thinkpiece

Promoting debate and fresh thinking in the financial services industry

Creating a safety net for workers: a radical proposal for a stable outcome?

Ann Rossiter

Summary

- This paper summarises the findings of a major research project undertaken by the Social Market Foundation and sponsored by Genworth Financial, a major international insurer.
- Despite record levels of employment and a trebling of personal GDP over the past 50 years, UK workers are feeling increasingly insecure regarding their employment status.
- Previous years have also seen a transfer of risk between the state and the individual. State income support has been in decline and private protection insurance is not filling the gap, either through lack of buyer or seller understanding, or lack of market confidence from mis-selling and competition inquiries.
- A model of a social insurance programme that combines 'hire and fire' flexibility and adequate unemployment benefits could correct this failure, whilst maintaining work incentives. Employees would be automatically enrolled with the option to opt out.
- Such a model of 'flexicurity' would allow Government and industry to better protect the UK workforce and maintain support for globalisation.

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CII Introduction: Our previous thinkpiece by Mick McAteer described how the transfer of risk from the state to the individual is failing. Protection is one area where this problem persists: state income support is rolling back and private protection insurance is simply not alleviating the gap, either through lack of buyer understanding, or lack of market confidence from mis-selling and competition inquiries. Social Market Foundation director Ann Rossiter has undertaken a detailed project sponsored by major insurer Genworth Financial and proposes a possible solution involving a joint Government-industry safety net. This fourth article in the CII's Thinkpiece series summarises these proposals, and provides a timely look at these issues amidst fears of a looming economic crisis.

Over the last ten years, the UK has experienced a period of strong growth and high employment, but workers are feeling increasingly insecure. With the turmoil in the credit market threatening to spill over to other parts of the real economy, calls for more security are getting louder. Some argue that this is the choice a modern economy faces: either growth fostered by flexibility without much security as is currently the case in Britain or security for workers coupled with high rates of unemployment as experienced in parts of continental Europe.

This paper argues that this choice is a false one. Looking at the Danish model of 'flexicurity' it becomes apparent that flexibility and security are not necessarily a trade-off. In Denmark, low employment protection legislation (flexibility) is combined with high out of work benefits (security) and mandatory training and up-skilling for the unemployed. The benefits of such an approach are significant: in times of an economic downturn with rising unemployment, aggregate spending on out-of-work benefits rises, because more people claim them. This mitigates the drop in their income and therefore cushions the downturn by preventing consumption falling as sharply as it would have without that support. By this mechanism, 'automatic stabilisers' have the potential to dampen business cycles. The more substantial the safety net, the better the stabilisation.

Furthermore, providing security for employees and flexibility for employers is an important tool to secure political support for globalisation given the growing interdependence of national economies. The challenge for British policymakers is to design a model of Anglo-flexicurity which delivers these benefits but avoids the high tax levels the Danish system is based on. The scheme we envisage is based on an improved private insurance product that all UK workers earning above a certain threshold would automatically be enrolled in. This paper outlines such an approach, and summarises a major research project undertaken by the Social Market Foundation and sponsored by international insurer Genworth Financial.

A strong labour market, but insecure workers

Britain's employment rate for the three months up to January 2008 stood at 74.8%, the highest level since records began in the seventies. Unemployment is, at 5.2%[1], low compared with a rate of 7.8% in both France and Germany.[2] As a nation, we are also far wealthier than even a generation ago. Between 1957 and 2006, the UK's GDP per head almost trebled in real terms, rising from £6,960 to £19,978.[3]

Redundancies fell after the early 1990s recession and have remained stable since[4] and today's job tenure is not significantly shorter than two decades ago.[5] However, in spite of these headline figures, British workers are feeling more and more insecure: an index measuring perceived insecurity among workers in 18 countries found that in 2006, British workers were more concerned than ever before that they would lose their jobs – and an increasing number of people think it would be very difficult to find a new job that is equally well-paid.[6] Compared to 2003, the UK experienced the "biggest increase in the percentage of employees who feel they could lose their jobs in the coming year,"[7] which makes the UK the country where workers feel most insecure in the advanced world.

This paradox of a strong labour market but insecure workers can be explained by the consequences of losing work. Workers who lose their jobs today face a steeper drop in income than workers in other countries and indeed, than previous generations in this country. So while a flexible labour market makes it more likely an employee will be laid-off, low levels of out-of-work state support provide little cover for people's increasing financial commitments.

The flexibility in the labour market leads to a twofold decline in income in the case of unemployment. The first occurs when actually losing work (falling from a

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[1] For the latest employment figures produced by the Office of National Statistics, please see http://www.statistics.gov.uk/CCI/nugget.asp?ID=12.

[2] OECD, "Standardised Unemployment Rates," New Release, February 2008, http://www.oecd.org/dataoecd/26/36/40049357.pdf.

[3] Office of National Statistics, "Time Series Data," www.statistics.gov.uk.

[4] Office for National Statistics, *Labour Market Statistics (*London: ONS, 2007).

[5] Simon Burgess and Hedley Rees, "Job tenure in Britain 1975-1992," *The Economic Journal* vol 106 no. 435 (1996), 334-344.

[6] Right Management, *Career Confidence IndexTM Overview and Key Findings*, November 2006 http://www.right.com/global/newsroom/cci.asp.

[7] Ibid., 2.

salary onto state benefits); the second and often longer lasting penalty arises when an unemployed worker accepts a job which is less well paid than his prior one. This double fall in income has become more problematic because people have become more financially fragile. Last year, mortgage debt rose above the £1 trillion mark, with a further £223 billion owed in personal loans and credit cards.[8] This has led to a situation where mortgage repayments alone account for more than 40% of take-home pay. In case of unemployment and subsequent less well-paid employment, such high repayment obligations become unbearable. As a result, personal insolvencies have increased by 45% from 2004 to 2005 alone.[9]

Box 1: The threshold for income insurance

Benefits for an average family with two children: Job Seeker's Allowance (JSA) for a workless couple with two children is worth £4,900 per year in 2008-09. Housing Benefit (HB) and Council Tax Benefit (CTB) for a typical family of this size is worth around £4,700 per year, while Child Tax Credit and Child Benefit provides a further £6,345 annually. In total, out-of work support available to such a family is therefore typically around £16,000 per year. Assuming a replacement rate of 60%, an insured employee must have a higher income than £27,000 per year in order to make the income insurance worthwhile for his or her family.

Benefits for a single childless couple: Financial support available to a single childless person is substantially less generous. HB/CTB and JSA are typically worth around £8,600. Again assuming that insurance would pay 60% of the previous income, the threshold for unemployment insurance to be worthwhile off is around £15,000.

Currently, neither state provision nor take-up of private insurance significantly ameliorates this problem. The state only offers meagre unemployment benefits, which cover basic living expenses, but does not allow for paying off a mortgage or maintaining a certain living standard. Only people earning less than £27,000 per year can expect a replacement rate – the ratio of the salary which is paid in case of unemployment – of around 60% (see Box 1 above). For higher income households, this rate is much lower, which means that they are not sufficiently protected by the state in case they are made redundant. The private sector in turn offers a variety of financial products, insuring mortgage payments, loss of income due to sickness or redundancy. However, for reasons discussed in more detail below, uptake of these kinds of insurance is very low. Only 12% of all borrowers are covered by mortgage protection payment insurance, and 13% are insured against a loss of income due to critical illness. Taking all these things into account, Scottish Widows has estimated that the average household has a protection gap of £52,000.[10]

Explaining the protection gap

There are four kinds of operational and structural failure that currently prevent a market-led solution emerging. First, despite feeling insecure, most consumers overestimate their ability to protect themselves against financial risk and do not take out insurance due to the complexity of the products on offer. The huge range of options leads to 'choice overload', a situation 'lessening both the motivation to choose and the subsequent motivation to commit to a choice.'[11] A lack of financial literacy exacerbates this problem.

Second, as with many forms of risk, people are typically myopic in their outlook. Myopia in financial affairs is a key driver of the lack of individual pension provision identified by the Turner Review.[12]

The third problem relates to the fact that insurance is often not the first product someone purchases but it is a side product, bought in a secondary market. Car insurance, for example, is purchased together with a car. For income insurance there is no obvious point of sale, or hook, as exists in the car insurance example at the point of purchase, making it much more difficult to sell than other insurance products.

Finally, information asymmetries leading to 'adverse selection' pose a major problem for this kind of insurance market. Adverse selection occurs when people who are more likely to claim for loss of employment – perhaps because they are in more risky jobs or simply less good at pleasing their employer – take out insurance but are not readily identifiable as high-risk by the insurance company. When this happens, insurance premiums are driven up for all claimants, the risky and the less risky, making protection too expensive for lower-risk customers. This feedback effect can result in an incomplete or absent market for that particular kind of insurance.[13]

For the reasons outlined above, this absence of sufficient private or public provision leads to a protection gap with repercussions both for the individual and society. On an individual level, insecurity lowers life quality. People enjoy what they have less if they are continuously threatened with its

[8] Bank of England, *Monetary & Financial Statistics*, (December 2007), http://www.bankofengland.co.uk/statistics/ms/2007.htm, Table A5.2.

[9] Abigail Self and Linda Zealay, *Social Trends 37*, (London: HMSO, 2007), 82.

[10] Scottish Widows, *Protection Report* (Scottish Widows, 2006), 8.

[11] Richard Thaler and Shlomo Benartzi, "Save more tomorrow: Using behavioural economics to increase employee saving," *Journal of Political Economy* vol. 112 (2004), 164-187.

[12] Pensions Commission, *Implementing an integrated package of pension reforms: The Final Report of the Pensions Commission* (2006).

[13] For a discussion of the problem of asymmetric information in markets, see George A. Akerlof, 'The Market for 'Lemons': Quality Uncertainty and the Market Mechanism,' *Quarterly Journal of Economics* vol. 84 no. 3 (1970), 488–500.

loss. In the aggregate, this fear might lead to growing dissatisfaction towards trends that are perceived to increase this insecurity, such as globalisation and immigration. But not giving people time and financial resources to face episodes of unemployment also comes at an economic cost for society. If an individual takes on a job which does not fit his skills and experience, these skills lie idle and thus productivity benefits are foregone.

Automatic enrolment as a solution

There are various possible approaches to closing the protection gap. Currently there are very few financial incentives in place to encourage individuals to make provisions for themselves. Indeed, the means-tested nature of the benefits system actively discouraged such efforts. Improving incentives here could be one way out of the dilemma. Research, however, has shown that financial incentives to encourage pension savings in Britain and abroad have not increased take-up of pension products significantly.[14] At the other end of the spectrum, it might be possible to require everyone to take out insurance. However, this would be politically and legally difficult since the new insurance could be seen as just another tax, and, in addition, this might insure people who in fact do not need the insurance.

Automatic enrolment or 'soft compulsion' occupies the middle ground between these two options and is the most viable solution. This paper advocates to automatically enrol everyone earning more than £27,000 in unemployment insurance, similar to the proposals of the Turner Commission for promoting private pension savings.[15] To prevent over-insurance, every employee would have the opportunity to opt out of the insurance scheme.

With a private sector-led system of automatic enrolment, the key tenets of Britain's labour market success could be maintained. A system of soft compulsion would preserve flexibility because it gives the option to opt out. In addition, it does not tinker with employment protection legislation and follows the principle to protect the worker and not the job. While employment protection would facilitate job-search for skilled workers, allowing them time to find an appropriate job in which to put their specific skills to productive use, it is important that insurance does not create large disincentives to return to work. In practice this means that the duration of claims should be limited, that, for example, after six months of payments, the individual worker should fall back on means-tested benefits. But overall this should not pose a significant problem to the insurance industry because they are used to safeguarding their contracts against misuse.

Box 2: Features of a British system of flexicurity

- Every employee earning over £27k per annum would be automatically enrolled
- Opting out is possible
- Insurance by current private sector providers, employers provide access
- Employees would be enrolled once they have passed their employer's probationary period and have been in employment for at least six months
- Only products which comply with a set of terms and conditions would qualify for the scheme
- The benefits provided would be time-limited to ensure the maintenance of a competitive economy
- The scheme would offer an agreed percentage of previous income, likely to be around 60%.

A viable model of flexicurity would also address the reasons for the current protection gap identified above. Automatic enrolment addresses the problems of choice overload, product complexity and resulting inertia by making being insured the start or default position. In fact, it harnesses inertia to protect them against the risks of the labour market. At the same time, automatic enrolment addresses the secondary nature of the unemployment insurance market and does not need a 'hook' to sell the insurance because it enrols people automatically.

Challenges ahead

Adverse selection might be overcome by using the forces of automatic enrolment to thicken the market. It is possible that a sufficient number of people would remain in the scheme to allow risks to be pooled, keeping premiums reasonably low. This might be the case because automatic enrolment in other areas has led to very high participation rates despite not being compulsory.[16] With a range of employees from different sectors enrolled, auto-enrolment would hedge against economic risk to any one sector of the economy. In addition it would be possible to require employees to disclose their previous employment history and grant insurance companies the right to reject certain applicants or even whole professions. If that was the case, however, special provisions should be made for those people, since they are the ones needing insurance most.

Moral hazard, while not a substantial risk in the relationship between the individual and the industry, may be one between the industry and government. It is difficult for the industry to ensure against economic shocks and without careful regulation there will be incentives for providers to insure a lot of people in good times, but not take precautions for such shocks. In a recession, this could lead to a

[14] Stephen Evans et al., *Anglo-Flexicurity: A safety-net for UK workers* (Social Market Foundation, 2008), 68.

[15] See footnote 12.

[16] James J. Choi et al., For Better or For Worse: Default Effects and 401(k) Savings Behaviour, *NBER Working Paper* No. 8651 (2003).

situation were a company is unable to meet all claims. From this perspective, unemployment insurance is different to, say, car insurance in that the risk of an individual becoming unemployed is related to the risk of another individual's being laid-off (e.g. in a recession). By contrast, the risk of one person having a car accident is unrelated to the risk for other customers. To address this problem, providers, in cooperation with the Financial Service Authority (FSA), would need to agree a regulatory framework to ensure that risk is spread not only across the insured, but also across time. Otherwise government would face the difficult situation of whether to bail out companies or be faced with unemployed people without protection.

Conclusions

These challenges, however, should not prevent us from seeking a solution to combine flexibility and security in the British labour market. The protection gap faced by Britain's middle classes and the rise in insecurity need to be addressed to ensure continuing popular support for globalisation. Currently neither government provision nor private insurance options sufficiently protect middle income earners from a potentially devastating loss of income in times of redundancy; there is a clear mandate for action. A private-public partnership to overcome the insecurities of a modern labour market – while maintaining its flexibility is the best way forward.

Private insurance, despite the failures of the current market that would need to be addressed, can offer a solution to mitigate the risks of redundancy. Automatically enrolling employees above an income threshold of £27k in private unemployment insurance schemes would address many of the problems which have prevented higher take-up of private insurance so far.

However, there are still questions to be explored about the detailed design of the system. The key challenges are, first, how to address the problem of moral hazard; and second, whether auto-enrolment would resolve the adverse selection concerns. Since both the insured and the insurance company might try to 'game the system', it is important to put measures in place which minimise adverse effects. A second Social Market Foundation (SMF) project currently under development will further explore these issues.

It is not enough to say that growing insecurity is an inevitable consequence of economic flexibility and globalisation; allowing insecurity to grow unchecked risks undermines popular support for both. The key is to find a model that maintains this flexibility while providing greater security for workers, ending the false choice between flexibility and security. This paper is a first step in this direction.

*This is an abridged version of a recently published SMF report **Anglo-Flexicurity: A safety net for UK workers.** This work was sponsored by Genworth Financial. Copies of the full report are available at www.smf.co.uk.*

If you have any questions or comments about this publication, please contact the CII Policy & Public Affairs team on:

☎ 020 7417 4783

💻 laurence.baxter@cii.co.uk

Ann Rossiter has been Director of the Social Market Foundation since July 2005. Since taking over she has broadened the range of SMF's work, taking it into new areas of social and economic policy, and doubled the size of the organsation. She is a specialist in reform of welfare and the public services. Before joining the SMF, her career included a number of advisory roles in politics and policy-making.

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