squaring the circle

how can welfare reform achieve a more reciprocal benefits system?

Max Wind-Cowie

Progressive Conservatism Project

DEMOS

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First published in 2013

Magdalen House, 136 Tooley Street,
London, SE1 2TU, UK

ISBN 978 1 909037 32 8
Series design by modernactivity
Typeset by Chat Noir Design, Charente
Printed by Lecturis, Eindhoven

Set in Gotham Rounded
and Baskerville 10
Cover paper: Flora Gardenia
Text paper: Munken Premium White

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Executive summary

This paper looks at the potential benefits – and challenges – for policy makers of involving the private sector in helping to boost financial wellbeing and security for the UK workforce. It uses as an example the current beneficial role that sickness and illness income protection products play on behalf of consumers, employers and government.

The British welfare state is undergoing a period of dramatic reform. While bringing down the overall cost of welfare is politically popular and enjoys a broad consensus among leading policy makers it carries inherent risks.[1] There are major problems with the UK welfare state that demand solutions:

- *Declining support* – public support for the benefits status-quo is diminishing and in decline, particularly among the 'squeezed middle'.[2]
- *Relatively ungenerous* – despite popular opinion to the contrary, the UK's benefits system is relatively ungenerous when compared with peer economies.[3] This is particularly problematic for wage-dependent families facing unemployment and for families where the primary earner is unable – for reasons of accident or ill-health – to return swiftly to the workforce.
- *Too expensive* – despite the above, it remains the case that the UK's total benefits spend (around £111.7bn each year) is unsustainably high and likely to be the target of future spending cuts.[4]

In order to sustain and rebuild public support for a welfare settlement, the Government must find ways of addressing these tensions between generosity, reciprocity and public trust.[5]

The Government should look at how to encourage workers to take up products designed to protect their long-term financial wellbeing against risks such as the inability to work. But industry must also respond. Insurers should work to make products simpler, more widely available and affordable, and look at whether products that protect against a greater range of forced redundancy circumstances can be developed and brought to market.

Greater take-up of protection products – and the development of forced redundancy products to work alongside existing income protection products – would offer a hybrid model to British workers. It would improve reciprocity for those protecting themselves, reduce the cost of welfare to the taxpayer and may help to reduce voter dissatisfaction with welfare.

But there remain huge challenges. Financial protection products suffer from a relatively low level of consumer awareness in the UK. This reduces demand in general and pushes up the cost by limiting the number of group policies facilitated by employers. There are also high levels of 'insurance apathy' among consumers.[6] While support for state-based welfare has declined in the UK,[7] middle earners remain suspicious of private sector involvement.

This research leads to a number of important questions for consideration – which should form the backdrop to any effort by policy makers to promote personal financial protection in the UK workforce:

- *Should the Government seek to involve the private sector further in meeting welfare needs?* This paper lays out some evidence of the need for private sector involvement in welfare – from the expense of the welfare state to the relative lack of generosity of our benefits system and its knock-on impact on living standards and demand. Nonetheless, many remain concerned that further private sector involvement in the welfare state may undermine fundamental principles of state provision. Should the Government instead seek to raise state-benefit levels? Can the taxpayer afford a welfare system that continues to be primarily state-based? Does the public still want a state-based welfare system?

- *How can we incentivise private protection?* Demos has made the case in the past for up-front incentivisation (via National Insurance (NI) rebates on protection products). Is this the right approach? Or should the Government concentrate on removing disincentives – such as tax levied on income protection payments – in order to remove the tax system's bias towards state dependency?
- *Is there scope to 'nudge' individuals into financial protection?* This paper draws a number of parallels between financial protection and pensions. As the Government proceeds with the roll-out of NEST (National Employment Savings Trust) – an 'opt-out' approach to pensions that will draw the previously unprotected into a pension scheme – is there scope to learn from this 'nudge' approach and apply a similar scheme to financial protection? Should employees be auto-enrolled into income protection products in order to achieve greater social benefits?
- *Can the income protection model be sustainably extended beyond sickness, ill-health and disability?* What are the barriers that may prevent the insurance industry designing successful, mass-market products to extend the principle of income protection beyond the incapacity market? Are there incentives to the insurance industry – to design products that fit the Government's social agenda – that can and should be offered? Can the income protection model be expanded to cover no-fault redundancy in general?
- *How can the Government persuade other stakeholders – such as employers – to take a role in promoting financial wellbeing?* A key reason for inaction among employers on income protection is the lack of demand exhibited by employees. This dampens the incentive for promoting financial education in the workplace and facilitating or supporting long-term financial planning and protection – it also potentially reduces the benefits available to responsible employers.

1 Next steps for welfare reform

There is both broad political consensus and deep political division when it comes to welfare reform. All three major UK political parties agree that the status-quo on welfare is bust – all three broadly agree on a roadmap to a more successful approach, a common purpose that is highlighted by the role of Lord Freud in driving reform as part of both Labour and Coalition Governments.[8]

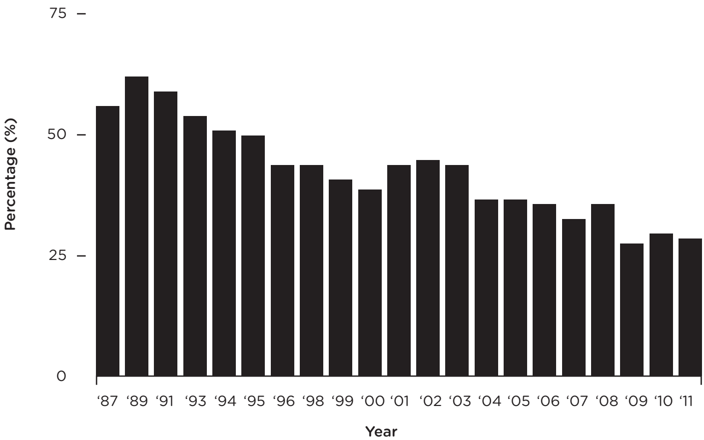
This paper is the second in a series of four looking at how government, employers and employees can work together to achieve a welfare system that is fairer, less expensive to the taxpayer and better focused on returning those individuals who can work to the labour force. The previous paper – published in 2012 – looked at the role of employers in helping to facilitate access to income protection products for their employees,[9] while this paper focuses on the role of policy makers in driving further reform.

The consensus that too much is spent on out-of-work benefits – and that not enough is achieved with that spending – reflects trends in public opinion. Only 28 per cent of us now believe that the Government should spend more on welfare benefits, compared with over 50 per cent just 20 years ago (figure 1).[10]

However, it is clear there are significant disagreements when it comes to deciding how best we can reduce expenditure on benefits while maintaining fairness and providing the opportunities for a return to work where appropriate.

The Government's radical approach to welfare reform is focused on merging multiple benefits into a single stream Universal Credit, capping benefit income, reforming disability benefits and changing the way in which individuals are assessed for incapacity. As a programme of change it is both ambitious

Figure 1 **Proportion of the public who agree that government should spend more on welfare benefits, 1987–2011**



Source: British Social Attitudes Survey[11]

and dynamic. But in its efforts to realign the benefits system in general with the moral intuition of the public this programme risks alienating individuals – particularly those in the 'squeezed middle' – from the welfare state and creating or exacerbating perverse incentives that punish those who have done 'the right thing'. For example, these reforms will not end the £16,000 means test, which the Institute for Fiscal Studies describes as a 'disincentive to saving'.[12]

What is more, simplification itself can often serve to undermine reciprocity in the system and leave net contributors feeling alienated. An example of these dangers can be found in the creation of the single state pension. This reform – rightly aimed at giving clarity to pensioners about their entitlements and at improving the overall generosity of the state pension – contains a hidden trap for hard-working individuals who have topped up their basic state pension with a second state pension.

This group – in contrast to the majority of pensioners – will actually lose out as a result of the reform. Understandably, many of them feel deeply let down by a reform that appears to disadvantage them simply because they have responsibly sought to protect themselves better against the financial costs of retirement.[13]

Of course, the Government has a long-term answer to such quirks of reform – that individuals still in work will be better able to plan under the new, clearer system and that this will encourage workers to protect themselves via private policies that will top up their state entitlement. While this does not answer the concerns of those currently frightened of losing out on their second state pension income, it does make strategic sense. Clarity about entitlement levels is vital to encouraging individuals to manage their own levels of protection against financial shocks such as unemployment, retirement and long-term social care.

The logic of the single state pension – with its benefits and disadvantages – can be seen at play, too, in the creation of the Universal Credit. This single income stream, guaranteeing that work pays better than unemployment, will make entitlements clearer and easier to calculate for those facing unemployment and those considering their relative exposure to long-term financial risk. The introduction of the Universal Credit, therefore, holds the potential to encourage the kind of long-term planning for unemployment that is being encouraged for retirement. Many households would simply be unable to survive a period of unemployment and reliance on state benefits while maintaining their living standards.[14] The 'squeezed middle', a category of workers and their families that extends from the relatively affluent to the relatively low-paid, are marked by their shared reliance on work-related income to support their lifestyles. The state welfare system is unable to replace that income when – due to accident, sickness, ill-health or redundancy – it temporarily disappears.[15]

The Universal Credit is not geared to replace income, even for those who have paid into the system and have high costs of living. Nor will any proposed reform to welfare from any of the three main parties be able to do so. The cost to the Government of guaranteeing income, even for a short amount of time, is simply too high.

There are existing proposals for more substantive reform. Among the most compelling is the case made by the Institute for Public Policy Research (IPPR) for a state-run form of state salary insurance. Under these proposals, individuals in work would be entitled to 70 per cent of their salary for six months post redundancy, as a bridging loan to be repayed at 0 per cent interest when they re-enter the workplace.

This system has appeal. It would provide more reciprocal coverage. But such a state-backed system will face the challenge of being either relatively easy to defraud or expensively bureaucratic to administer and protect. Because the loans are charged at 0 per cent – so the state will lose money on them – it is possible that schemes like National Salary Insurance could end up providing state subsidies for career breaks and proving hugely costly to the taxpayer.[16]

Instead, as with the state pension, the direction of travel for the Universal Credit is towards providing a straightforward minimum income for those who find themselves unable to work. Such an approach is necessary to improve the transparency of the welfare system, reduce perverse incentives to worklessness and (alongside the benefits cap) ensure that the public rebuilds a sense of trust that welfare is not being exploited. However, this approach also means that for many individuals access to state benefits is a guarantee against little other than penury – they face catastrophic financial shocks to their standard of living when suffering from even temporary unemployment. Just as the Government has simplified the state's offer on pensions while encouraging greater private, individual provision, so it should do with welfare.

There is huge scope to provide a more robust welfare offer for UK workers, built out of a combination of state and private provision. Doing so may involve using the state to encourage mass take-up of protection products by individuals, and facilitation of these products by employers, but the potential benefits are significant and mutual. The Government stands to save considerable expenditure by enabling individuals to lift their unemployment income and reduce their exposure to financial risk; individuals in the wage-rich, asset-poor 'squeezed middle' stand to acquire greater security and financial autonomy even; employers stand to reap the benefits of a more financially secure and productive workforce.[17]

This paper examines some of the policy problems that remain pertinent as the welfare reform agenda gathers pace – particularly those that affect the 'squeezed middle' – and makes a series of potential recommendations to policy makers on how they might square the circle of a cheaper, leaner welfare system that also provides financial security and reciprocity for workers.

2 What's the problem?

There are three primary, ongoing problems with the UK's unemployment benefits system – which are examined briefly in this paper:

- *Declining support* – public support for the benefits status-quo is diminishing and in decline, particularly among the 'squeezed middle'.
- *Relatively ungenerous* – despite popular opinion to the contrary, the UK's benefits system is relatively ungenerous when compared with peer economies. This is particularly problematic for wage-dependent families facing unemployment and for families where the primary earner is unable – for reasons of accident or ill-health – to return swiftly to the workforce.
- *Too expensive* – despite the above, it remains the case that the UK's total benefits spend (around £111.7bn) is unsustainably high and likely to be the target of future spending cuts.[18]

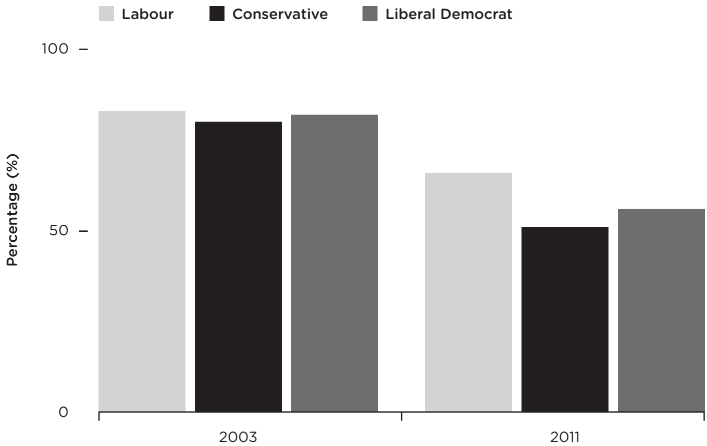
It is the premise of this paper that it is possible to pursue further reform that seeks to answer all three of these problems – rather than to trade one or other off against the others.

Public opinion

There is a dichotomy in public attitudes to welfare in the UK – brought to the fore in ongoing Demos qualitative research with middle earners. Many still view the UK's overall welfare provision as too generous and polling demonstrates very high levels of public support for the Government's cap on total benefits – indeed many argue for it to be set lower than £26,000pa.[19]

Conversely, however, many of the same people also believe that the benefits system is unfairly ungenerous when it comes to

Figure 2 **Proportion of voters who think government should be the main provider of support to the unemployed in the UK, by mainstream parties, 2003 and 2011**



Source: NatCen[21]

catering to their needs in the event of unemployment: '[The idea of living on benefits] make me more scared. It would not benefit me as someone who has contributed significantly.'[20]

What is more, the British public's belief in government as the correct provider of out-of-work benefits is in decline – and not simply among Conservative members (figure 2).

It is clear that although there is still a majority of people who believe that government is the best provider of support for the unemployed, that majority has shrunk dramatically across all three main political partied, over the last decade.[22]

This sentiment represents a very real threat to the welfare state itself. As Peter Kellner – the president of polling firm YouGov – has argued, 'People are turning against welfare, other than help for the elderly and disabled, doubtful that politicians give money to the right people for the right reasons'[23]

Many associate the welfare state with on the one hand wasteful spending and excessive generosity, and on the other an inability to protect individuals and families against the shock of unemployment.

The concern that the state will either be unable or refuse to support their family properly in a time of financial need is not, on its own, enough to incentivise more responsible financial risk-management. Qualitative work with middle earners has highlighted the strong feeling among many that if they are to be expected to take more responsibility, the Government must reciprocate with some form of incentive – both to encourage and to compensate for the 'paying twice' phenomenon.[24] The trends in polling and public opinion indicate there is a strong sense among taxpayers that a lack of reciprocity is to blame for declining support for welfare. It is this perception – that those who pay in often suffer most and that those who don't gain disproportionately – that undermines consent for the benefits system.[25]

Lack of generosity

It is also important to acknowledge that, historically, it is true that the British welfare system has been poor at replacing income for the 'squeezed middle'. In 2011 Demos published an Index of Financial Protection, which compared the state, private and overall income protection enjoyed by UK workers with those enjoyed by workers in peer economies. On state protection, private protection and overall financial protection, the UK fairs relatively badly.

Demos' Index of Financial Protection (table 1) lays out the varying, relative levels of financial protection that were available to workers in the UK and peer countries in the event of unemployment in 2009 – before fiscal retrenchment began. The index looks at how generous different countries' welfare states were at the time and the extent to which individuals protected themselves against the risk of unemployment – combining those levels of protection to arrive at an overall score.

First, it looks at how much the average individual, on the

Table 1 **The Index of Financial Protection**

Country	Replacement ratio (%)	State benefits	Unemployment levels	Labour force	Total A&H (adjusted) and pecuniary loss premium value	Public expenditure on health (%)	State protection	State protection index	Private protection	Private protection index	Total protection index	Rank
Norway	65.5	23,318.04	207,200	2,590,000	4,591.32	84.1	1,865.44	95.22	1,772.71	70.55	83	1
Sweden	48.1	14,552.70	392,560	4,907,000	12,330.45	81.7	1,164.22	59.42	2,512.83	100.00	80	2
Netherlands	74.2	24,489.88	715,024	8,937,800	8,953.50	74.7	1,959.19	100.00	1,001.76	39.87	70	3
Canada	62.6	17,336.40	1,474,632	18,432,900	28,795.15	70.3	1,386.91	70.79	1,562.16	62.17	66	4
USA	51.4	16,738.00	12,436,320	155,454,000	202,334.72	45.5	1,339.04	68.35	1,301.57	51.80	60	5
Germany	59.9	17,852.47	3,335,920	41,699,000	39,355.00	76.7	1,428.20	72.90	943.79	37.56	55	6
France	66.5	18,049.59	2,295,520	28,694,000	19,877.35	78.3	1,443.97	73.70	692.74	27.57	51	7
UK	38	14,991.36	2,499,216	31,240,200	20,637.29	82.0	1,199.31	61.21	660.60	26.29	44	8
Spain	60	16,333.42	1,843,000	23,037,500	6,022.63	71.8	1,306.67	66.69	261.43	10.40	39	9
Italy	59	14,886.75	1,997,592	24,969,900	2,662.75	76.4	1,190.94	60.79	106.64	4.24	33	10
Australia	31.1	10,106.00	920,368	11,504,600	2,128.88	67.5	808.48	41.27	185.05	7.36	24	11
Poland	45.3	6,205.77	1,382,400	17,280,000	2,797.33	70.8	496.46	25.34	161.88	6.44	16	12

Source: 2009 OECD data

average wage, received when they became unemployed in each country. To make sure that the figures are comparable they are adjusted to take account of the different costs of goods and services in each country through using 'purchasing power parity'. This gives us a good idea about the pre-retrenchment generosity of the welfare systems in different countries. Because we are interested in how much each person is protected by the state we then divide this figure by the size of the labour force. We rank each country's performance relative to each other to produce the state protection index.

Because we also want to see how much individuals protect themselves, regardless of state protection, against the risk of unemployment, we also measure 'private protection'. We do this by looking at two key ways people protect themselves: through taking out accident and health insurance to pay for loss of income when they are ill, and by taking out pecuniary loss insurance in case of loss of income, which covers financial loss

All monetary figures converted into US dollars PPP

Definitions

Replacement ratio Ratio of income before unemployment to benefits in unemployment that a person is eligible for as a percentage

State benefits Per annum benefits available to an unemployed single person, with no children, on 100% of average wage for private sector

Unemployment levels Number of labour force unemployed which is set at 8% (average of selected countries in 2009)

Labour force Number of people actively in employment or seeking employment

Total A&H premium (adjusted) and pecuniary loss insurance Total value of accident and health insurance premiums if countries have a level of public health expenditure equivalent to Germany (in millions) and total value of pecuniary loss expenditure

Public expenditure on health (%) Proportion of expenditure on health that comes from the public purse

State protection Total state expenditure on unemployment-related benefits divided by size of the labour force

State protection index Level of state protection as a proportion of the state protection in the most generous country

Private protection Total value of A&H premiums divided by labour force

Private protection index Level of private protection as a proportion of the protection in the country with the highest A&H (adjusted) and pecuniary insurance expenditure

Total protection index An index of the average state and private protection index across a variety of other circumstances, such as through fraud or criminality. However, we know that health care systems vary around the world, none more so perhaps than those of the UK and USA. Therefore we adjust the accident and health figure to account for how large the private health system is in the country concerned. This gives us a better indication of how much protection people need against unemployment, irrespective of the size of the private sector in the health system. Because we are interested in how much each person is protected by the state we then divide this figure by the size of the labour force. We rank countries' performance in protecting citizens from unemployment through private protection using this figure. This gives us the private protection index.

Finally, because we are interested in how well people are protected overall, we take the average of the state protection index and the private protection index to produce the 'total protection index'. The countries are then ranked according to how highly they score on this index. This gives us our indicative picture of relative financial protection around the world.

As the results show, unsurprisingly, Norway and Sweden performed highly in the amount of total protection they provided, but the results show that this is largely because they protected themselves privately fairly highly, relative to the size of their private insurance sectors. Furthermore, the USA performs a lot better on this index than most people expect, coming several places above the UK; the USA's higher level of private protection helps explain this in part. The UK did not perform well in either state or private protection.

As we can see from table 1, in 2009 the relative generosity of UK state unemployment benefits – before fiscal retrenchment and the cuts to welfare spending that have been a crucial plank of the Coalition Government's economic policy – was already low. At the same time the reach of private coverage in our workforce was markedly lower than in most peer economies. This results in a lower level of overall protection for UK workers.

What is more, the replacement ratio for UK benefits – the extent to which state benefits match the pre-unemployment income of recipients – was the second worst of the economies measure, so even before simplification and retrenchment have had an impact, our welfare system was fundamentally failing the challenge of reciprocity.[26]

And yet not only have we further reduced welfare spending and levels of entitlement in the UK – without taking active measures to encourage compensation by improving private protection take-up – but all three parties acknowledge that further cuts may be necessary.[27]

High cost

The British welfare state is expensive. The Department for Work and Pensions spends £160.7bn a year.[28] The leaders of all three of our main political parties agree that welfare spending has to be reduced in the long term. As Liam Byrne – the Shadow Secretary of State for Work and Pensions – has acknowledged, 'Savings are going to have to be made and I think there will be savings that are needed on welfare spending too.'[29]

Chancellor George Osborne used his speech to the Conservative Party Conference in 2012 to pledge a further £10bn in cuts to the welfare bill by 2017 – on top of the £18bn in reductions that the Government aims to achieve by the end of this parliament.[30] In his autumn statement on 5 December 2012, the Chancellor identified £3.7 billion of these proposed savings – crucially, this will be achieved by uprating benefits payments by 1 per cent rather than inflation. This will further downgrade the relative value of out-of-work benefits.[31]

Finally, Danny Alexander – Chief Secretary to the Treasury and a leading Liberal Democrat member of Cabinet – has confirmed that the Liberal Democrats are committed to further rounds of spending cuts (including further cuts to the welfare bill) in the next parliament.[32]

It is clear, then, that a political consensus – at least among the three mainstream parties – exists about the need to reduce spending on welfare. That is not to say that there is much (if any) agreement on how to do so or the level of spending that is desirable. Nonetheless, it is likely that whichever party (or parties) forms the next government there will, almost certainly, be another round of spending reductions – including cuts to spending on welfare.

That being the case, any government should consider how to reform and reduce welfare spending in such a way as to meet the challenges of public opinion and relative lack of generosity. To do otherwise is to risk alienating the squeezed middle from the welfare state and ramping up the financial insecurity of millions of people. What is more – a solution that is built on cutting benefit entitlements and levels alone will jeopardise the financial security of the UK economy at large. Welfare payments are vital not simply to keeping individuals and families afloat in difficult times but also to maintaining demand in the consumer economy by keeping disposable income in the pockets of the unemployed. Significant reductions in benefit levels put at risk the system of 'automatic stabilisers', which sustains demand during recessions such as that caused by the 2008 economic crash.

It is clear that although our welfare system is relatively ungenerous it is also unsustainably expensive. If we are to maintain a welfare system that is fair, reciprocal and sustainable then we must look closely at how we can raise levels of protection against unemployment while keeping down the costs of welfare. It is likely – as former Labour Secretary of State for Work and Pensions James Purnell has acknowledged – that some form of insurance will be central to the long-term solution.[33]

3 Why an insurance hybrid?

Why should policy makers encourage individuals and families to make provision, in addition to that currently offered by the state, against the risk of sudden unemployment? One answer to the relative lack of generosity and reciprocity in our welfare system is simply to increase the levels of payment available. The counter-argument runs that if the UK wants to introduce greater levels of reciprocity into welfare – and encourage personal responsibility – then the entirety of the system ought to be left to choice and private, market mechanisms.

Both arguments have their political merits, but neither fully meets the complex (and sometimes contradictory) aims of fairness, reciprocity and sustainability.

To increase the generosity of welfare payments across the board would involve massively ramping up the direct cost and financial risk to the Exchequer of unemployment benefits at a time when further cuts are likely to be needed. Only around a quarter of the population agree that such a course is advisable.[34]

To privatise the whole of the system – and to remove the state entirely from the welfare equation – is equally unsatisfactory. To do so would obviously put at risk the level of care that we provide to those who will never, and can never, work. But furthermore, it would seriously risk the financial security of workers in very low-paid employment. Products such as income protection, which can provide a vital safety net for workers earning average wages and less, are unlikely ever to be reduced in price sufficiently to become the rational choice for those in part-time or short-term work.[35]

However, the Government can and should seek to promote personal provision where appropriate – to top up state entitlements, boost personal financial security and reduce the risks posed to the taxpayer by unemployment. Changing attitudes and expectations around pensions illustrate what this might mean in practice. All parties recognise that the state pension is insufficient to provide for the vast majority of people in their retirement. However, rather than escalate the level of the state pension to the point where it offers real replacement for pre-retirement incomes (and dramatically increasing the cost to the taxpayer) or simply abolish it, policy makers have rightly sought to encourage (and, more recently, to 'nudge') individuals into adopting hybrid solutions that involve private and public provision. A similar normalisation of hybrid protection for unemployment benefits would benefit individuals, the state and the wider economy all at once.

The UK could achieve this by incubating the market for insurance products that guarantee a proportion of individuals' income in the event of sickness or injury – using this as the starting point for developing robust products to protect individuals and families against a wider range of faultless unemployment scenarios.

Countries that have a higher-value market in income insurance, and broader coverage, have more financially robust citizens, who are better able to withstand the shock of worklessness with less (or even without) significant investment from the state. Furthermore, those countries that have better levels of coverage are able to be more generous to those for whom personal financial protection is not an option.[36]

In pursuing such an objective, policy makers can square the circle of creating a welfare system that is appropriately generous, works with the grain of public opinion and reduces the risk and direct cost to the taxpayer. By following the logic of our broad political consensus on pensions – that the state should provide a minimum standard underpinning while encouraging and incentivising peronalised, private provision – the Government could create a lower-cost welfare state that ensured protection for all while recognising and reciprocating personal responsibility.

The example of income protection

Members of the squeezed middle who lose their jobs are disproportionately affected by the inflexibility of unemployment benefits and their relatively ungenerous rates. What is more, the relatively higher pre-unemployment incomes enjoyed by the squeezed middle exacerbate the financial shock of unemployment. The squeezed middle simply has more to worry about when faced with even temporary worklessness – the impact of becoming unemployed on their mortgage, savings and planned future is very high and causes huge amounts of stress, anxiety and disruption.[37]

There needs to be an effective means for these people to protect themselves – above and beyond state aid – against the risks of unemployment, so they can feel confident in their ability to withstand financial shocks and the Government can concentrate its efforts effectively. This can be achieved if we build a more vibrant and broader market in personal protection, incentivise those who would benefit to participate, and find ways of encouraging employers to share the burden of the costs of welfare.

The kind of products that would benefit from governmental support would be those that encourage future-orientated financial behaviour in citizens, treat people fairly, allow them to be secure and confident, and embed reciprocity in individuals' relationship to welfare. These products deserve public support for two reasons: they are most likely to reduce dependency on the state and (therefore) to reduce long-term costs to the taxpayer; and they will develop, encourage and reward the kind of long-term financial planning and responsibility that is positive and necessary in a reduced welfare culture.

An example of the kind of savings that the Government can expect to make if personal protection products were to become more widespread can be found in the impact of income protection – by far the most well established and popular of these types of product.

It is worth establishing what income protection is and how it differs from other products, such as payment protection and critical injury protection. Like any insurance product, beneficiaries of income protection pay a premium to cover themselves against the risk of disability or serious ill-health and are then covered if that risk (which affects us all) becomes a reality for them. Income protection is cheaper for individuals when it is bought through their employer – known as 'group cover'. Where employers offer group cover many also choose to contribute towards protection on behalf of their employees.

Income protection is designed to give people an income if they find themselves unable to work as a result of an accident, sickness or ill-health. In that sense it works a little like state benefits – claimants receive an income if they are incapacitated and unable to work. But there are significant differences. Income protection relates the income received by an individual to the income that they have lost – paying out between 50 per cent and 75 per cent of their previous salary. Therefore the financial shock of losing work following illness or injury is significantly reduced for those who are covered by an income protection scheme.

Income protection, in effect, functions as a top-up to the state's safety net – preventing people slipping into poverty in the event of being unable to work. Because it is related to previous income the sum of money received is relevant to an individual's outgoings and current standard of living, which makes those covered less likely to suffer additional financial problems such as potential loss of their home or suddenly being unable to pay bills. But it also functions as a parallel support mechanism to help people return to the workplace if and when able, and to return to relative health. Most income protection plans include rehabilitation services to help people recover and re-enter the workplace. These interventions are hugely successful – in fact they lie at the centre of the Government's efforts to shift claimants out of Employment and Support Allowance and onto Jobseeker's Allowance so they can return to work.[38]

Income protection policies – therefore – can serve to answer the concerns about the relatively ungenerous nature of incapacity and employment support benefits, but it is their role in saving the taxpayer money – while also providing more generous coverage and, in tune with the moral intuition of the public, helping to return individuals to work – that is most exciting for policy makers.

Every new claimant of Employment and Support Allowance who has an income protection policy saves the taxpayer money – at differing levels depending on their income. The UK's mix of universal and means-tested incapacity benefits means that there are automatic savings to be made – even without further reform to means test more of the benefits offer. Improving the penetration of income protection in the UK from its current level – of around 9.4 per cent[39] – to a similar penetration to the USA (around 27 per cent)[40] would create huge savings for the Exchequer.

Based on a conservative estimate of a person's likelihood of being unable to work because of disability or ill-health, government could expect to save around £1.9 billion a year (at a 3 per cent rate of disability).[41] The current rate of disability in the UK labour market is just over 5 per cent; if a rate of 5 per cent were recreated exactly among those with income protection then the projected annual saving for the state would be around £3.1 billion a year.[42]

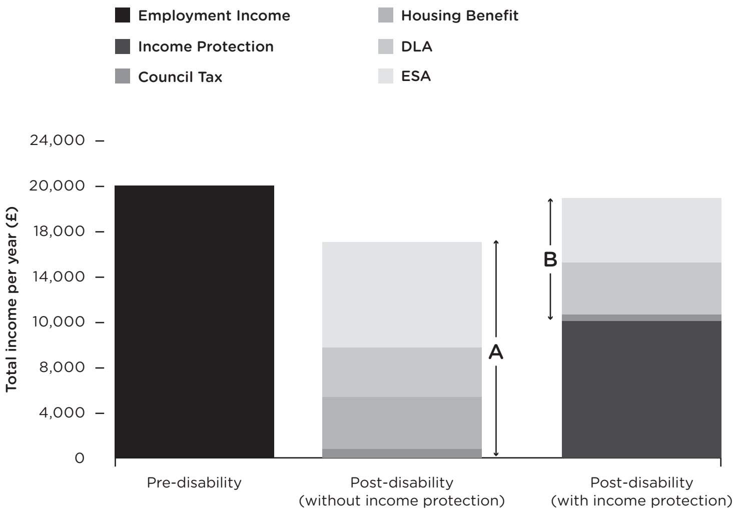
At the same time, as figure 3 demonstrates, individuals on annual income as low as £20,000 are better off with an income protection policy than relying on state benefits – even as they save the Exchequer money.

We can see that expanding insurance cover – even in the very specific area of disability and incapacity cover – holds the potential to achieve huge savings for the Government while simultaneously improving living standards for the unemployed.[44] It is a solution that squares the circle of welfare reform.

Expanding income protection?

There are two primary practical questions hanging over hybrid insurance solutions such as that outlined above. First and foremost, how can the Government best incentivise workers to protect themselves in this way? Second, can the hugely successful income protection model be extended to cover other forms of involuntary, no-fault redundancy? While it is true that – through savings achieved via means-tested benefits such as Housing

Figure 3 **Sources of income for a single person with and without income protection, and savings to the taxpayer**



Income advantage: £19,117 - **A** (£16,439) = £2,678

Tax savings: **A** (£16,439) - **B** (£8,870) = £7,569

Source: Wind-Cowie[43]

Benefit and Income Support – the taxpayer would almost certainly save money were individuals to be protected by an income protection type product for redundancy, it is less than clear whether such products could ever be designed in such a way as to be effective and affordable for the mass market.

Challenges

As laid out above – financial protection products such as income protection can be hugely beneficial to medium-earners and offer the potential for savings for the state. Why then, considering the built-in incentives, do British workers under-buy such products?

Part of the answer lies in the cost to the individual. Group products are much, much cheaper for the consumer – bought as they are through an employer and sharing as they do the risk among a workforce.[45] But the proportion of companies offering income protection products to their workforce remains worryingly low – despite the benefits to morale, productivity and staff retention brought about by such benefits to employers.[46]

The primary reason employers give for not offering such products across their workforce is the relative lack of awareness and demand among their employees.[47] It is clear, therefore, that any attempt to promote such products must overcome a knowledge gap in British workers and encourage demand.

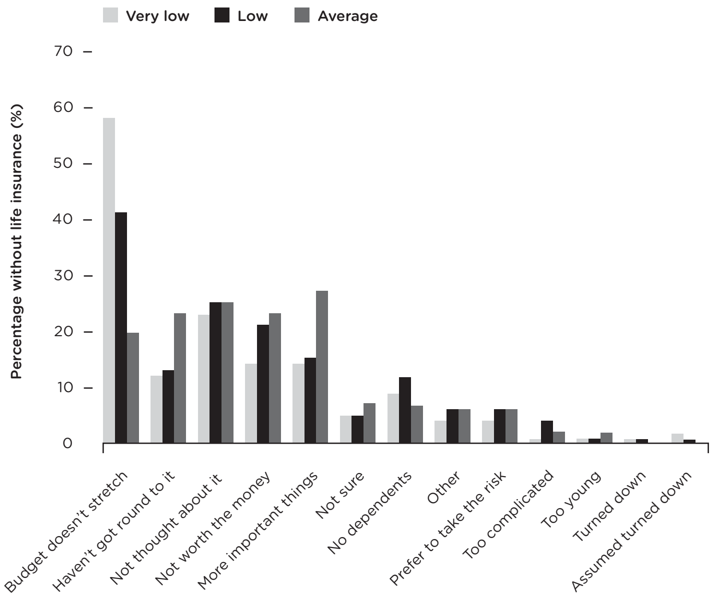
Another, inter-related, potential explanation for low take-up in the British workforce is our relative apathy about the insurance industry in general. The Association of British Insurers (ABI) asked people on medium incomes their reasons for not having life insurance, which has a substantially greater UK market than does income protection and does not suffer from the same levels of low awareness.[48] Unlike those on very low incomes, who said that their budget could not cover the premiums, the most common response among those on 'average incomes' was that it was 'not worth the money' (figure 4).

According to figure 4, apathy is one of the key barriers to those in average income households engaging in insurance. The Office of Fair Trading found that 7 per cent of people without life insurance have never thought about taking out a policy.[49]

Importantly, those on middle incomes are also the most sceptical about the ability of private providers to help the long-term unemployed find work. When asked by the British Social Attitudes (BSA) survey 'Who do you think is best at getting the long-term unemployed into work – the Government or private companies?', middle earners were the most likely to say the Government (table 2).[50]

Despite the importance of income protection insurance in supporting middle earners, those middle earners first need to be shown that it is effective at meeting their needs. Apathy about

Figure 4 **Reasons for not having life insurance, by income group**



Source: ABI ORC International Survey 2006

the role of insurance in particular, and the role of the private sector in general, becoming involved in the challenges of welfare is a major barrier to government action.

Overcoming this apathy – and normalising the role of insurance in securing financial protection for the squeezed middle – will require a concerted effort on the part of policy makers to demonstrate the advantages of such an approach and to reassure potential consumers. It would seem obvious that any government attempting to familiarise workers with the need to insure against financial shocks should – initially at least – focus their efforts on the most established products available. In the case of financial protection, this means starting with income protection products – aimed at protecting individuals from the costs of accident, ill-health and disability – in order to familiarise

Table 2 **How the UK public answered the question 'Who do you think is best at getting the long-term unemployed into work – the Government or private companies?', 2009**

	Definitely government (%)	Probably government (%)	Probably private companies (%)	Definitely private companies (%)
1st quintile – less than £15,000 pa	39.2	35.7	18.5	6.5
2nd quintile	39.5	37.6	17.6	5.3
3rd quintile – middle earners	39.9	42.7	12.6	4.8
4th quintile	35.6	42.5	16.8	5.1
5th quintile – over £56,000 pa	35.9	42.2	19.2	2.7

Source: Demos analysis of BSA survey, 2009[51]

the workforce with the role such products can and should play. The Government should look at how it can increase awareness, promote take-up and reward those who save the state money by protecting themselves. – Demos has previously argued that this could most simply be achieved through targeted rebates for employers and workers who choose to purchase protection.[52]

It is worth noting that the Sickness Absence Review, co-authored by Dame Carol Black and David Frost, did not recommend using tax breaks for employers or employees to incentivise take-up of protection products. However, as Dame Carol Black herself has acknowledged, this decision was driven primarily by a fear that the Treasury would reject such proposals as new spending.[53]

This may be the case. Nonetheless, Demos qualitative research with mid-earners has shown that targeted rebates may be an effective way of driving take-up and reducing the cost to the Exchequer over time.

4 Discussion points

This paper has sought to lay out some of the challenges facing Britain's state-centric approach to incapacity and sickness welfare and to explain some of the reasons why policy makers should seek to address them. There are huge potential benefits for the Government from spreading the responsibility for welfare more fairly between the state, individuals and employers. This holds not only the possibility of the Exchequer making enormous savings – £2.4 billion a year could be saved by promoting income protection insurance alone – but also the promise of reconnecting welfare for the 'squeezed middle' with their needs and understanding of fairness.[54]

What's more, greater financial security among medium-earners – in the form of insurance in particular – would add a new, private-sector-funded set of automatic stabilisers to the armory of governments faced with downturns and recessions. It would reduce the risk to the wider economy of unemployment without leading to sudden increases in public spending.

The Government should look at how workers can be encouraged to take up products designed to protect their long-term financial wellbeing against risks such as unemployment. But industry must also respond – in particular by identifying how such products can be made more widely available and affordable, and whether products that protect against a greater range of forced redundancy circumstances can be developed and brought to market.

The evidence leads us to address a number of questions if the Government wishes to build a more generous, affordable and reciprocal welfare system:

- *Should the Government seek to involve the private sector further in meeting welfare needs?* This paper has laid out some evidence of the need for private sector involvement in welfare – from the expense of the welfare state to the relative lack of generosity of our benefits system and its knock-on impact on living standards and demand. Nonetheless, many are concerned that further private sector involvement in the welfare state may undermine fundamental principles of state provision. Should the Government instead seek to raise state-benefit levels? Can the Government afford a welfare system that continues to be primarily state-based? Does the public still want a state-based welfare system?
- *How can we incentivise private protection?* Demos has made the case in the past for up-front incentivisation (via NI rebates on protection products). Is this the right approach? Or should the Government concentrate on removing disincentives – such as tax levied on income protection payments – in order to remove the tax system's bias towards state dependency?
- *Is there scope to 'nudge' individuals into financial protection?* This paper has sought to draw a number of parallels between financial protection and pensions. As the Government proceeds with the roll-out of NEST – an 'opt-out' approach to pensions that will draw the previously unprotected into a pension scheme – is there scope to learn from this 'nudge' approach and apply a similar scheme to financial protection? Should employees be auto-enrolled in income protection products in order to normalise these products, protect living standards and reduce the risk to the state?
- *Can the income protection model be sustainably extended beyond sickness, ill-health and disability?* What are the barriers that may prevent the insurance industry designing successful, mass-market products to extend the principle of income protection beyond the incapacity market? Are there incentives to the insurance industry – to design products that fit the Government's social agenda – that can and should be offered?

- *How can the Government persuade other stakeholders – such as employers – to take a role in promoting financial wellbeing?* A key reason for inaction among employers on income protection is the lack of demand exhibited by employees. This dampens the incentive for promoting financial education in the workplace and facilitating or supporting long-term financial planning and protection. It also potentially reduces the benefits available to responsible employers.

Appendix – The Index of Financial Protection

Total protection is calculated by taking the average index value of state protection per member of the labour force and private protection per member of the labour force. It serves as an indicative figure of total protection.

Types of protection

State protection

State protection is calculated by looking at total expenditure on unemployment benefits divided by the size of the labour force. Total expenditure on unemployment benefits is calculated by multiplying the level of benefits by the number of unemployed people.

We have standardised unemployment rates at 8 per cent so that relative generosity of the state system is shown, irrespective of the level of unemployment at the time. The average level of unemployment in 2009 for the selected countries was 8 per cent.

The state protection index looks at how well the different countries do relative to the country with the most generous state protection.

Private protection

We use accident and health insurance premium expenditure as the proxy for income protection. This is the best proxy available.

The private protection index looks at how well the different countries do relative to the country with the largest private protection.

Methodology

In awareness that there are significant differences in healthcare systems around the world, which affect the level of expenditure on accident and health insurance premiums, we have standardised the healthcare systems in different countries. We have done this by weighting the proportion of private (in contrast to public or state) expenditure on healthcare in each country so they are the same.

Using the German health system as our reference, where 23 per cent of health expenditure is private, we set about looking at what accident and health premium expenditure would look like in each country if it had a similar healthcare system as Germany. We selected Germany because it has a level of public health expenditure that is average among the countries. Assuming that accident and health insurance premium expenditure is proportionate to the size of the private healthcare market, we multiplied the level of healthcare expenditure in each country to what it would be if the country also had a health system that was 23 per cent private. This accounts for differences in health systems. Therefore, the difference in accident and health insurance premium expenditure reflects the differences in individual preference for, and availability of, accident and health insurance, not the health system.

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This research was generously supported by

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This paper is the second in a series investigating how we can promote financial security and wellbeing at a time of declining living standards and constrained public spending. The British welfare state is confronted by three inter-connected and intractable problems: declining public support; relative ungenerosity (particularly for those on middle incomes); and imposing too high a cost to the Exchequer. In order to sustain and rebuild public support for a welfare settlement, the Government must find ways of addressing these tensions between generosity, reciprocity and public trust.

Squaring the Circle looks at the role that policy makers can play in addressing these tensions, through driving financial literacy, promoting the take-up of products that boost financial security and highlighting the everyday financial risks to which we are all exposed. The previous paper in the series, Duty of Care, looked at the role of employers, and subsequent papers will be focused on employees and other key stakeholders, including trade unions and disability groups.

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ISBN 978-1-909037-32-8 £10

This research was generously supported by

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