# Social long-term care insurance with two-sided altruism

Helmuth Cremer [a,*], Pierre Pestieau [b,c,d], Kerstin Roeder [e]

[a] Toulouse School of Economics (GREMAQ, IDEI and Institut universitaire de France), 21 Allée de Brienne, 31015 Toulouse, France
[b] CREPP, Université de Liège, TSE, France
[c] CORE, Université catholique de Louvain, TSE, France
[d] TSE, Belgium
[e] University of Augsburg, Germany

## ARTICLE INFO

## ABSTRACT

This paper studies the design of a social long-term care (LTC) insurance when altruism is two-sided. The *laissez-faire* solution is not efficient, unless there is perfect altruism. Under full information, the first-best can be decentralized by a linear subsidy on informal aid, a linear tax on bequests when the parent is dependent and state specific lump-sum transfers which provide insurance. We also study a second-best scheme comprising a LTC benefit, a payroll tax on children's earnings and an inheritance tax. This scheme redistributes resources across individuals and between the states of nature and the tax on children's labor enhances informal care to compensate for the children's possible less than full altruism.

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## 1. Introduction

Long-term care (LTC) is becoming a major concern for policy makers. Following the rapid aging of our societies, the needs for LTC are expected to grow and yet there is a lot of uncertainty as how to finance those needs; see Norton (2000) and Cremer et al. (2012) for an overview. Family solidarity, which has been the main provider of LTC, is reaching a ceiling, and the market is remains rather thin.[1] Not surprisingly, one would expect that the state takes the relay.

This paper studies the design of social LTC insurance when both parents and children are altruistic towards each other. Children's altruism is however only partial. First, it is only triggered by the occurrence of dependency and second it is limited. In a pure market economy the dependent parents have to devote their resources to purchase professional care services, but also to leave some bequests to boost informal care.

One cannot be but struck by two parallel evolutions: the soaring needs for LTC and the growing share of inherited wealth in overall capital accumulation; see Piketty and Zucman (2014). LTC is surely not a problem for the very wealthy households, but for many households LTC can eat up most of their assets and make it impossible to bequeath anything. It is thus not surprising that some people have thought of using the proceeds of estate taxation to finance public long-term care. An example of this is the English green paper proposing a voluntary inheritance levy. Accordingly, people in England and Wales

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* Corresponding author.
  E-mail address: helmuth.cremer@tse-fr.eu (H. Cremer).
  [1] The economic literature has identified a number of factors that can explain the low level of LTC insurance demand. These include significant loading factors due to high administrative costs, adverse selection in the demand for insurance (Sloan and Norton, 1997; Finkelstein and McGarry, 2006; Brown and Finkelstein, 2007, 2009) and the existence of cheaper substitutes like family care or public assistance (Pauly, 1990; Zweifel and Strüwe, 1998; Brown and Finkelstein, 2008).

could pay a one-off 'inheritance levy' of up to £12,000 in return for free public long-term care in their old age. The fee would either be deducted from the estates of older people when they die or be paid when they enter retirement age.[2] The aim is to avoid forcing many pensioners to sell their family homes to fund massive nursing home bills.

There is indeed a close link between bequests and long-term care. In a world without a well-developed LTC insurance market, households are forced to oversave or to self-insure. Consequently, in case of good health they end up with an excess of saving that can lead to involuntary bequests. It is then clear that if it were possible to tax those bequests, the proceeds could be used to finance long-term care. Actually if some type of insurance, private or public were available, one would end up with the same result, that is, a perfect smoothing of consumption between the two states of the world, dependency or not. Brunner and Pech (2012) made that argument by showing that a tax on bequests to finance LTC causes a smaller deadweight loss than an income or consumption tax. This holds true whether or not the parents are altruistic. The problem is that in a world with heterogeneous agents it might be impossible to distinguish bequests that are made by dependent parents from those made by autonomous parents.

The matter gets more complicated when we look at the case of formal LTC financed by saving or insurance and informal services coming from children. For the time being we assume that formal and informal care are complements. Dependent parents will have to exchange those informal services against the prospect of some bequests. If children are not altruistic, we will have a pure *quid pro quo* exchange; if they are altruistic they might help their parents even if these cannot bequeath anything. The amount of help will depend on the extent of filial altruism. In case of perfect altruism, children will provide the optimal amount of assistance to their parents.

In a world of identical individuals, the social insurance scheme will serve two purposes: it redistributes resources across the two states of nature and it induces the child to help his parent. If individuals differ in the level of their wage, social insurance must also redistribute resources across individuals.

To study these issues we consider a population consisting of one parent and one child families. Parents are pure altruists towards their child, while the child's altruism may be imperfect. Parents are retired and have accumulated some wealth. They face a probability of becoming dependent and needing LTC. The need of LTC requires expenditures of some monetary amount. In case of dependency parents would like to benefit from the aid of their children, who are ready to help their parent out of altruism but also with the expectation of some inheritance.[3]

We characterize the first-best allocation and show that the *laissez-faire* is not efficient, unless there is perfect altruism. Under full information the first-best can be decentralized by a linear subsidy on informal aid, a linear tax on bequests when the parent is dependent, and state specific lump-sum transfers which provide insurance.

Next, we study the second-best allocation when the instruments available are linear (state independent) taxes on bequests and children's labor income which finance a transfer to the dependent elderly.[4] Observe that the tax on children's labor income is in our setting effectively equivalent to a subsidy on informal care.[5]

We first consider a setting with *ex ante* identical individuals. We show that both taxes should be positive. The tax on labor which subsidizes informal care compensates for possible imperfect altruism; this is like in the first-best implementation. Both taxes also provide insurance, and that is relevant as the first-best state specific lump-sum transfers or taxes that provide full insurance are not available. Labor and bequest taxes are then used to provide (partial) insurance.

Finally, we consider a setting with *ex ante* heterogenous families, which differ in children's productivities and parents' wealth. We show that the results obtained in the homogenous family case carry over. However, the two tax rates now also include a positive redistributive term. Throughout this paper private LTC insurance is assumed away. This is for the sake of simplicity but also because in most countries the LTC insurance market is extremely thin; see Brown and Finkelstein (2007, 2009).

## 2. Identical individuals

### 2.1. The model setup

Consider a population of a size normalized to one, consisting of one parent (subscript '$p$') and one child (subscript '$c$') families. Parents are pure altruists towards their child, while a child's altruism may be imperfect. Parents are retired and have accumulated wealth $y$. They face the probability $\pi$ of becoming dependent and needing long-term care. The need of LTC requires expenditures of amount $L$. In case of dependency the parent would like to benefit from the aid of his child, who is ready to help his parent out of altruism but also when receiving some inheritance $b$. Parents choose the bequest to their children. In case of autonomy, the child inelastically supplies one unit of labor at a wage rate $w$. In case the parent needs long-term care, the child's time spend on the labor market is reduced by the time spend for informal care provision $a$ and gross earnings amount to $w(1-a)$. Care provided by the child reduces the monetary loss from LTC by $h(a) \leq L$ (with $h' > 0, h'' < 0$) since then the parent requires less professional care services.

In sum, the parent's and child's expected utilities are given by

$$EU_p = \pi\left[H(y+h(a)-L-b)+u(w(1-a)+b)\right]+(1-\pi)\left[u(y-\widehat{b})+u(w+\widehat{b})\right],\tag{1}$$

$$EU_c = \pi\left[u(w(1-a)+b)+\beta H(y+h(a)-L-b)\right]+(1-\pi)\left[u(w+\widehat{b})+\beta u(y-\widehat{b})\right],\tag{2}$$

where $\beta \in [0, 1]$ reflects the child's degree of altruism and a ⌢ indicates the state of staying healthy. The utility function $u$ is the standard one whereas, $H$ denotes the utility for long-term care. These functions satisfy $u', H' > 0$ and $u'', H'' < 0$. Furthermore, we assume $H(x) < u(x)$ for any $x$, due to the loss of autonomy.

The timing of the model is as follows: the government moves first and announces its policy (stage 0). Then, the parent and the child play the following two-stage game. In stage 1, the parent chooses (for each state of nature) a level of bequest. In stage 2, after the state of nature is revealed, children decide how much informal care to provide if their parent is dependent. Otherwise, children simply consume their income plus the bequest.

To determine the subgame perfect Nash equilibrium, we solve this game by backward induction. We first study the first-best allocation which provides a benchmark against which we can compare the *laissez-faire* allocation, obtained by dropping stage 0.

## 2.2. First-best solution

With *ex ante* identical families, we can define the optimal allocation as the one maximizing the expected utility of a representative dynasty. Assuming that both parents and children receive equal social weights, the first-best problem can be written as

$$\max_{m,c,\widehat{m},\widehat{c},a} \quad \mathcal{W} = \pi[H(m)+u(c)]+(1-\pi)\left[u(\widehat{m})+u(\widehat{c})\right],$$
$$\text{s.t.} \quad (1-\pi)\left[\widehat{m}+\widehat{c}-L\right]+\pi[m+c]=y+(1-\pi)w+\pi\left[w(1-a)+h(a)\right],\tag{3}$$

where the decision variables are informal care provision $a$ and parent's and child's consumption in both states of nature. We denote the latter by $m$, $\widehat{m}$, $c$ and $\widehat{c}$ respectively. In the first-best all variables are directly set, assuming full information and disregarding the multi-stage structure of the game. The specification of the game will of course be relevant below, when we study the decentralization of the first-best optimum. Let $\mu$ denote the Lagrange multiplier associated with the resource constraint (3). The first order conditions (FOCs) characterizing the optimal solution can be written as follows:

$$H'(m)=u'(\widehat{m})=u'(c)=u'(\widehat{c})=\mu,\tag{4}$$

$$w=h'(a).\tag{5}$$

Eq. (4) states the equality of marginal utilities of incomes across generations and states of nature (full insurance), while Eq. (5) describes the efficient choice of informal care. It states that the opportunity cost of informal care $w$ equals its marginal benefit.

## 2.3. Laissez-faire allocation

### 2.3.1. Stage 2: choice of children

In case of autonomy, children do not have to make any decision. They consume their income and bequest, enjoying a utility $u(w+\widehat{b})$. When their parents are in need of LTC, they solve the following problem:

$$\max_a u(w(1-a)+b)+\beta H(y-L+h(a)-b).$$

The first-order condition of the above problem is given by

$$-wu'(w(1-a)+b)+\beta H'(y-L+h(a)-b)h'(a)=0.$$

This equation defines the optimal level of $a$ as a function of $b$: $a^* = a(b)$. We have

$$\frac{\partial a^*}{\partial b}=\frac{wu''(c)+\beta H''(m)h'(a)}{SOC^a}>0,\tag{6}$$

as the second-order condition (SOC) is negative

$$SOC^a = w^2 u''(c)+\beta H'(m)h''(a)+\beta H''(m)(h'(a))^2 < 0.$$

In words, if parents increase their bequest, the willingness to provide informal care by the child also increases.

### 2.3.2. Stage 1: choice of parents

The problem of the parents is to choose (in both states of nature) the level of bequests to their children. In case of dependency parents have more needs but at the same time they might leave a higher bequest to induce more assistance from their children. Their problem is the following:

$$\max_{b,\widehat{b}} EU_p = \pi\left[H(y-L+h(a^*)-b)+u(w(1-a^*)+b)\right]+(1-\pi)\left[u(y-\widehat{b})+u(w+\widehat{b})\right].\tag{7}$$

Taking into consideration Eq. (6) the FOCs with respect to $b$ and $\widehat{b}$ can be written as

$$-H'(m)\left[1-h'(a^*)\frac{\partial a^*}{\partial b}(1-\beta)\right]+u'(c)=0, \tag{8}$$

$$-u'(\widehat{m})+u'(\widehat{c})=0. \tag{9}$$

It can be easily verified that for $\beta=1$ the parent leaves the efficient amount of bequests so that $H'(m)=u'(c)$. This in turn goes hand in hand with an efficient amount of aid provided by the child $h'(a)=w$; see Eq. (5). This result is not surprising as for perfect altruism, on both the parent's and the child's side, the optimization problem of the two family members coincides with the one of the social planner. Whenever $\beta<1$ this is no longer the case as the child puts a too low value on the parent's benefits of informal care. In this case the parent leaves a large than otherwise efficient bequest to induce the child to provide more care. We summarize our results in the following proposition.

**Proposition 1.** *The laissez-faire solution of the two-stage game of altruistic parents and (partly) altruistic children has the following properties*:

 (i) *When $H'(m)>u'(\widehat{m})$ parents and children are less than fully insured against the risk of LTC.*
 (ii) *When children are perfectly altruistic, i.e. $\beta=1$, informal care and bequests are efficiently chosen.*
(iii) *When children are partly altruistic, i.e. $\beta<1$, then*
  (a) *informal care is inefficiently low since children do not take into consideration the full benefit of their care to their parents, and*
  (b) *bequests are inefficiently high since parents move first and want to induce their child to provide more care.*

### 2.4. Decentralization of the first-best allocation

Assume for the time being that there is no asymmetry of information so that all relevant variables including informal aid are publicly observable. In the following we show that the FB allocation within our multi-stage setting can be decentralized by a lump-sum transfer (social LTC insurance) from the healthy to the dependent elderly $(\widehat{D}, D)$ supplemented by a tax on labor income $\tau_a$ and on bequests $\tau_b$ for those children whose parents are dependent. Public transfers must be chosen such that the government's budget constraint

$$\pi D=(1-\pi)\widehat{D}+\pi\left[\tau_a w(1-a^*)+\tau_b b^*\right] \tag{10}$$

is balanced.

#### 2.4.1. Family's problem reconsidered

Again, in case of autonomy children do not have to make any decision; they consume their income and bequest enjoying a utility $u(w+\widehat{b})$. When their parents are in need of long-term care, they now solve the following problem:

$$\max_a u((1-\tau_a)w(1-a)+(1-\tau_b)b)+\beta H(y+D-L+h(a)-b). \tag{11}$$

The first order condition of the above problem is given by

$$-(1-\tau_a)wu'(c)+\beta H'(m)h'(a)=0. \tag{12}$$

The above equation yields $a^*=a(b,\tau_a,\tau_b,D)$. The comparative static effects with respect to $b$ and the policy instruments are[6]

$$\frac{\partial a^*}{\partial b}=\frac{(1-\tau_a)wu''(c)(1-\tau_b)+\beta H''(m)h'(a)}{SOC^a}>0, \tag{13}$$

$$\frac{\partial a^*}{\partial \tau_a}=\frac{-wu'(c)-(1-\tau_a)w^2(1-a)u''(c)}{SOC^a}\lessgtr 0, \tag{14}$$

$$\frac{\partial a^*}{\partial \tau_b}=\frac{-(1-\tau_a)wbu''(c)}{SOC^a}<0, \tag{15}$$

$$\frac{\partial a^*}{\partial D}=\frac{-\beta H''(m)h'(a)}{SOC^a}<0. \tag{16}$$

Care increases with bequests while a tax on bequest dampens it. An income tax either pushes or dampens informal care provision and public LTC decreases informal care. Comparison of Eq. (12) with the first-best allocation (Eqs. (4) and (5)) shows that to implement the first-best level of care we first need a tax on child's income, i.e. $\tau_a=1-\beta$. A tax on income

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[6] The second order condition is $SOC^a=((1-\tau_a)w)^2u''(c)+\beta H'(m)h''(a)+\beta H''(m)h'^2<0$.

implicitly subsidizes the child's informal care provision so that the trade-off between the child's marginal costs and marginal benefit of care is the efficient one.

The problem for the parents is now the following:

$$\max_{b,\widehat{b}} U_p = \pi\left[H(y+D-L+h(a^*)-b)+u((1-\tau_a)w(1-a^*)+(1-\tau_b)b)\right]+(1-\pi)\left[u(y-\widehat{D}-\widehat{b})+u(w+\widehat{b})\right]. \quad (17)$$

Using Eq. (12), the FOCs with respect to $b$ and $\widehat{b}$ are

$$-H'(m)\left[1-h'(a^*)\frac{\partial a^*}{\partial b}(1-\beta)\right]+(1-\tau_b)u'(c)=0, \quad (18)$$

$$-u'(\widehat{m})+u'(\widehat{c})=0. \quad (19)$$

Eqs. (18) and (19) yield $b^*=b(D,\widehat{D},\tau_a,\tau_b)$ and $\widehat{b}^*=\widehat{b}(D,\widehat{D},\tau_a,\tau_b)$. When the transfers $(D,\widehat{D})$ are chosen such that the parent (and thus also the child) is fully insured implying $H'(m)=u'(\widehat{m})$ we have $H'(m)=u'(\widehat{c})$. The tax on bequests must then be chosen such that its effect on informal care is offset, *i.e.*

$$\tau_b=h'(a^*)\frac{\partial a^*}{\partial b}(1-\beta)>0.$$

That is, we have to tax bequests when the parent ends up being dependent. This tax offsets the parent's incentives to induce informal care above its first-best level.[7] We summarize our results in the following proposition.

**Proposition 2.** *To decentralize the first-best optimum we need three types of tools*

(i) *a distortionary tax $\tau_a$ that fosters child's assistance in case of impure altruism,*
(ii) *a tax $\tau_b$ on bequests when the parent is dependent, and*
(iii) *lump-sum transfers $(D,\widehat{D})$ acting as redistributive device between the two states of nature.*

Note that we have assumed away private insurance. If private insurance were available, its role would depend on the existence and the size of loading costs. With zero loading costs, a first best could be achieved simply by taxing child's labor at the appropriate rate, namely $1-\beta$, and by taxing bequests when the parent is dependent. With positive loading cost, we also need the lump-sum transfers, which then completely crowd out private insurance.

## 3. Second-best solution

### 3.1. Identical children

We now turn to the second-best. We assume that the government can use only linear (proportional) taxes on bequests $\tau$ and on labor earnings $t$, to finance a LTC benefit $g$. Tax rates cannot be conditioned on the parents' health status. We use the notation $t$, $\tau$ and $g$ rather then $\tau_a$, $\tau_b$ and $D$ to avoid confusion with the first-best implementation.

With our instruments we write the revenue constraint as

$$\pi g=t(1-\pi a^*)w+\tau\left[\pi b^*+(1-\pi)\widehat{b}^*\right].$$

#### 3.1.1. The child's problem
The child solves

$$\max_{a} u((1-t)w(1-a)+(1-\tau)b)+\beta H(y-L-b+g-h(a)), \quad (20)$$

which apart from the change in notation is equivalent, to (11) so that the FOC continues to be given by (12) and can be written as

$$(1-t)wu'(c)=\beta H'(m)h'(a^*). \quad (21)$$

The solution is given by $a^*=a(b,t,\tau,g)$. The comparative statics properties of this function follow those described by Eqs. (13)–(16). Using subscripts to denote partial derivatives, we thus have $a_b^*>0, a_\tau^*<0, a_t^*\gtrless0, a_g^*<0$.

#### 3.1.2. Parent's problem
Turning to the parent's problem, it is given by

$$\max_{b,\widehat{b}} EU_p = \pi\left[H(y-L-b+g+h(a^*))+u((1-t)w(1-a^*)+(1-\tau)b)\right]+(1-\pi)\left[u(y-\widehat{b})+u\left((1-t)w+(1-\tau)\widehat{b}\right)\right]. \quad (22)$$

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[7] The expression for $\partial a^*/\partial b$ is not independent of $\tau_b$.

The two FOCs with respect to $\widehat{b}$ and $b$ are

$$u'(\widehat{m}) = u'(\widehat{c})(1-\tau), \tag{23}$$

$$H'(m)\left[1 - h'(a^*)a_b^*\right] = u'(c)[(1-\tau) - (1-t)wa_b^*]. \tag{24}$$

Using (21), Eq. (24) can be rewritten as

$$H'(m)\left[1 - h'(a^*)(1-\beta)a_b^*\right] = u'(c)(1-\tau).$$

These conditions define the bequests supply functions, *i.e.* $b^* = b(t,\tau,g)$ and $\widehat{b}^* = b(t,\tau)$. We implicitly assume positive bequests in either state of nature. Substituting for $b$ into $a^*$ yields the level of aid as a function of the government's instruments $a^* = a(b(t,\tau,g),t,\tau,g) \equiv \tilde{a}(t,\tau,g)$.

### 3.1.3. The government's problem

The second-best problem can now be expressed by the following Lagrangean:

$$\mathcal{L}(g,t,\tau) = \pi\left[H(y - L - b^* + g + h(a^*)) + u((1-t)w(1-a^*) + (1-\tau)b^*)\right] + (1-\pi)\left[u\left(y - \widehat{b}^*\right) + u\left((1-t)w + (1-\tau)\widehat{b}^*\right)\right]$$
$$- \mu\left[\pi g - t(1 - \pi a^*)w - \tau(\pi b^* + (1-\pi)\widehat{b}^*)\right] \tag{25}$$

Using the envelope theorem, we can write the FOCs with respect to $g$, $t$ and $\tau$ as

$$\frac{\partial\mathcal{L}}{\partial g} = \pi\left[H'(m)h'(a^*) - u'(c)(1-t)w\right]\tilde{a}_g^* + \pi H'(m) - \mu\left[\pi + \pi tw\tilde{a}_g^* - \tau\left(\pi b_g^* + (1-\pi)\widehat{b}_g^*\right)\right] = 0,$$

$$\frac{\partial\mathcal{L}}{\partial t} = \pi\left[H'(m)h'(a^*) - u'(c)(1-t)w\right]\tilde{a}_t^* - \left[\pi u'(c)(1-a^*) + (1-\pi)u'(\widehat{c})\right]w + \mu\left[w(1 - \pi a^*) - \pi tw\tilde{a}_t^* + \tau\left[\pi b_t^* + (1-\pi)\widehat{b}_t^*\right]\right] = 0,$$

$$\frac{\partial\mathcal{L}}{\partial\tau} = \pi\left[H'(m)h'(a^*) - u'(c)(1-t)w\right]\tilde{a}_\tau^* - \left[\pi u'(c)b^* + (1-\pi)u'(\widehat{c})\widehat{b}^*\right] + \mu\left[\pi b^* + (1-\pi)\widehat{b}^* - \pi tw\tilde{a}_\tau^* + \tau\left[\pi b_\tau^* + (1-\pi)\widehat{b}_\tau^*\right]\right] = 0.$$

These FOCs can be rearranged using the compensated form with

$$\frac{dg}{d\tau} = \frac{\pi b^* + (1-\pi)\widehat{b}^*}{\pi}, \quad \text{and} \quad \frac{dg}{dt} = \frac{(1 - \pi a^*)w}{\pi}.$$

In other words, we keep the tax rates $t$ and $\tau$ as sole decision variables, while accounting of course for their impact on $g$, via the government's budget constraint. This yields[8]

$$\frac{\partial\mathcal{L}^C}{\partial\tau} = \frac{\partial\mathcal{L}}{\partial\tau} + \frac{\partial\mathcal{L}}{\partial g}\frac{dg}{d\tau} = \pi(1-\beta)H'(m)h'(a^*)\tilde{a}_\tau^c - \left[\pi u'(c)b^* + (1-\pi)u'(\widehat{c})\widehat{b}^*\right] + H'(m)\left(\pi b^* + (1-\pi)\widehat{b}^*\right)$$
$$- \mu\left[tw\tilde{a}_\tau^c - \tau\left(\pi b_\tau^c + (1-\pi)\widehat{b}_\tau^c\right)\right] = 0, \tag{26}$$

$$\frac{\partial\mathcal{L}^C}{\partial t} = \frac{\partial\mathcal{L}}{\partial t} + \frac{\partial\mathcal{L}}{\partial g}\frac{dg}{dt} = \pi(1-\beta)H'(m)h'(a^*)\tilde{a}_t^c - \left[\pi u'(c)(1-a^*) + (1-\pi)u'(\widehat{c})\right]w + H'(m)(1 - \pi a^*)w$$
$$- \mu\left[tw\tilde{a}_t^c - \tau\left(\pi b_t^c + (1-\pi)\widehat{b}_t^c\right)\right] = 0. \tag{27}$$

To interpret these formulas, we make the standard assumption that the cross-derivatives are negligible. This amounts to posit that the cross effects of taxation do not dominate the direct effects. Formally, $b_t^c = \widehat{b}_t^c = \tilde{a}_\tau^c = 0$. We show in Appendix A.1 that we then have

$$\tau = \frac{-\pi\Delta b^* - (1-\pi)\widehat{\Delta}\,\widehat{b}^*}{-\mu\left[\pi b_\tau^c + (1-\pi)\widehat{b}_\tau^c\right]}, \tag{28}$$

$$t = \frac{\pi(1-\beta)H'(m)h'(a^*)\tilde{a}_t^c - \pi\Delta y - (1-\pi)\widehat{\Delta}w}{\mu w\tilde{a}_t^c}, \tag{29}$$

where $\Delta \equiv u'(c) - H'(m) \gtreqqless 0$ and $\widehat{\Delta} \equiv u'(\widehat{c}) - H'(m) < 0$.[9] The denominators in these two formulas are standard. They reflect the (adverse) efficiency effect of taxes. Remember that $\mu > 0$ reflects the welfare gain when the budget constraint is marginally relaxed. Normally, one expects $\tilde{a}_t^c > 0$ and

$$\pi b_\tau^c + (1-\pi)\widehat{b}_\tau^c < 0.$$

To interpret the numerator of Eq. (28), we have to return to our assumption of positive bequests and on the inequalities $\Delta \equiv u'(c) - H'(m) \gtreqqless 0$ and $\widehat{\Delta} \equiv u'(\widehat{c}) - H'(m) < 0$. As shown above in the first-best, $\Delta = \widehat{\Delta} = 0$. The numerator will thus be positive if

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[8] We define $\tilde{a}_x^c = \frac{\partial\tilde{a}}{\partial x} + \frac{\partial\tilde{a}}{\partial g}\frac{dg}{dx}$, $b_x^c = \frac{\partial b^*}{\partial x} + \frac{\partial b^*}{\partial g}\frac{dg}{dx}$ and $\widehat{b}_x^c = \frac{\partial\widehat{b}^*}{\partial x} + \frac{\partial\widehat{b}^*}{\partial g}\frac{dg}{dx}$, where $x = \tau, t$.
[9] This means that $\widehat{m} > \widehat{c} > c$.

$\pi$ is not too high and if $\left|\widehat{\Delta}\right| > \Delta > 0$, which is likely if $L$ is large enough. Turning to the numerator of Eq. (29), note that the first term in this numerator vanishes if $\beta = 1$. Otherwise, it represents the need to foster child's assistance. This term mirrors the first-best implementation but has a different structure in the second-best. The second and third terms are the same as in the previous condition. They reflect the insurance benefits provided by the tax. They give the welfare gap between the young and the dependent elderly in the two states of nature. The larger the marginal utility of the dependent is relative to that of the young, the larger are the benefits of the LTC benefits. Consequently, there is a need for a higher tax to finance the social benefit $g$.

Private insurance would not change our qualitative results. Even with zero loading cost, the first-best cannot be achieved with the instruments considered here; it would require a state-contingent inheritance tax. With a positive loading cost individuals buy less than full insurance and the two taxes continue to make up for part of the incompleteness of private insurance protection.

## 4. Heterogenous families

So far families were assumed to be identical. Thus the role of social policy was limited to insuring families against dependency shocks. In other words the role of social LTC benefits was solely to enhance efficiency (including that of insurance coverage). We now assume that families differ *ex ante* in the children's productivity levels and in the parents' resources. This introduces a redistributive concern into our problem. We assume that both ($w_i$ and $y_i$) are positively correlated so that our assumption of positive bequests is valid across families. Again, the government levies a flat tax $t$ on earnings and $\tau$ on bequests to finance a uniform LTC benefit $g$. Within such a framework the social insurance scheme pursues an additional objective, namely redistribution.

The government's revenue constraint has to be modified such that

$$\pi g = \sum_i n_i \Big[ t(1 - \pi a_i^*) w_i + \tau (\pi b_i^* + (1 - \pi)\widehat{b}_i^*) \Big],$$

where $n_i$ is the relative number of families with productivity $w_i$ and $y_i$. The optimizing behavior of children and parents remains the same as described above; each child and parent of type-$i$ solves the problem given in (20) and (22). From this we obtain optimal long-term care provision $a_i^* = \tilde{a}(t, \tau, g)$ with $\tilde{a}_{i\tau} < 0, \tilde{a}_{it} \gtreqless 0$ and $\tilde{a}_{ig} < 0$ and optimal bequests $b_i^* = b(t, \tau, g)$ and $\widehat{b}_i^* = b(t, \tau)$.

### 4.1. Government's problem

The second-best problem of a utilitarian government with heterogenous families can be expressed by the following Lagrangean expression:

$$\mathcal{L}(g, t, \tau) = \sum_i n_i \left\{ \pi H(y_i - L - b_i^* + g + h(a_i^*)) + u((1-t)w_i(1-a_i^*) + (1-\tau)b_i^*) . + (1-\pi)\left[ u\left(y_i - \widehat{b}_i^*\right) + u\left((1-t)w_i + (1-\tau)\widehat{b}_i^*\right) \right] \right.$$

$$\left. - \mu\left[ \pi g - t(1 - \pi a_i^*)w_i - \tau\left( \pi b_i^* + (1-\pi)\widehat{b}_i^* \right) \right] \right\}. \tag{30}$$

Maximizing this expression with respect to $g$, $t$ and $\tau$ yields the following FOCs:

$$\frac{\partial \mathcal{L}}{\partial g} = E\left\{ [\pi[H'(m)h'(a^*) - u'(c)(1-t)w]\tilde{a}_g + \pi H'(m) - \mu[\pi + \pi t w \tilde{a}_g - \tau \pi b_g] \right\} = 0,$$

$$\frac{\partial \mathcal{L}}{\partial t} = E\left\{ \pi[H'(m)h'(a^*) - u'(c)(1-t)w]\tilde{a}_t - [\pi u'(c)(1-a^*) + (1-\pi)u'(\widehat{c})]w + \mu[w(1 - \pi a^*) - \pi t w \tilde{a}_{\tau_a} \right.$$

$$\left. + \tau\left( \pi b_t + (1-\pi)\widehat{b}_t \right) \right] \right\} = 0,$$

$$\frac{\partial \mathcal{L}}{\partial \tau} = E\left\{ \pi[H'(m)h'(a^*) - u'(c)(1-t)w]\tilde{a}_\tau - [\pi u'(c)b^* + (1-\pi)u'(\widehat{c})\widehat{b}^*] + \mu[\pi b^* + (1-\pi)\widehat{b}^* - \pi t w \tilde{a}_\tau \right.$$

$$\left. + \tau\left( \pi b_\tau + (1-\pi)\widehat{b}_\tau \right) \right] \right\} = 0,$$

where we use the operator $E$ for $\sum_i n_i$. As for identical families we can rearrange the above FOCs in terms of compensations with $dg/d\tau$ and $dg/dt$; see Appendix A.2. By assuming that the cross derivatives are nil, *i.e.* $b_{it}^c = \hat{b}_{it}^c = \tilde{a}_{i\tau}^c = 0$, we have

$$\tau = \frac{-\pi \text{cov}(\Delta, b^*) - (1-\pi)\text{cov}(\hat{\Delta}, \hat{b}^*)}{-\mu E\left[\pi b_\tau^c + (1-\pi)\hat{b}_\tau^c\right]} + \frac{-\pi E\Delta Eb^* - (1-\pi)E\hat{\Delta}E\hat{b}^*}{-\mu E\left[\pi b_\tau^c + (1-\pi)\hat{b}_\tau^c\right]},$$

(31)

and

$$t = \frac{\pi(1-\beta)E\left[H'(m)h'(a^*)\tilde{a}_t^c\right] - \pi\text{cov}(\Delta, w(1-a^*)) - (1-\pi)\text{cov}(\hat{\Delta}, w)}{\mu E w\tilde{a}_t^c} + \frac{-\pi E\Delta Ew(1-a^*) - (1-\pi)E\hat{\Delta}Ew}{\mu E w\tilde{a}_t^c}$$

(32)

The interpretation of these two formulas is the same as in the case of identical individuals with one exception, namely the covariance terms that are expected to be negative. This is because with higher income/wealth the difference in marginal utilities between states of nature decreases. In other words, earnings inequality pushes for more taxation of either earnings or bequests. The covariance terms thus measure the redistributive benefits of social LTC which come on top of the efficiency benefits described in the earlier sections.

The results of this section are summarized in the following proposition.

**Proposition 3.** *Assume that informal aid a is not observable and that policy instruments are restricted to public LTC provision to dependent parents, g, financed by a linear tax on the children's labor income at rate t and a linear tax on bequests at rate $\tau$. Assume further that the cross compensated effects of $\tau$ on a and of t on b and $\hat{b}$ are negligible. Then we have*:

(i) *With ex ante homogenous families the tax on inheritance depends on two terms: an insurance term and an efficiency term that is the compensated derivative of bequests with respect to the tax. The earnings tax depends on a third term reflecting the need to foster aid of partially altruistic children.*
(ii) *With heterogenous families the two taxes depend also on an additional equity (redistributive) term that increases their social desirability.*

## 5. Conclusion

The starting point of this paper is the concomitance of two trends: the increasing needs for LTC, and unusual growth of inheritance. In a *laissez faire* economy with neither public nor private insurance, dependency would bite a big chunk of accumulated wealth with the consequence that bequests would greatly differ for kids with dependent parents and kids with healthy parents. Children's care can only partially mitigate those differences. Given that the market for LTC insurance is typically thin or even absent, one has to rely on public action to restore some balance between the two states of nature.

In a first-best world, a subsidy on children's care, state-dependent bequest taxes and a state-contingent lump sum tax could achieve the optimum and provide full insurance. If for obvious reasons individualized lump sum taxes are not available, one has to rely on second-best schemes. In this paper a wage tax and a linear inheritance tax contribute to finance a uniform LTC benefit.

The main conclusion is that under plausible conditions linear taxes on both inheritances and wages to finance a public LTC flat rate benefit are desirable. The tax on children's labor income effectively subsidizes informal care, like in the first-best implementation. It is required when altruism is less than full. Both taxes also provide insurance and, in the case of heterogenous families (differing in children's productivity and parent's wealth) redistributive benefits. We have seen that we can end up with a subsidy of bequests or even earnings in the special case where the welfare of the dependent would be quite high relative to that of his children and the probability of dependency would be particularly high.

Throughout this paper we have assumed that parents in both states of nature were leaving some bequests. This implies that parents are relatively wealthier than their children, and that dependency does not represent a large financial loss. In an extension of this work we would like to explore cases where some parents do not leave any bequest or they only bequeath in the healthy state. It is expected that if bequests in the healthy state were much higher than those in the state of dependency and if the wealthy families were leaving high bequests whereas the poorer families were bequest-constrained, estate taxation would play an even more important role. Additionally, we would like to introduce private insurance with loading costs and study the possibility of non-linear LTC policies. Another possible extension is to look at a society where only a share of elderly dependent individuals have children and thus the possibility to rely on informal care provision. In such a framework the government is confronted with a tagging problem (see, Kanbur and Tuomala, 2015).

## Appendix A

### A.1. Identical families: second-best

Using a shorter notation, and defining $\Delta \equiv u'(c) - H'(m) \gtreqqless 0$ and $\widehat{\Delta} \equiv u'(\widehat{c}) - H'(m) < 0$, we can write

$$- \left[ \pi u'(c)b^* + (1-\pi)u'(\widehat{c})\widehat{b}^* \right] + H'(m)(\pi b^* + (1-\pi)\widehat{b}^*) = -\pi \Delta b^* - (1-\pi)\widehat{\Delta}\widehat{b}^*,$$

$$- \left[ \pi u'(c)(1-a^*) + (1-\pi)u'(\widehat{c}) \right]w + H'(m)(1-\pi a^*)w = -\pi \Delta(1-a^*)w - (1-\pi)\widehat{\Delta} w.$$

We now rewrite Eqs. (26) and (27) as

$$\pi(1-\beta)H'(m)h'(a^*)\tilde{a}^c_\tau - \pi \Delta b^* - (1-\pi)\widehat{\Delta}\widehat{b}^* = \mu \left[ tw\tilde{a}^c_\tau - \tau \left( \pi b^c_\tau + (1-\pi)\widehat{b}^c_\tau \right) \right],$$

$$\pi(1-\beta)H'(m)h'(a^*)\tilde{a}^c_t - \pi \Delta(1-a^*)w - (1-\pi)\widehat{\Delta} w = \mu \left[ tw\tilde{a}^c_t - \tau \left( \pi b^c_t + (1-\pi)\widehat{b}^c_t \right) \right].$$

Using $b^c_t = \widehat{b}^c_t = \tilde{a}^c_\tau = 0$ and solving by using Cramer's rule then yields expressions (28) and (29).

### A.2. Heterogenous families: second-best

$$\frac{\partial \mathcal{L}^c}{\partial \tau} = E \left\{ \pi(1-\beta)H'(m)h'(a^*)\tilde{a}^c_\tau - \left[ \pi u'(c)b^* + (1-\pi)u'(\widehat{c})\widehat{b}^* \right] \right.$$
$$\left. + H'(m)(\pi b^* + (1-\pi)\widehat{b}^*) - \mu \left[ tw\tilde{a}^c_\tau - \tau \left[ \pi b^c_\tau + (1-\pi)\widehat{b}^c_\tau \right] \right] \right\} = 0, \tag{33}$$

$$\frac{\partial \mathcal{L}^c}{\partial t} = E \left\{ \pi(1-\beta)H'(m)h'(a^*)\tilde{a}^c_t - \left[ \pi u'(c)(1-a^*) + (1-\pi)u'(\widehat{c}) \right]w. \right.$$
$$\left. + H'(m)(1-\pi a^*)w - \mu \left[ tw\tilde{a}^c_t - \tau \left[ \pi b^c_t + (1-\pi)\widehat{b}^c_t \right] \right] \right\} = 0. \tag{34}$$

We use $\Delta \equiv u'(c) - H'(m) \gtreqqless 0$ and $\widehat{\Delta} \equiv u'(\widehat{c}) - H'(m) < 0$, to represent the gap between the child's marginal utility of consumption and that of the dependent parent. We now rewrite the FOC's as

$$\pi(1-\beta)E\left[H'(m)h'(a^*)\tilde{a}^c_t\right] - \pi \mathrm{cov}(\Delta, w(1-a^*)) - (1-\pi)\mathrm{cov}(\widehat{\Delta}, w)$$
$$- \pi E\Delta Ew(1-a^*) - (1-\pi)E\widehat{\Delta}Ew = \mu E \left[ tw\tilde{a}^c_t - \tau \left[ \pi b^c_t + (1-\pi)\widehat{b}^c_t \right] \right], \tag{35}$$

$$\pi(1-\beta)E\left[H'(m)h'(a^*)\tilde{a}^c_\tau\right] - \pi \mathrm{cov}(\Delta, b^*) - (1-\pi)\mathrm{cov}(\widehat{\Delta}, \widehat{b}^*)$$
$$- \pi E\Delta Eb^* - (1-\pi)E\widehat{\Delta}E\widehat{b}^* = \mu E \left[ tw\tilde{a}^c_\tau - \tau \left[ \pi b^c_\tau + (1-\pi)\widehat{b}^c_\tau \right] \right]. \tag{36}$$

Solving for $t$ and $\tau$ yields the expressions in the text.

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