Giving 40-46 (1985).

\(^100\) Bradford & Shaviro, supra note __, at 46 (“The classic argument for competitive private supply, going back to Adam Smith’s ‘invisible hand,’ is that the profit motive, when combined with the need to satisfy customers who have other options in order to get their business, is the best available goad to inducing both economizing behavior in production and socially valuable innovation.”).
employees who are spending only public money. The same could be true in the life-insurance context. That is, we may prefer to rely on competition among life insurance companies for individual customers as a means of inducing efficient provision of insurance benefits rather than to rely on the social security bureaucracy to do the job.

A second related advantage of price subsidies over direct government provision is the possibility of increased efficiency in the following peculiar sense: If we conceive of the life-insurance problem as an issue of distributional equity—creating a need to move dollars across states of the world from the pockets of the relatively wealthy (living breadwinners) and into the pockets of the relatively poor (dependents whose providers have recently died)—, the question becomes what is the most efficient, least distortionary, means of achieving that objective. Put differently, we can conceive of the life-insurance question as raising a question of generational equity, albeit intra-family generational equity. Under that conception, if a breadwinner has a price elasticity of demand for making transfers to his or her dependent-beneficiaries that is greater than one (in absolute value), a dollar of price subsidy will induce the breadwinner to purchase more than a dollar of life insurance. So long as the elasticity condition holds, the government gets more bang for the buck by using a price subsidy than it would get by making the expenditure directly.

101 Bradford & Shaviro, supra note __, at 29. Below I argue that a supply-side tax preference is less likely to have this beneficial monitoring effect.

102 Clotfelter, supra note __, at 60 (1985)

103 Clotfelter, supra note __, at 281; Feldstein (1975). Relatedly, it is also possible that if the government sends a dollar of direct subsidy to the beneficiary, the breadwinner would respond by reducing his transfer to the beneficiary by a dollar (or something less than a dollar). This is the “crowding out” effect, and it can mean that the government will have to spend more than a dollar on life
Price elasticities of demand have been studied extensively in the context of charitable contributions. There it has been shown that for middle- and upper-income individuals, the price elasticity of demand is indeed greater than one.\textsuperscript{104} It is possible that the same might be true of expenditures on life insurance, in which case a price subsidy approach would be a “more efficient” means of achieving this redistributive vision of life insurance than would expanded survivorship benefits.\textsuperscript{105} Given the relatively low (by historical standards) marginal rates currently imposed on individual income, however, it might be necessary to provide either a “double” deduction or to use a relatively high credit percentage to achieve the same effect.\textsuperscript{106} Before this analysis is taken too far, insurance to get a full dollar transferred to the beneficiary.

\textsuperscript{104} See generally Id. at 274 (summarizing studies, which consistently found price elasticities greater than one in absolute value for all but the lowest income groups; for low-income groups, the studies were inconclusive); Charles T. Clotfelter & C. Eugene Steuerle, \textit{Charitable Contributions}, in \textit{How Taxes Affect Economic Behavior} 436 (1981) (finding highest price elasticities in higher income groups).

\textsuperscript{105} It might be argued that shifting money from the pockets of rich breadwinners into the pockets of their slightly less rich children or spouses contradicts the principles of progressivity that lead us to enact a graduated income and estate-and-gift tax in the first place. That is a fair complaint. However, a partial response to the complaint would be to target the subsidy at relatively young high-income households, which will tend not to be amount the very wealthiest taxpayers. Still, it cannot be denied that this policy response will tend to benefit high-income individuals. However, recall that we are assuming at this point that social security survivorship benefits will be dealing with the underinsurance problem for the low-income households. And unless we have decided that myopia and externality justifications for government intervention only apply if the affected parties are relatively poor, then a life-insurance subsidy that tends to benefit the middle- and upper-income needs no special defense, other than the sort offered in Part II.B above.

\textsuperscript{106} Cf \textit{Commission on Private Philanthropy and Public Needs} (1977) (proposing a 200 percent charitable contribution deduction for individuals with incomes less than $15,000 and a 150 percent deduction for those with incomes between $15,000 and $30,000).
however, there obviously needs to be empirical research done on the elasticity of intra-family giving patterns.

Even if one believes in the general consumer sovereignty and supplier-competition benefits of demand-side price subsidies (and perhaps the bang-for-the-buck story), there remain issues of program design. For example, to use Bradford and Shaviro’s terminology, a choice has to be made regarding the “marginal reimbursement rate” [MRR], which is the “percentage of a dollar of extra expenditure for an earmarked commodity that the government, rather than the consumer, would bear.”107 As the authors observe, the characteristic MRR for the demand-side price subsidy called a voucher is 100% up to a point and then 0% thereafter. By contrast, the MRR for a tax deduction, one that has no floor or ceiling, would be equal to the taxpayer’s marginal tax rate; and that for a credit would be equal to the credit percentage. Which of these structures is to be preferred will depend upon the justification for the subsidy in the first place. For example, if we believe that individuals tend to undervalue life insurance by 20 percent of its cost, we might provide a 20% credit or, for taxpayers with marginal rates approximating 20 percent, an unlimited deduction. Alternatively, if we thought that it was irrational for a household not have at least some minimal amount of life insurance, we might use the voucher approach and set the cutoff at the desired minimum.108

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107 Id. at 30.

108 Id. at 31-32 (making these points using the example of underconsumption of food). Price subsidies always present a tradeoff between encouraging consumers to make the underconsumed expenditure (the so-called merit good) and still encouraging cost consciousness on the part of consumers. Id. at 29. For example, it is often argued that the exclusion for employer provided health insurance blunts the taxpayers awareness of the full costs of their healthcare consumption decisions and thus has contributed to the overconsumption of healthcare. A common recommendation, therefore, is to cap the amount of the exclusion at some level of minimum but decent health insurance coverage. That recommendation might well be a good idea; however, it should be noted that considerable doubt remains as to the relationship between the tax exclusion and the healthcare-overspending problem. It
Another structural question is why the subsidy should be located on the demand side rather than the supply side. It is possible that the same benefits associated with price subsidies could be achieved through some sort of subsidy to *life insurance companies* rather than to life insurance purchasers. For example, previous versions of the Code contained what were considered substantial tax preferences for life insurance companies, mainly in the form of special reserve deductions not available to other firms.\textsuperscript{109}

Such preferences, in a competitive market, would reduce the cost of life insurance to consumers (as compared with a world without such special reserve deductions), which would have the effect of subsidizing life insurance purchases. Notice that this approach too, in its idealized form, would involve both be consistent with consumer sovereignty and provide for supplier competition, if we think those values are worth promoting.

However, it is questionable whether the effect would be the same as a demand-side price subsidy. For example, one wonders whether an individual would be motivated by a cost reduction in life insurance stemming from a supply-side subsidy in the same way that he would be motivated by an insurance deduction, credit, or voucher. Also, as compared with a demand-side subsidy, a supply-side subsidy may involve a larger oversight role on the part of government agency, who still must decide

\textsuperscript{109} Those preferences were apparently reduced but not eliminated by the 1984 Deficit Reduction Act.

could be argued that sky-rocketing healthcare costs were caused more by the old fee-for-service financing structure then from the tax exclusion, although both may have played a role.
which firms get the tax benefit.\textsuperscript{110} Still, if it could be shown that a supply-side subsidy were as effective, such an approach could be used instead of or in combination with a premium deduction.

2. Assorted Issues of Implementation

Even if it is decided that a demand-side price subsidy for life insurance would be a useful supplement to the existing (or a revised) social security survivorship program, there remain many issues of implementation to be worked out. This section highlights a few of those issues.

\textit{a. The tax expenditure debate}

A large literature exploring the efficiency and distributional consequences of using tax preferences to accomplish social policy already exists. Much has been written over the years on the idea of a comprehensive tax base [“CTB”], as zealous supporters of the CTB have called into question the use of “tax expenditures”\textsuperscript{111} and anti-CTBers have questioned the coherence and validity of the CTB ideal;\textsuperscript{112} and I will not re-plow all of that ground here. But a few points are worth emphasizing. I generally tend to side with the anti-CTBers (that is, the critics of the anti-tax-expenditure position) in two respects. First, I am skeptical of any suggestion that there is a “pure” tax base (whether it be an

\textsuperscript{110} Demand-side subsidies, however, can require agency substantial agency oversight as well. For example, the Treasury Department maintains some involvement (at times considerable involvement) in determining what counts as a “charitable contribution.”


ideal accretion tax or an ideal consumption tax) that should be granted a presumption of superiority. Thus, I tend to agree that whether a particular tax expenditure provision is a good or bad idea turns not on issues of “correct” measurement of the tax base but on the questions of efficiency and equity that are standard fare of public finance economists. Second, tax-expenditure critiques tend to exaggerate the disadvantages and understate or ignore the potential advantages of using tax subsidies to achieve social policy. For example, complaints that tax preferences increase the complexity of the tax laws seem to ignore the fact that some amount of complexity and administrative costs are inherent in the use of any subsidy, wherever that subsidy is located. And it is not clear why those complexity costs are greater for tax expenditures than for direct expenditures.

Another criticism often made of tax subsidies is that they are overbroad. According to this argument, we are essentially throwing money away if some individuals who receive the tax subsidy would have engaged in the targeted activity anyway. This is true enough. But the overbreadth complaint can be applied to any price subsidy, whether it is in the tax code or not and whether it is a deduction or a credit. There is inevitably a tradeoff between a subsidy’s accuracy (that is, the extent to which it is tailored so as to apply only to marginal consumers of the good or service in question) and the subsidy’s complexity; and that tradeoff exists wherever the subsidy is located.

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113 More precisely, the subsidy in such a case has the effect of a purely redistributive cash transfer rather than a price subsidy.

114 See generally Bradford & Shaviro, supra note __, at 18-24 (explaining circumstances in which price subsidy—in their case, a voucher—is a cash equivalent transfer).

115 For more of my skeptical take on tax-exceptionalism arguments, see Kyle D. Logue, *If Taxpayers Can’t Be Fooled, Maybe Congress Can: Applying Public Choice Theory to Tax Transitions*, __ CHI. L. REV. __ (forthcoming 2000). Two complaints about tax expenditures that may
Finally, tax-expenditure critiques almost always downplay, if not ignore, the potential cost savings of using tax laws to implement social policy. The possibility of such cost savings was one of the original justifications for the use of tax expenditure provisions as subsidies, and in some cases that argument still makes sense. In the case of the life insurance subsidy, for example, there would clearly be a cost advantage to using the already existing tax system and its ability to reach a broad group of individuals rather than creating an entirely new voucher system. Nevertheless, if this administrative-cost advantage of tax subsidies proves to be false, I would certainly recommend consideration of a voucher alternative.

b. Deduction or credit?

If we decide to go with a demand-side tax expenditure for life insurance, we still must decide whether to use a deduction or credit. The basic difference between the two has already been mentioned: The value of a deduction to the household is a function of the household’s marginal tax rate; whereas, the value of a credit is a function of whatever credit percentage Congress sets when it enacts the credit. As a result, tax expenditures in the form of deductions are often criticized as being

have special application to the tax law arena and that therefore deserve close attention are the lack-of-
regular-legislative-review concern (because they tend to be a permanent part of the Code) and the lack-of-administrative-expertise concern (because the IRS is asked to administer social policy in realms outside of its area of competence). For a discussion of ways to overcome these potential problems, see Edward A. Zelinsky, Efficiency and Income Taxes: The Rehabilitation of Tax Incentives, 64 Tex. L. Rev. 973 (1986); Edward A. Zelinksy, James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions, 102 Yale L. J. 1165 (1993); Edward A. Zelinsky, Are Tax “Benefits” Constitutionally Equivalent to Direct Expenditures, 112 Harv. L. Rev. 379 (1998).
distributionally unfair because they disproportionately benefit households with relatively high incomes—households which, in our system of progressive tax rates, will be subject to the relatively high marginal tax rates. The argument is that, if a tax expenditure is to be used, a credit is the superior approach from the perspective of distributive justice. This argument has been made, for example, in connection with the charitable contribution deduction. Some commentators have complained that the charitable deduction, because it is more valuable to higher-bracket taxpayers, disproportionately benefits the charities preferred by high-income individuals. Others contend, however, that the force of that objection depends on who tends to benefit from the charities in question. For example, it has been argued that the charities preferred by high-bracket taxpayers tend to provide more in the way of public goods to society than the charities preferred by lower-income donors. High-income taxpayers tend to give more to educational institutions and hospitals; whereas, low-income taxpayers tend to give more to religious organizations. The argument is that educational institutions and hospitals provide more public goods per dollar received than do religious organizations, which are primarily devoted to serving the interests of their donors. Thus, it has been argued that even if switching from a charitable deduction to a charitable credit could be designed to maintain the same overall level of charitable giving, such a change would likely substantially alter the distribution of gifts—a big increase for religious institutions at the expense of educational institutions and hospitals. Whether or not this defense of the charitable

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117 Feldstein (1975).
deduction is persuasive, it seems unlikely to move anyone as a defense a life-insurance subsidy that disproportionately benefits the households of high-income families.

In sum, unless an argument can be made that a price subsidy skewed in favor of high income families is appropriate, a credit would seem superior to a deduction on fairness grounds. Therefore, the only possible argument in favor of the deduction would be that a different approach to the problem is being used for low-income households—namely, government-provided survivorship benefits, which replace a much larger fraction of income for the lowest income households as compared with the highest income households. And the choice of direct government provision for low-income households with a deduction-price-subsidy for higher income households might be justified on the bang-for-the-buck price-elasticity theory mentioned earlier. That is, the best way of achieving intra-family generational equity in a relatively high-income household might just be the use of a deduction, since relatively high-income individuals tend to have the higher price elasticities of giving. And the best way of achieving intra-family generational equity within relatively low-income households might therefore be government provided survivorship benefits.\(^\text{118}\)

\textit{c. accuracy vs. complexity}

Finally, there is the lingering question of fine-tuning—that is, whether it would be worthwhile to target the subsidy by, for example, varying the amount of available deduction or credit on the basis of

\(^{118}\) Of course, with really low-income households, it is not so much intra-family generational equity that concerns us, but rather inter-family equity. That’s why we have the progressive income-tax rate structure in the first place. Therefore, if survivorship benefits are to be retained as the principal means of dealing with the underinsurance problem in low-income households, we need to rethink the funding mechanism. Currently, survivorship benefits are funded by a highly regressive payroll tax. We should consider changing the system so that revenue source for survivorship benefits is collected in a more progressive manner.
the number of dependents living in, and/or the net worth of, each household. For example, on the theory that net worth tends to rise with age for most people (and thus—all else equal—life insurance need tends to diminish), we might allow a 100% premium deduction for households in which the primary taxpayer is 25 years or younger and then phase the deduction out gradually until it is eliminated for taxpayers who are 45 or 55 or whatever age is chosen. Similarly, the percentage of premium that is deductible could be linked to number of dependents within the household: The more children or other dependents who are living within the household, the greater the insurance deduction would be. And some households—maybe single-person households with no dependents or households with net worth above a certain amount—would be entitled to no insurance deduction whatever. The precise details of such a rule, and whether extensive fine-tuning would be worth the cost, are beyond the scope of the current analysis.

E. Existing Tax Subsidies for Life Insurance

The analysis of this Part has led to the conclusion that, in response to the problem of inadequate life-insurance coverage in this country, some form of demand-side tax subsidy may be a desirable supplement to the existing social security survivorship program. The issue to which I will now turn is the extent to which the existing demand-side tax expenditures for life insurance—the exclusion for employer provided insurance and the treatment of cash value life insurance—serve this function. In one sense, the obvious answer is no, given that the existing empirical research indicates substantial underinsurance

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119 It is possible that a 100% premium deduction might not be a sufficiently generous starting point for the phase down. For example, depending on the elasticity of demand for life insurance, it might be that a 150% or 200% deduction would be the appropriate starting point. See supra discussion of double-deduction proposal in charitable giving context.
notwithstanding the existence of the existing tax subsidies. Therefore, one general recommendation, which will be expanded upon in the subsections that follow, would be to make these tax subsidies more generous than they currently are.
1. The exclusion for $50,000 of employer-provided coverage

That suggestion would apply perhaps least controversially to the existing income tax exclusion for employer-provided group term coverage. That exclusion, which applies to the premiums paid by an employer on behalf of an employee to purchase up to $50,000 of group term coverage on the employee’s life, represents a clear (albeit small) step in the general direction suggested by the analysis of this Part. Inherent in the exclusion, of course, are implicit assumptions along the lines described above in subsections ___ of this Part. That is, except for the fact that we are using an exclusion (which ties the subsidy’s MRR to the taxpayers marginal tax rate, which in turn is tied to income level), we have chosen not to fine-tune the subsidy to target the households most likely to be underinsured. In addition, we have capped the subsidy arbitrarily at $50,000 of coverage, presumably not because we think that all employees tend to underconsume life insurance by precisely the amount of $50,000, but because $50,000 is a nice round number that fit within the existing revenue constraints at the time of enactment. A reform of this rule which the analysis of this paper suggests would be to expand the existing exclusion to cover employer-provided group term coverage up to an amount that roughly equals the amount by which most households tend to underinsure. Again, this is where additional theoretical and empirical work is needed. Nevertheless, for the sake of argument, consider the following proposal: Provide an exclusion for employer-provided group term life insurance coverage up to 5, 7, or 10 times the employee’s annual income. Either we could choose one of those annual-income multiples and apply the same rule to everyone, or we could have different multiples apply to employees in different circumstances—with relatively high multiples applying to younger employees and
low multiples applying to older ones.\textsuperscript{120} Some employers already offer such life-insurance options as benefits to their employees, and many employees take full advantage of the provision (maxing out the amount of employer-provided coverage), even though only the first $50,000 of coverage is tax free. But many employers do not; and where such plans are offered, many employees fail to take maximal advantage of them. Increasing the amount subject to the exclusion, along the lines just described, might be enough to encourage the desired level of insurance. Whether such a change would be worth the cost, in terms of tax revenue, is of course precisely the sort of question that requires further investigation.

\textit{2. The tax treatment of cash value life insurance}

The other primary tax expenditure for life insurance that can be found in current law, which again is much larger in magnitude than the group-term-insurance exclusion just discussed,\textsuperscript{121} is the set of rules governing the tax treatment of cash value life insurance. The following summary captures the gist of those rules.\textsuperscript{122} If an individual purchases a cash value life insurance policy (which is a contract that combines pure term life insurance and an investment vehicle into one product), the accrued earnings in the investment side of the policy–sometimes called the “inside buildup”–are not taxed unless and until the policy is partially or wholly surrendered. And even then, those investment earnings get preferential

\begin{footnotesize}
\begin{enumerate}
\item[\textsuperscript{120}] Note that, if this proposal were expanded to included a deduction for the self-employed, it would be the same as the proposal mentioned supra in Part \_\_.
\item[\textsuperscript{121}] See supra note \_\_.
\end{enumerate}
\end{footnotesize}
treatment. For example, upon surrender of the policy, gains are taxed only to the extent they exceed the “total policy costs,” which includes the actuarial costs and the loading charges. Also, the taxpayer is allowed to recover these costs on a first-in/first-out basis. What’s more, given the availability of policy loans (under which insured’s can borrow part or all of the inside buildup without causing a realization event) and the exclusion for life insurance proceeds paid out upon the death of the insured, it is possible for cash value policyholders virtually to eliminate rather than just defer taxation on investment earnings accumulated inside a cash value insurance policy.123

These rules create an obvious tax preference for cash value life insurance products. More precisely, they create a preference for combining one’s life-insurance and one’s investments into a single “bundled” product rather than separating or “unbundling” those transactions though an approach that is sometimes generically referred to as the “buy term and invest the rest” [BTIR]). This is because, if an insured-investor uses the unbundled approach, the earnings on the investments may not get the same tax-favored treatment as they would inside a cash value policy. Thus, for those taxpayers who have the resources and the desire to do both things (insure and invest), the cash value rules can be understood as subsidizing the decisions both to insure one’s life and to save for future consumption, so long as those two things are done together. Indeed, these two policy objectives—the need to encourage the purchase of life insurance and the need to encourage long-term savings—are offered as the only plausible justifications for the cash value rules by everyone who has written on the subject, critics as well as defenders.

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123 All of these rules apply only if the policy meets certain statutory requirements designed to limit the extent to which cash value policies can be heavily weighted towards investment rather than insurance. See Pike, supra note __, at __.
These rules have been the subject of several extremely critical studies. All of those studies implicitly or explicitly agree with the assumption that the principal justification for the cash value rules is the problem of underinsurance. However, each of the studies either explicitly concludes or strongly implies that the cash value rules should be repealed altogether. The main reason given for that conclusion is that the cash value rules primarily, and unjustifiably, benefit high-income individuals. Those studies also recommend that, at the very least, the tax treatment of inside buildup should be amended to be more consistent with the current tax treatment of other types of long-term investing. Thus, with that goal in mind, two recommendations are commonly made: 1) policy loans should give rise to taxation of inside buildup with perhaps a penalty tax to boot (as is currently done with other tax-favored retirement accounts). And 2) the first-in/first-out basis-recovery rule for cash surrenders (to be contrasted with loans) should be repealed and replaced with a rule similar to the one that applies to annuities or stocks, where basis recovery is less “accelerated.”

I am no fan of the cash value rules. They are among the most complicated provisions in the tax code, and they do not seem to have made much of a dent in the underinsurance problem. Indeed, despite all of the tax advantages provided to those who adopt the bundled approach, the BTIR approach still dominates the market. Moreover, there is little doubt that the cash value rules do not

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124 See, e.g., GAO Report, supra note __; Treasury Department, Report to The Congress on the Taxation of Life Insurance Company Products, March 30, 1990. See also Pike, supra note __. The influence of the Pike article can be seen throughout both the GAO Report and the Treasury Report.

125 Cash-value policies represented 31 percent and term policies 69 percent of the total new policies sold in 1997. AMERICAN COUNCIL OF LIFE INSURANCE, LIFE INSURANCE FACT BOOK 7 (1998). When the statistic is “life insurance in force” rather than new policies issued, term insurance still dominates both in terms of policies issued and face amounts of coverage. Id. at 8.
create an ideal response to the underinsurance problem. Any version of the deduction, exclusion, or credit proposals mentioned in the previous sections of this Part would probably be a better approach, if for no other reason than their relative simplicity. Nevertheless, if those rules are to be retained as the principal existing tax subsidy for life insurance (as seems likely to happen), consider the following tentative observations.

First, a case can be made that, contrary to the conclusions of previous studies, the cash value rules should be made more generous to taxpayers, not less. Those studies have emphasized the ways that the cash value rules tend to favor savings that are bundled within a cash value policy, thus creating a “distortion” in favor of doing one’s savings through the bundled approach rather than any number of BTIR approaches. But that is precisely the point of the bundled subsidy. It is the nature of such a subsidy that the after-tax return to savings in the bundled form will outperform the savings in the unbundled form. If not, there is no subsidy. And because there exist many other tax expenditure provisions that favor savings outside of cash value policies, perhaps the cash value rules should be made more generous.

126 Previous government studies have universally called for cutting back on the tax advantages provided in the cash value rules. See, e.g., GAO Report, supra note __, at __; Treasury Report, supra note __, at __; and Pike, supra note __, at __.

127 To take one example, consider the income tax treatment of state supervised pre-paid tuition plans. As those rules have recently been amended, taxpayers can invest for their children’s college education in a highly tax-favored manner, without having to buy any life insurance whatever. The availability of that option, however, along with all the other tax-favored ways of investing undermines the value of the cash value subsidy, since the value of that subsidy is directly related to the after-tax opportunity cost of the funds.

128 For example, the various reforms enacted in the 1980s designed to reduce the amount of investment earnings that can be sheltered inside a cash value policy could be repealed or at least
Second, and related, perhaps the most interesting aspect of the cash value subsidy is the conventional wisdom among financial advisors that it is a “bad buy,” that the unbundled approach is generally better. What is the source of the negative views of cash value insurance? As best I can tell, it stems from beliefs about how cash value insurance works in the real world. The claim is that, although cash value insurance in theory may be a great deal, in reality the tax benefits of most policies are more than outweighed by hidden administrative costs.¹²⁹ But this claim presents a further puzzle: Given that cash value insurance is, in theory, nothing more than two separate financial products—life insurance and investment—bundled together, why would the administrative costs be higher for the bundled approach than for the unbundled approach? And why would the difference in administrative costs be large enough to offset the tax advantages of the bundled approach? And if cash value insurance is, in fact, merely a bundled version of BTIR, then how, in a competitive market, could such large differences in administrative costs persist? Why would they not be competed away? Presumably, in a competitive market they would. And that is the problem: The failure of cash value insurance to clearly dominate its BTIR alternatives, to the extent explicable by the higher administrative costs and loading charges associated with the former, is partial evidence that the cash value market may be less than fully competitive, which should be a concern—again, only if the cash value subsidy is to be retained.

Conclusion

Why is the problem of underconsumption of life insurance so little studied? The problems of inadequate private savings (especially retirement savings) and inadequate health insurance coverage have been the subject of countless studies and legislative proposals. By contrast, the findings of the relatively few studies of life-insurance adequacy that many households are significantly underinsured have gone largely unnoticed by policy makers and subsequent scholars. Why is that? Granted, the magnitude of the life-insurance problem may be small in comparison with the problem of inadequate retirement savings. Most households that own term insurance policies never collect on those policies. This is because most breadwinners live long enough that the household becomes largely independent of the breadwinner’s human capital, and the policies are allowed to lapse. Children grow up and move out on their own; and families eventually accumulate sufficient non-life-contingent assets—household savings plus social security entitlements—to provide for the financial needs of surviving spouses. And, after all, premature death is, by definition, a rare event; so we should not expect it to be a “front burner” issue for most people most of the time.

Still, the level of underinsurance documented in the Bernheim et al. study discussed in Part II is not trivial. If underinsurance is truly as “widespread” as they suggest, one would expect more public concern about the question. Perhaps it will come as their study gets play in the academic community.

But I doubt it. And let me suggest why. As reflected in Part I, there remains a great deal of uncertainty about the central assumption on which all of the existing empirical studies have been based: that the optimal or correct amount of life insurance entails an amount of coverage necessary to leave the dependent with the same consumption power she or he had when the breadwinner was alive. And
even if we could agree on that assumption, there would remain the equally difficult, and equally
important, question what constitutes “maintaining the household standard of living.”

Consider, for example, the response I received upon asking a friend how much life insurance a
household should buy: “Enough so that the breadwinner’s dependents would not be left destitute, but
probably no more than that.” A number of others I have asked this question have expressed similar
opinions. One colleague even went so far as to suggest that he wanted to arrange his affairs so that,
when he died, his family would actually be a little worse off (financially) as a result, so that they would
be sure to experience regret. He didn’t want them dancing on his grave, he said. The life insurance
decision is complex one, no doubt. And the living-standard-maintenance baseline, even if it can be
given some content in particular contexts, may not be for everyone. My concern, however, is that the
impossibility of identifying a single correct formula for determine life-insurance adequacy will serve to
justify a lack of introspection and a lack of intra-household communication (such as between spouses,
and on a regular basis) about what the household’s actual life insurance needs are, problems that in my
view can easily be made worse by the sort of market failures (for lack of a better term) that I describe
in Part II.B above.

With this concern in mind, consider one other anecdote that arises out of my research for this
Article. In getting comments on earlier drafts, the initial reaction (especially from colleagues with
economics or business backgrounds) has often been decisive and adamant: I have gotten this all
wrong—exactly backwards, in fact. The life insurance market is one that should be expected to work
especially well. Life insurance contracts are quite simple and easy to understand (at least that is the
case with term insurance policies); therefore, consumers should have no difficulty understanding and
evaluating the various alternatives. And the market seems especially competitive, given the price wars being waged over the Internet. Moreover, the laundry-list of market-failure rationales that I describe in part II.B. (adverse selection, externalities, myopia, and intra-household agency problems) just do not ring true. Ironically, however, a few of those same critics have come back to me and, without backing down one bit from their assessment of the paper, have confessed that, upon reflection (and after discussion of the matter with their spouses), it occurs to them that, well, they personally are in fact woefully underinsured, a fact that (they admit) had not occurred to them until after they had read my paper. Therefore, even if this Article does not lead to policy changes of the sort described in Part III, perhaps it will, by prompting a discussion of the life-insurance-adequacy question, help to encourage more careful assessments of household insurance needs among its audience.