Norms, Incentives and Information in Income Insurance

by

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\[ u(b) \quad \text{when living on benefits} \]
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\[ [1 - F(\theta^*)] \cdot p = F(\theta^*) \cdot b \]
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\[ [1 - F(\theta^*)] \cdot p = F(\theta^*) \cdot b \]

\[ [1 - F(\theta^*)] \cdot [u(1 - p) + E(\theta|\theta > \theta^*)] + F(\theta^*) \cdot u(b) \]
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2. Two rationales for insurance: Income smoothing and pain relief.
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3. Concavity of consumption utility \(u(\cdot)\) not sufficient for insurance to be warranted.

4. Tax wedge will reduce labor supply also under an optimal insurance contract.
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How to change the model to make it more realistic? Introduce a third sector.
Blunt Norms

\[ u(1 - p) + \theta \]
\[ [u(w) + \alpha \theta - \varphi] \]
\[ u(w + b) + \alpha \theta - \varphi \]
\[ u(b) - \varphi \]
Blunt Norms

\[ u(1 - p) + \theta \]
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The norm is blunt. Harms not only cheaters: “collateral damage
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\[ \frac{dL}{d\varphi} : \text{undetermined sign} \]
Blunt Norms

Numerical simulations:

Utility function CRRA,\n\( \theta \) normally distributed.

\( V \) derive optimum norms for large combinations of \( \alpha \) and \( w \)
Figure 5.2: Distribution of the population on different activities when there is a norm against working outside the regular economy. Baseline case with $\alpha = 0.6$ and $w = 0.3$. 
Figure 5.3: The optimal contract \((p, b)\) for different values of \(\varphi\) when there is a norm against working outside the regular economy. Baseline case with \(\alpha = 0.6\) and \(w = 0.3\).
Figure 5.4: Expected utility when there is a norm against working outside the regular economy. Baseline case with $\alpha = 0.6$ and $w = 0.3$. 

$\varphi_{opt}$
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The optimal norm falls with higher $\alpha$, and increases with higher $w$. 
A Norm Against Cheating

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\[ u(w) + \alpha \theta \]
\[ u(w + b) + \alpha \theta - \varphi \]
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Simulations with large number of combinations of $\alpha$ and $w$. Norms optimal for more combinations of $\alpha$ and $w$ than in the case of blunt norm.
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The optimal $(p, b)$ vector looks like in the previous model.
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The distribution on activities looks like in the previous model.

The optimal $(p, b)$ vector looks like in the previous model.

But expected utility, as a function of the norm term, is different!
The norm is robust!

Figure 6.1: Expected utility when there is a norm against cheating. Baseline case with $\alpha=0.6$ and $w=0.3$. 
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Some activities are allowed to be combined with benefits without being regarded as “cheating”. For instance, activities with low $\alpha$ (personal hygiene, cleaning, recreation...)