ANGLO-FLEXICURITY:

A safety net for UK workers

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EXECUTIVE SUMMARY

Despite the threat of an economic downturn, the continued strength of the UK labour market over the last decade is one of Labour's undoubted achievements. The employment rate has been sustained at historically high levels and unemployment has remained among the lowest in the advanced nations.

A GROWING FEELING OF UNEASE

Even before there was any evidence of an economic downturn in the UK, levels of insecurity across the UK have been high by international standards. People have worried about the security of their jobs and prospects even in the absence of any objective external factors to suggest that they should be concerned. British workers have among the highest feelings of insecurity about their job prospects in the advanced countries. This feeling of insecurity has risen over recent decades, despite the strong labour market.

This apparent paradox can be explained by an increase in the *consequences* of losing work. People who lose their jobs today face a steeper drop in their income as they claim benefits than workers in other countries and, indeed, than previous generations of workers in this country. They also face a greater permanent pay penalty: even though they are likely to find a new job relatively quickly, these new jobs tend to be lower paid than their previous work.

Coupled to this, people's finances are more fragile than in the past. This is the result of increased home ownership, higher mortgage debts and greater availability of credit and loans. Consequently, people are less able to bear the permanent drop in income that a spell of worklessness can bring.

THE UK'S PROTECTION GAP

The UK faces a significant protection gap, with neither state provision nor take-up of private insurance matching up to the scale of financial fragility individuals face.

The state benefit system does not provide security against this fall in income for those on moderate or good incomes. Indeed, setting benefit levels relatively low compared to earnings is an implicit policy choice to sharpen work incentives and encourage people back into work quickly, even if the new job is less well paid and, often, less sustainable. This has aided labour market flexibility and contributed to the UK's employment success of the last decade. But it leaves UK workers without public protection against the risk of unemployment and may undermine UK productivity.

A range of private products is available to help people insure against the impact of losing their job. Many of these are linked to specific commitments that people have, such as Mortgage Payment Protection Insurance (MPPI) and Payment Protection Insurance (PPI). Others offer more general protection, with Income Protection (IP) offering policyholders a given proportion of their in-work income for a particular time period if they suffer long-term permanent disability, or Involuntary Unemployment Cover (UI) providing people with a fixed sum to cover costs in the event of unemployment.

However, take-up of this range of products is low, and those with some form of coverage against the risk of redundancy are particularly low at less than 11%. In total, 60% of borrowers have some form of insurance, but this still leaves approximately 3.5m people without any cover.

In addition, less than one-third of borrowers have more than one type of policy. This carries clear risks as each policy has limited cover. Take-up of MPPI is around 18% currently, but it is estimated that the take-up needed to sustain home-ownership is 50-55%. As a result, Scottish Widows estimate that the average household faces a £52,000 shortfall in the cover they have available in the event of a loss of income. It is clear that the UK faces a significant protection gap.

WHY CURRENT PROTECTION FALLS SHORT

A number of structural and operational problems in the market for private insurance are at the heart of this protection gap. The two most significant operational issues are incomplete and asymmetric information and consumer myopia. Evidence suggests that individuals lack information about both the risks they face and the protection available. In part, this results from the amount of time it would take for people to research the many different types of policy. This creates a barrier to effective decision-making by individuals.

Evidence also suggests that consumers can be shortsighted when it comes to financial planning. They often underestimate their risk of unemployment and the consequences of losing their job. Consequently, they are less likely to prioritise protecting themselves against these risks. Both of these operational problems are likely to have significantly constrained take-up of private insurance products by individuals and are key causes of the UK's protection gap.

As well as these operational problems, there are key structural failings in the market. Central among these is that the markets for most forms of this kind of insurance are secondary markets: people's primary purchase is of the mortgage or car or other item, rather than the insurance. Consequently, they give the insurance product relatively little consideration and tend not to shop around. The sellers tend not to be experts either; they are usually trained to sell for example retail merchandise or cars only. In the case of UI, there is not even a secondary market: the lack of a 'hook' to engage with workers is a key part of the explanation for such low take-up of this product.

The second key structural problem is complexity. The range of protection products and terms and conditions for each is dizzying. Having separate underlying insurance for separate products also adds to complexity: to be fully covered in the event of unemployment, individuals would need many different types of insurance (i.e. one for their mortgage, one for their car, one each for other major household purchases). It is highly questionable whether consumers are ever likely to do this given the time it would take and the complexities of the individual products themselves.

A third structural problem in the market is one of adverse selection. This can arise (especially in insurance markets) where those people more likely to need protection are attracted to available schemes, thus driving up insurance premiums and deterring others.

These structural problems suggest that action to tackle operational problems alone is unlikely to have a significant effect or close the protection gap. Action is also needed to tackle the problems of complexity (both that consumers need several types of insurance to protect themselves and that each type of insurance is complex), and those of secondary or 'missing' markets and adverse selection. Indeed, in some cases structural problems can reinforce the operational failings. For example, the complexity of the market makes it more difficult for consumers to gain the information they need to make decisions.

PROVIDING BRITISH WORKERS WITH GREATER SUPPORT

It is clear that the UK suffers from a significant protection gap and that action to ensure workers have access to effective support might ease the growing sense of insecurity.

It is clear too that this action must tackle the structural failings of the market. Any such action must, however, maintain the work incentives and flexibility that have been central to the UK's economic success of the last decade. The choice must not be between flexibility without security or security without high employment.

There are some who argue that a degree of insecurity is the inevitable consequence of a flexible economy; the flipside of the success that this brings. They argue that the only alternative is the inflexibility and high unemployment of some of the Continental European economies. Others point to the Scandinavian model of flexicurity; combining economic flexibility with greater security, but at the price of higher taxation. The challenge is to build a British form of flexicurity.

This is particularly important if the government wants to maintain support for its policy of open markets. An increasingly insecure society that is ill prepared financially for job loss is likely to be a discontented society and is less likely to accept current levels of migration and competition.

There is also a significant positive rationale for a UK flexicurity model. Job search models from economic theory suggest that there are substantial productivity benefits from longer job-search among higher-skilled people yielding better employee-employer matches. Better protection for middle-income groups, particularly, would facilitate this.

These issues point to a clear role for government in enabling or providing access to greater protection. There are four key challenges to be met if the UK is to increase take-up of insurance against the risks of unemployment, while maintaining economic flexibility.

The first challenge is to maintain work incentives. Lengthy periods away from the labour market cause job-specific skills to atrophy. Those making claims should be encouraged to look for work (as current benefit claimants already have to do) and any transfer to benefits at the end of the insurance period must be effectively managed. However, many current providers of such insurance products already have experience of encouraging work activation; it is, after all, in their interests to keep the average claim duration to a minimum.

The second is to build agreement on the need for greater protection. Here there are clear lessons to be learnt from the recent pensions debate, which managed to build a degree of consensus around the need for significant change from the status quo.

The third is to improve the quality of the offer, so that consumers are confident in the products available. This paper recommends that the government work with industry to develop more effective Charges, Access and Terms (CAT) standards for unemployment protection products. The evidence suggests that this can both make the market easier to navigate for individuals and help to drive up standards, though clearly such standards are not, on their own, a magic bullet. In addition, the paper notes the need for a new product model, which combines some of the best characteristics of the range of products currently on offer in the market.

The fourth is to overcome the secondary nature of the market, to provide a stimulus for significantly increasing take-up. At present there are few if any financial incentives for individuals to take-up insurance. One option, therefore, would be to provide such incentives, for example, through the provision of tax relief. However, evidence from elsewhere suggests this could be expensive (up to £1 billion per year) without achieving a large increase in take-up.

A second option would be to regulate to require everyone to take out insurance. However, this is unlikely to be politically acceptable and also would target those who already had other forms of protection or simply did not need it. The danger with this approach would be that the target population might move from being under-insured to being over-insured.

A final option would therefore be to automatically enrol everyone in insurance, but give them the option of opting out. This would allow those who do not need the insurance to opt out. Evidence suggests that for many people, having no insurance at present is a function of inertia. This suggests that auto-enrolment could significantly increase take-up. This option would also have the effect of reducing problems of adverse selection whereby those people more likely to need protection are attracted to available schemes, thus driving up insurance premiums and deterring others.

This paper proposes the development of a new, privately provided form of national scheme for unemployment insurance, with the following characteristics:

- Every employee earning over £27k per annum would be automatically enrolled in a new scheme

- The scheme would be provided by current private sector providers through employers

- Employers would have a duty to provide access to a scheme

- The benefits provided would be time-limited to ensure the maintenance of a competitive economy. Such a time-limit would be between six and twelve months

- The combination of limited marketing costs and broad pooling of risk would reduce costs significantly

- The scheme would offer an agreed percentage of previous income, likely to be in the range of 60% - 70%

- Products would need to have a set of clear and transparent terms and conditions in order to qualify as an eligible scheme

- New employees eligible once they have (a) passed their employer's probationary period and (b) have been in employment at least six months

- New employers eligible once they have been acting as a going concern for at least a year

- Insurers would be able to refuse insurance to certain employers or categories of occupation

- An upper limit for payouts likely to be a set percentage of salary, probably in the region of 100k

- Premiums to be paid after tax

- From the perspective of the benefits system, eligibility for benefits to be judged on the basis of the point of unemployment, rather than the point of claim

- Requirement for insurers to show adequate protection against the risks of recession.

CONCLUSION

It is clear that insecurity about work is growing and that this is partly due to the increased financial consequences of losing employment today. At present, neither the state nor the private market provides an adequate response to this. Yet it is clear from the Scandinavian example that it is not impossible to find a middle way between flexibility and security. The challenge is to achieve that in an Anglo-Saxon economy without Scandinavian levels of taxation.

This paper aims to sketch out a way to bridge that gap, to build a British form of flexicurity. It argues that we can do this by significantly increasing access to insurance against the risks of unemployment among those facing the greatest financial fragility (identified as middle income earners with income of above £27,000) in part through auto-enrolment in such insurance. Since this approach has been shown to significantly increase take-up of financial products elsewhere, it is expected to be successful in insurance for unemployment risk as well.

It is not enough to say that growing insecurity is an inevitable consequence of economic flexibility and globalisation; allowing insecurity to grow unchecked risks undermining popular support for both. The key, therefore, is to find a model that maintains this flexibility while providing greater security for workers. This paper aims to provide a blueprint for just such a model, ending the false choice between flexibility and security.

INTRODUCTION

The government has seen the UK labour market, rightly, as one of its major successes, with employment at record levels and unemployment among the lowest in the advanced world.[1] It remains the case even now that people in work today are no more likely to lose their jobs than previous generations. Employment is higher than ever before, and the statistics show it to be equally secure. However, with a new sense of economic insecurity developing, it is right to consider the implications for individuals and for society of an increase in levels of unemployment. How resilient is the average household to a job loss? What would the implications be for individual finances and what would this mean for labour markets?

Even before there was any evidence of an economic downturn in the UK, levels of insecurity across the UK have been high by international standards. People have worried about the security of their jobs and prospects even in the absence of any objective external factors to suggest that they should be concerned.

In part this may be a result of living in a modern economy. Globalisation brings the possibility of enormous benefits, but also the potential for increased risks. Today, jobs can be located almost anywhere in the world. The old certainties about the geographic location of jobs and the 'stickiness' of industries within a particular country are gone. And although the process of globalisation has been with us for centuries, the speed at which it is now taking place has become considerably faster in recent years. As a result, leaving aside the impact of fluctuations in the economy, the current workforce perceives itself to have less job security than its parents enjoyed, and this applies across an ever-increasing range of professions. Outsourcing, off-shoring and competition present an apparent risk to millions of Britons.

Although workers are encouraged to keep their skills up to date and to be prepared to be flexible and retrain if necessary, the increasing speed of change makes it difficult for the workforce to adapt sufficiently. Even the most assiduous and able workers may find themselves without a job irrespective of any actions they take – in other words, they are subject to forces outside

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.

their control, and perhaps more importantly, outside the apparent control of government.

In addition, while the likelihood of losing work has not increased, the consequences of doing so have. The financial commitments that the average household has far exceed that of their parents' generation. There are 10.45 million mortgage holders in the UK with only limited access to financial support from the state in the event of redundancy;[2] the average UK consumer has three thousand pounds in unsecured debts such as personal loans and credit card debt, with one in five of the population having unsecured debts of over £10,000.[3]

As a result, for many families, even short periods of unemployment can have a devastating impact on their finances. Very few families have made provision against such an eventuality, either through insurance or savings. According to the Financial Services Authority (FSA), 70% of British citizens lack any provision for unexpected, sudden income loss or reduction.[4]

At the same time benefit levels in Britain are lower than in many other OECD countries and lower than in the past. And although most people find a new job relatively quickly, this new job tends to be less well paid. People are walking a financial tightrope like never before.

This presents a serious problem for government. An insecure society is likely to be a discontented one and the costs for government and society can be considerable. First, however healthy the economy, government is unlikely to reap the rewards of this if the voters do not feel the benefits. Second, toleration for inward migration is going to be limited amongst a population who feel that they are likely to be less well off as a result. Third, there is a risk of an increasingly protectionist attitude among voters and a backlash against globalisation and the government's policy towards open markets. Finally, if skilled workers have to return to work immediately to avoid financial

2 In addition the Insurance Support Mortgage Interest (ISMI) policy, which provides some payment protection on mortgage payment interest, is only available after nine months of unemployment.

3 The research, conducted by YouGov in March 2006, comprised an Omnibus followed by an in-depth survey on 1336 adults, a high proportion of whom had unsecured debts of £10,000 or over. From Thomas Charles & Co Ltd, "Thomas Charles Research reveals extent of debt repayment problems and high likelihood of personal insolvency in Great Britain," Press Release, May 22, 2006, http://www.thomascharles.com/rss/0013press_release_you.pdf.

4 Financial Services Authority, *Financial Capability in the UK: Establishing a Baseline* (London: FSA, 2006).

collapse, they may not return to the kind of jobs in which they can be most productive, with a consequent impact on the overall productivity of the UK economy.

This paper examines how best to respond to this new challenge of globalisation. Just as people are walking a tightrope, so too must the government. Any action to provide workers with better access to protection against the financial consequences of unemployment must not dull work incentives or harm the flexibility that is a central part of the UK's labour market success over the last decade. The UK must take care not to choose between flexibility without security or security without high employment.

But the risk is that, if we fail to attempt to provide greater security combined with flexibility, popular support for globalisation may diminish or people may fall off their financial tightrope with significant economic and personal consequences. While the challenge facing us is great, so too are the consequences of inaction and the prize of success. This paper provides a starting point, setting out options for a public-private partnership to meet the insecurity so evident in our society.

CHAPTER 1. A RISING TIDE OF INSECURITY

SUMMARY

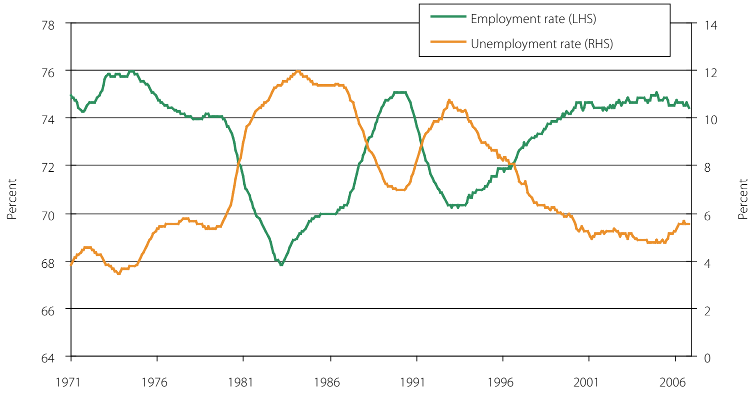
This chapter discusses the rising tide of insecurity felt by British workers about their jobs and financial prospects. Following ten years of a benign economic climate, people today are more likely to be in work than their parent's generation was, no more likely to lose their jobs and no more likely to change jobs frequently.

Yet even before the threat of an economic downturn became apparent, most people would not have recognised this as a description of the working world in Britain today. Today's British workers feel significantly less secure than the previous working generation, leaving them feeling among the most insecure in the world.

This apparent paradox is, at least partly, the result of two key factors. The first is that people who lose their jobs today suffer a permanent pay penalty that has grown over time. The second is that, as a result of increased debt, people's finances are more fragile than they were in the past. It is the combination of these factors that has led to increased insecurity. Put simply, people are less able to cope with the greater loss of income that they face if they lose their jobs today.

Despite the newly challenging economic climate, the strength of the UK labour market over the last decade remains one of Labour's significant achievements. As Chart 1.1 shows, the employment rate has been sustained at historically high levels. Today the employment rate stands at almost 75%, a level only reached previously at cyclical peaks but one that has been sustained for almost ten years and counting. Unemployment has fallen and remains among the lowest of the G7 nations.

Chart 1.1: The UK labour market



Source: Office for National Statistics.

During the 1980s and early 1990s, the UK labour market seesawed between strength and weakness, with unemployment twice hitting the 3m mark. By contrast, employment has been stable and high over the past decade and unemployment stable and low.

It is true that there remain very significant challenges ahead. A downturn could well have a significant effect on this picture. Even in the absence of this, around 4.5m people of working age are without work and the falls in unemployment have not been mirrored by falls in economic inactivity.[5] However, it remains the case that the labour market is stronger than it has been for a generation.

READING BETWEEN THE LINES

The overall strength of the UK labour market could mask increased uncertainty or reduced prospects for certain groups within society. In this way, the aggregate labour market statistics could hide more worrying trends.

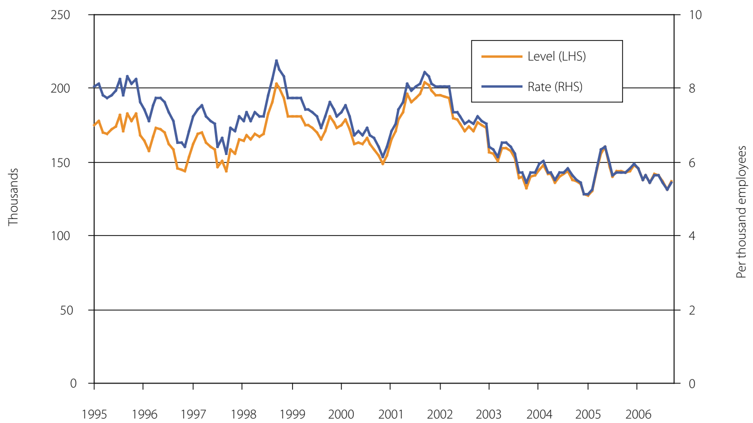
However, the evidence does not seem to bear this out. For example, today's overall high level of employment could hide a higher degree of 'churn' in and out of employment than previously seen. But evidence shows

5 Those not in work and either not seeking work or not able to start work in the next four weeks.

that the proportion of the unemployed who resigned from their previous job has been relatively stable over the past 25 years.[6] The proportion of the unemployed who resigned from their jobs was 10.0% over 1992-97, compared to 10.1% over 1982-86.

People are also no more likely to be laid off than they were – redundancies fell after the early 1990s recession and have remained stable since then.[7] Again, this may change as the economy tightens, but as Chart 1.2 shows, today there are 5.4 redundancies for every 1,000 employees, down by more than one-third from the levels generally seen in the mid to late 1990s. For now redundancies in the UK remain at their lowest for a decade.

Chart 1.2: UK redundancy levels



Source: Office for National Statistics.

Similarly, evidence shows that the average length of time people stay in a particular job has been relatively stable, at around ten years for men and seven years for women.[8] Furthermore, most of those who have lost work, have found another job relatively quickly – around 80% of people claiming Jobseeker's Allowance leave the benefit within six months.[9]

6 Stephen Nickell, Patricia Jones, and Glenda Quintini, "A Picture of Job Insecurity Facing British Men," *Centre for Economic Performance Discussion Papers 0479* (London: CEP, 2000).

7 Office for National Statistics, *Labour Market Statistics* (London: ONS, 2007).

8 Simon Burgess and Hedley Rees, "Job tenure in Britain 1975-92, " *The Economic Journal vol. 106 no. 435* (1996), 334-344.

9 HM Treasury, *Pre-Budget Report* (London: HMSO, 2002), 79.

However, there appear to be some important distributional differences in average job tenure. Mean job tenure for men in the bottom income quartile was 7 years, compared to 12 years for those in the top income quartile.[10] Furthermore, tenure rates for the lowest paid have fallen, to seven years from nine years in 1982. So job insecurity has risen for this group.

So there is some tentative evidence of greater job insecurity at the bottom end of the labour market. But overall the labour market is stronger than for a generation, people are no more likely to leave their jobs than they were and, if they do, they are likely to return to work quickly.

FEELING INSECURE

Yet, despite this overall strength, it is clear that many people have consistently felt a greater sense of insecurity about their jobs, finances and lives than in the past. A recent survey of 18 countries found UK workers have the lowest sense of job security of the countries surveyed.[11] Almost one quarter of British workers thought it highly or somewhat probable that they would lose their jobs in the next 12 months. This was similar to the proportions in Canada and the US, but much higher than, for example, the 3% of Norwegian workers who felt insecure. 71% of British workers thought they would find it difficult to find a new job if they lost theirs, a high figure but one which compares more favourably with the 95% of Germans who thought it would be difficult.

Not only is job insecurity high in the UK relative to other countries, it has risen over time. Survey evidence suggests a gradual increase in job insecurity between 1966 and 1986, with the trend most pronounced for blue-collar workers during the late 1970s and early 1980s.[12] This is perhaps not surprising given the heavy job losses in these occupations over this period. More surprising is the extent to which so many people continued to worry about their jobs even after the economy recovered. The researchers concluded that feelings of job insecurity are higher now than at any point in the post-war years.

10 Ibid.

11 Marianne Curphey, "UK tops world league of work insecurity," *Guardian Unlimited*, March 27, 2003, http://www.guardian.co.uk/money/2003/mar/27/redundancy.workandcareers.

12 Joseph Rowntree Foundation, *Job Insecurity and Work Intensification* (London: JRF, 1999).

Comparisons also revealed that the *spread* of job insecurity has been widening. In the mid-1980s, operatives and craft workers felt much more insecure than those in professional and managerial jobs.[13] But, by the mid-1990s, although a large percentage of manual workers continued to worry, there was a slight reduction in their feelings of insecurity, as shown in Table 1.1.

Table 1.1: Perceived change in job insecurity, 1986 versus 1997

Professionals	+28
Clerical	+10
Manager	+9
Associate professionals	+9
Craft	-4
Operative	-7

Source: Joseph Rowntree Foundation.

By contrast, non-manual workers experienced a significant increase in feelings of job insecurity during this period – despite the fact that their *actual* job insecurity did not increase, whereas for the lowest paid it did. Within this broad category, the biggest 'losers' were professional workers; they went from being the most secure group of workers in 1986 to the most insecure in 1997.

13 Ibid.

THE CAUSES OF INSECURITY

The previous sections identified the paradox between a strong and stable labour market and the long-term trend of rising insecurity felt by British workers. This section examines the potential causes of this apparent paradox.

The impact of losing work: high stakes?

The paradox between continued labour market strength and an increasing feeling of individual insecurity might be explained if the cost of losing work is higher today than it was in the past. In other words, even if the risk of losing work has not risen, if the consequence of falling out of the labour market is greater than it was in the past, then insecurity might rise.

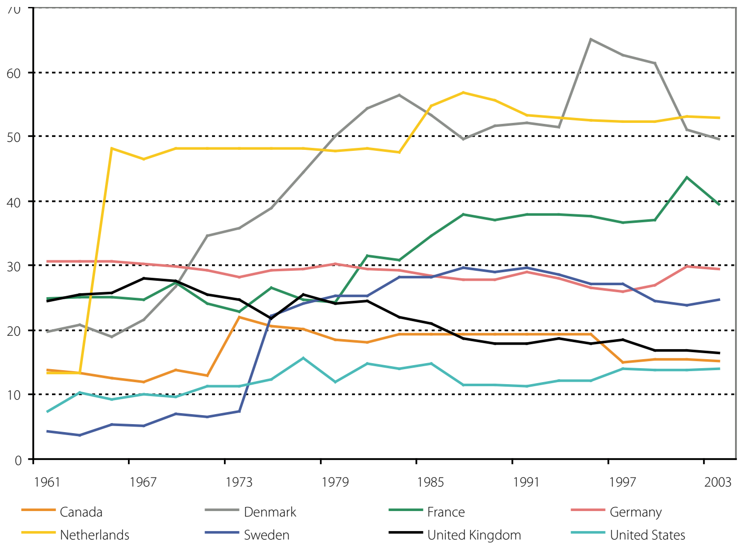
The consequences of leaving employment depend on factors such as the ease of obtaining a new job, the characteristics of the new job, the individual's financial fragility and the experience of being jobless.[14] As the previous section set out, workers in the UK have tended to be able to find work relatively quickly when they leave their current job.

However, on the other factors the UK scores less well and this might help to explain why workers in the UK feel less secure than workers in other countries. The drop in income workers face when they leave work and move into benefits is measured by the replacement rate, the ratio of unemployment benefits to earnings. Chart 1.3 shows the replacement rate in selected OECD countries.[15]

14 In this paper we use the phrase 'financial fragility' to mean a situation of general heightened financial risk, such as an individual with a higher debt to earnings ratio, or someone in more unstable employment.

15 This OECD measure of the replacement rate is defined as the average of the gross unemployment benefit replacement rates for two earnings levels, three family situations and three durations of unemployment.

Chart 1.3: The replacement rate in OECD countries



Source: OECD, Benefits and Wages: Gross replacement rates 1961-2003 (March 2006).

The chart shows that workers in the UK tend to face a bigger drop in income when they leave work and move onto benefits than in many other countries. The UK has one of the lowest replacement rates in the OECD, at 16%, compared to around 50% in Denmark and the Netherlands and almost 40% in France (2003). British workers receive benefits that are a much lower percentage of their average income than their European counterparts. The average British household earns slightly over £32,000 per year[16], and the total amount of benefits they could receive is less than £6,000 per year.[17]

Furthermore, the UK's replacement rate has fallen over time, from more than 25% in the 1960s to 16% today. By contrast, replacement rates in other OECD countries have not generally seen such dramatic changes. So UK workers who lose their jobs today face a much larger drop in income when they move onto benefits than workers in other countries and than UK workers who lost their jobs in the 1960s and 1970s.

16 BBC News, "The UK family: In statistics," *BBC News*, November 6, 2007, http://news.bbc.co.uk/1/hi/uk/7071611.stm.

17 OECD, *Benefits and Wages: Gross replacement rates 1961-2003* (March 2006), http://www.oecd.org/document/0/0,3343,en_2649_34637_34053248_1_1_1_1,00.html#statistics.

Low replacement ratios can aid labour market flexibility and provide people with a better incentive to find work again quickly. The UK's low replacement ratio is therefore one of the factors that has delivered the high employment and rapid returns to work discussed above. However, it has meant that people in the UK face a bigger drop in income when they fall out of work and hence adds to insecurity.

While workers in the UK tend to find work quickly after leaving their job, partly as a result of relatively low replacement ratios, the jobs they find tend to be lower paid than their previous work. A wealth of evidence shows that those who return to work after a spell of unemployment suffer a permanent pay reduction.[18] Evidence suggests that people suffer a pay penalty of 10-20% in their first year back in work.[19] Furthermore, the size of this pay penalty has risen by about 70% since the early 1980s – people lose more income permanently through a spell of unemployment than they did in the past.

In addition, the impact of a drop in income is likely to be higher today than it was in the past. Individuals have more personal debt than ever before. Last year, mortgage debt rose above the £1 trillion mark, with a further £223 billion owed in personal loans and credit cards.[20] This has been boosted by the expansion of home ownership (today more than 70% of people own their own home, up from 60% twenty years ago) and financial liberalisation in the early 1980s. As a result, total household debt is now 140% of total household income.[21] Today, mortgage repayments account on average for more than 40% of take-home pay, making them vulnerable to further rises in interest rates, but also to a fall in take-home pay.

Most individuals have been able to afford the levels of debt they hold, particularly as their assets (in most cases housing) have, up until now, also risen substantially. But their finances are more fragile than they were: a drop in take-home pay resulting from unemployment could quickly make

18 See, for example, Mary Gregory and Robert Jukes, "The Effects of Unemployment on Subsequent Earnings: A Study of British Men 1984-94," *Centre for Economic Performance & Institute of Economics Papers* (Oxford: Oxford University: 1997), http://ideas.repec.org/p/fth/cepies/21.html.

19 See footnote 6.

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

21 Bank of England, *British household indebtedness and financial stress: a household-level picture* (2004), http://www.bankofengland.co.uk/publications/quarterlybulletin/qb040401.pdf.

current levels of personal debt unaffordable, particularly as the permanent pay penalty means their earnings are unlikely to recover to previous levels. For example, in the second quarter of 2006, there were 26,021 individual insolvencies in England and Wales, up from just 5,000 a decade ago.[22] Though some of this can be attributed to the Enterprise Act 2002, which came into force in 2004, insolvencies have been steadily rising well before the change in bankruptcy law.[23] Increasingly it appears that individuals have taken on as much debt as they can currently afford, leaving them more vulnerable to the (often permanent) drop in income a spell of unemployment will bring.

To conclude, while workers are, in general, no more likely to lose their jobs than they were in the past, the consequences of them doing so are much more serious for them today. They face a bigger drop in income than they did in the past. The increased fragility of their finances means they are less able to bear this permanent pay penalty. This is a major source of the increased insecurity we see today.

The impact of global economic change

As well as the increased impact of losing work today, wider global economic trends may also be increasing job insecurity. This can come through two channels. The first is that the increased integration of the global economy along with the growth of India and China means that much work can now be undertaken almost anywhere. Consequently, companies have a much bigger range of options for where to produce their goods or services. Witness the rise of the Indian call centre and outsourcing of basic manufacturing to China.

This fragmentation of production means people feel their jobs are at more risk of outsourcing. Even though this feeling of threat is not borne out by the facts (a tiny proportion of jobs have been affected by outsourcing), it may have had an important psychological effect, in part aided by the nature of the media and political discourse surrounding globalisation.

22 Insolvency Service, *Statistical Release: Insolvencies in the Second Quarter 2006*, http://www.insolvency.gov.uk/otherinformation/statistics/200608/index.htm; and historical figures from Historical Insolvency Statistics, http://www.insolvency.gov.uk/otherinformation/statistics/historicdata/HDmenu.htm.

23 Insolvency service, *Statistical Release: Insolvencies in the Second Quarter 2007*, http://www.insolvency.gov.uk/otherinformation/statistics/200708/index.htm.

The second impact is through the changing nature of jobs. The impact of technological and institutional changes are said to have eradicated traditional labour market patterns, brought about the destandardisation and individualisation of work and ushered in a new 'age of insecurity'. The transformation of work, according to Sennet, has witnessed the advent of a 'New Capitalism' in which there is 'no long term'.[24]

Of course, increased insecurity can have benefits too. By limiting wage demands, greater insecurity (real or perceived) may have helped to hold down inflation, contributing to the 15 years of unbroken growth the UK has seen. This is an impact Alan Greenspan highlighted for the US economy too.[25] This might lead some to argue that increased insecurity is the flipside of the prosperity brought by economic flexibility and globalisation.

CONCLUSION

The UK labour market has had the longest period of sustained strength for at least a generation. Employment is currently at record highs and unemployment among the lowest of the advanced countries. Even beneath these headline figures, the picture has looked relatively rosy. People today are no more likely to lose their jobs than their parents' generation and they have tended to stay in their jobs for roughly the same length of time.

Yet most people would not recognise this as a description of today's working world. Even before the arrival of the credit crunch and the threat of a slowdown in the economy, British workers have had some of the most acute feelings of insecurity in the world. Indeed, their insecurity has increased even as the labour market has strengthened. This is a seeming paradox. Are people simply wrong, or do they have legitimate fears that drive their insecurity?

24 Richard Sennett, *The corrosion of character: The personal consequences of work in the new capitalism* (New York: Norton and Company, 1998).

25 Statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs (U.S. Senate, February 26, 1997), http://findarticles.com/p/articles/mi_m4126/is_n4_v83/ai_19405192.

The strength of the labour market has not translated into a greater sense of security for two key reasons. The first is that people who lose their jobs today suffer a permanent pay penalty that has grown over time. Coupled to this is the second reason, that, as a result of increased debt, people's finances are more fragile than they were in the past. It is the combination of these factors that has led to increased insecurity. Put simply, people are less able to cope with the greater loss of income that they face if they lose their jobs today.

CHAPTER 2. THE UK'S PROTECTION GAP

SUMMARY

Chapter 1 showed how British workers are feeling increasingly insecure as a result of the fragility of their finances, in part because of the permanent pay penalty that a spell of unemployment would bring. This chapter analyses the financial protection to which UK workers have access in order to protect themselves against the impact of unemployment.

Current public provision, through the welfare system, is specifically designed *not* to provide anything more than a minimal safety net. Rather, it is designed to encourage people back into work as quickly as possible. It does this relatively successfully but at the cost of people accepting lower paid work and being more likely to lose their jobs again in the future.

There are five main types of private insurance products available: Mortgage Protection Payment Insurance, Critical Illness Insurance, Permanent Health Insurance, Involuntary Unemployment Insurance and Payment Protection Insurance (for specific debts, such as a loan for a car). To be fully covered, borrowers need a mix of these. However, just 60% of borrowers have some form of insurance to protect their financial well-being, leaving 3.5m without any cover, and many with insufficient cover.

It is clear, therefore, that the UK faces a significant protection gap.

Chapter 1 showed the rising sense of insecurity felt by British workers and how a key cause of this is that individuals are increasingly unable to bear the permanent pay penalty and the risks that losing their job would bring given their increasingly fragile finances. This chapter analyses the tools, from both the public and private sector that individuals can access to try to insulate themselves from the impact of unemployment.

CURRENT STATE PROVISION

For people who lose their job, the Welfare to Work system provides a safety net and support to find a new job. Today, the four key benefits for those without work are:

- **Jobseeker's Allowance (JSA).** Currently around 900,000 people claim JSA and each claimant is required to actively seek work. If they are out of work for a long period (6 months for young people, 18 months for those aged over 25), they are subject to more intensive help through the New Deal;[26]

- **Income Support (IS).** This is the main benefit for around 800,000 workless lone parents. They are required to attend regular work-focussed interviews to discuss employment opportunities, but are not currently required to seek work;[27]

- **Child Tax Credit.** This is the main form of financial support available for workless (and working) families with children. For a workless family with two children the support available is worth £4,715 per year in 2008-09;

- **Incapacity Benefit (IB).** Around 2.7m sick and disabled people (mostly long-term claimants) receive IB. Again, they must attend interviews, but are not required to seek work.[28]

However, as discussed in the previous section, the benefit levels they receive, particularly for people without children, are low relative to other nations (as measured by the income replacement rate) and an increasing number of conditions designed to get people more quickly back to work have been attached to all benefits in recent years.

26 Department for Works and Pensions, *Quarterly Statistical Summary*, by Martin McGill (London: ONS, 2007), http://www.dwp.gov.uk/asd/asd1/stats_summary/Stats_Summary_Feb_2007.pdf.

27 Though the recent Green Paper on welfare reform proposes that, by 2012, lone parents whose youngest child is aged seven should be required to claim JSA and seek work, rather than being able to claim IS until their youngest child is aged 16.

28 See footnote 26.

In addition to these benefits, help is also available with housing-related costs. People on low incomes (either out of work or in work) can claim Housing Benefit (HB) for help with their rent and Council Tax Benefit (CTB). Around 4m people are currently in receipt of HB, of whom 3m are out of work.[29] While this benefit secures people's housing, the high withdrawal rate dulls work incentives. The combined HB and CTB support means that for every extra pound of income (after tax and tax credits), 85 pence of HB and CTB is withdrawn, severely reducing gains to work, particularly for people with high housing costs (e.g. families with children).

People who own their own home may be able to get help with their mortgage interest payments and other housing costs if they qualify for Income Support, income-based Jobseeker's Allowance or Pension Credit. Income support-mortgage interest (ISMI), a means-tested benefit, pays for interest on home loans up to £100,000, although even those who qualify are not usually eligible for it until they have been on the relevant benefits for 39 weeks.

The average UK house price is more than £200,000,[30] owner occupation stands at around 70 percent,[31] and many people have little or no savings.[32] Clearly, therefore, this system does not provide adequate support to cover mortgage payments for those who become medium- to long-term unemployed – the system is designed to help them by getting them back into work quickly and encouraging private provision rather than by providing long-term financial support.[33]

THE DEVELOPMENT OF THE CURRENT SYSTEM

Today's means-tested, flat-rate system has changed significantly from the early days of the welfare state, where receipt of benefits depended much more on having 'paid in' to the system.

29 Department for Work and Pensions, *Housing Benefit and Council Tax Benefit Summary Statistics* (London: DWP, 2006).

30 Department for Communities and Local Government, *House price index* (London: DCLG, 2007).

31 Department for Communities and Local Government, *Housing and Planning Key Facts* (London: DCLG, 2007).

32 Department of Work and Pensions, *Family Resources Survey*, http://www.dwp.gov.uk/asd/frs/.

33 Elaine Kempson, Janet Ford and Deborah Quilgars, *Unsafe Safety Nets* (York: Centre for Housing Policy, 1999).

A new system of National Insurance (NI) was introduced in 1911 (although even prior to this many trade unions and other societies provided cover for their members in the event of unemployment). Both employees and employers were to make a contribution and it would be their contribution record that would determine their eligibility for benefits, not their income. The National Insurance system was hugely expanded in 1946 following the Beveridge Report, which proposed a much more comprehensive National Insurance system to protect people (although mostly men) against the risk of losing their jobs.[34]

Over time, the link between individual contributions and benefits has weakened, and the overall revenue from NI is no longer hypothecated. This was in part a response to the failure of the scheme to cover key categories of workers (for example, men or women who, because of long-term mass unemployment or time out of the labour market to raise families, did not build an adequate contribution record), but also to the new era of mass unemployment in the 1980s which made it impossible for the scheme to be self-financing. So today around 800,000 lone parents claim the means-tested Income Support and by the mid 1990s just 8% of unemployed males were receiving NI benefits.[35]

As means-tested benefits have grown in importance, so the conditions attached to receipt of them have grown. Whereas the National Insurance system was characterised by conditions to *entry* onto benefit (that is, sufficient contributions to the scheme), today's more means-tested system has a greater reliance on conditions for what recipients must do *while* they receive benefits. For example, claimants of Jobseeker's Allowance (JSA), which replaced Unemployment Benefit, have to demonstrate to their Jobcentre Plus adviser that they are actively seeking work or face benefit sanctions. Similarly, lone parents claiming IS and disabled people claiming IB have to attend regular Work Focused Interviews (WFIs) to discuss the options for returning to work.

34 William Beveridge, *Social insurance and allied services* (London: HMSO, 1942).

35 Paul Spicker, "An Introduction to Social Policy: Social Security," The Robert Gordon University, http://www2.rgu.ac.uk/publicpolicy/introduction/socialsecurity.htm.

EVALUATING THE CURRENT SYSTEM IN AN INTERNATIONAL CONTEXT

The current benefit system has been highly successful at helping the UK maintain high employment and low unemployment for a decade, as discussed in Chapter 1. More than 80% of those claiming JSA have found a job within six months. The combination of low replacement rates and active intervention to encourage people to find work has, along with macroeconomic stability and a more flexible labour market, helped to reduce the structural rate of unemployment.

However, the system is less good at helping people stay in the labour market and build a career: around two out of every three JSA claimants have already made a claim in the past year. The focus on getting any job as quickly as possible has helped to increase employment, but the lack of sustained support means that too many people lose work again quickly or fail to progress. This may not be best for the individual, or for the UK economy as a whole.

By contrast, many other countries have time-limited contributory benefits based on previous income and backed up by means-tested assistance, as discussed in Box 2.1.

Box 2.1: Unemployment benefits around the world

In the US, people can generally receive unemployment benefit for a maximum of 26 weeks. The rate of benefit paid is income-related, a weekly rate equal to 4.1% of earnings during one quarter of the previous year. Around one quarter of low income families receive help with housing costs.

Sweden has an unemployment insurance consisting of a basic assistance scheme and a voluntary income related scheme for those who are members of an Unemployment Insurance Society. The gross replacement rate from the contributory scheme is 80% of previous earnings, with a maximum daily benefit of SEK 730 and a minimum of SEK 320. The basic assistance benefit is paid at a daily flat rate of SEK 320. Both are paid for a maximum of 300 days.

In Germany, unemployment insurance benefits are paid at 60% of after-tax income, up to a weekly maximum of €3,090, and are augmented when there are dependent children. The duration of benefits depends on age and employment record with a maximum of 32 months. When insurance benefits are exhausted, people move onto the means-tested, flat-rate Unemployment Assistance.

Similarly, Canada has an earnings-related Unemployment Benefit which replaces 55% of previous earnings up to a maximum of CAN$413 per week for a maximum of 45 weeks. By contrast, both Australia and New Zealand have flat-rate, means-tested unemployment benefits, more similar to the current UK system.

The complexity of these systems, with adjustments made for family size and type for example, means that the average replacement rate faced differs significantly across countries, as Chart 1.3 showed. Perhaps a key finding is that many Continental European countries as well as the US and Canada have time-limited contributory benefits based on previous earnings, whereas the UK, New Zealand and Australia have means-tested, flat-rate benefits.

The information in this box is taken from OECD country profiles, available at www.oecd.org.

As Box 2.1 shows, the UK's shift away from a social insurance benefit based on previous earnings has not been mirrored across the world. Many countries still retain some degree of time-limited, contributory benefit based on previous earnings. There is no clear correlation between this and labour market performance. Other institutional factors, such as the strict criteria and short payment period in the US, or focus on 'flexicurity' in some of the Scandinavian countries, appear more important.

Box 2.2: Flexicurity in Denmark

The Scandinavian model of flexicurity (combining flexibility and security) is based on a 'golden triangle' of a flexible labour market, generous welfare system and active labour market policies.

Labour market flexibility has various dimensions: flexibility of hiring, conditions of employment, flexibility of firing and the rigidity of labour market law. On many of these measures, Nordic countries such as Denmark are more flexible even than the UK.

This flexibility could create the insecurities as seen in the UK. But flexibility is matched by the security of a generous welfare system. For example, in Denmark, unemployment benefits are paid at a rate of 90% of the last salary for up to four years, subject to tax and a maximum payment. These measures are paid for by relatively high pay roll taxes: the average worker pays around 41% of their wage.

Without additional measures, these generous benefits would create a disincentive to go back to work. But the flexible labour market and the generous benefits are linked by an active labour market policy. Receiving unemployment insurance benefits in 1994 was made conditional upon retraining and actively searching for a new job. This pushes people back into work quickly, thus neutralising the effect of the generous replacement rates.

In this way, countries such as Denmark have succeeded in combining security and flexibility. Generous unemployment benefits provide security, but high employment and turnover rates show flexibility. Compared to many Continental European labour markets, security is not built on tight labour market legislation that often hampers growth. Consequently, Denmark's employment rate is equal to the UK's at 75% (far ahead of 65% in Germany), but this has been achieved without the high levels of perceived insecurity seen in the UK.

Source: Peter Kongshoj Madsen, "The Danish Model of 'Flexicurity' – A paradise with some snakes," European Foundation for the Improvement of Living and Working Conditions (Brussels: European Foundation for the Improvement of Living and Working Conditions, 2002).

Box 2.3: Flexicurity in Austria

In 2003 Austria reformed its system of severance pay. What before had been a system providing security only for a small number of workers became a model of flexicurity for other countries. In Austria, employers contribute 1.53% of the gross wage to an individual account for each worker. These accounts are administered by a range of licensed companies, among which employers in cooperation with the work council choose. When the employee becomes unemployed after at least three years of job tenure, he has the option of receiving his severance pay – but he could also transfer the account to his new employer. If the unemployment is voluntary or within the first three years of job tenure, the latter option is compulsory. Tax incentives encourage employees not to take out the cash but wait until their retirement and use the money they accumulated as an additional pension.

The Austrian system offers more security to employees when they lose their jobs but at the same time does not interfere with labour market flexibility. Since it is portable it does not create disincentives to change jobs – which means flexibility in the labour market – and it offers the possibility of turning into a pension fund for people who are not in need of the severance pay – which increases flexibility for the employee.

Source: Helmut Hofer, "Reform of Severance Pay Law in Austria," Discussion Paper, Institute for Advanced Studies (Vienna: HIS, 2006).

Box 2.4: "Negotiated flexibility" in Sweden

A key characteristic of the Swedish labour market is the involvement of the social partners. 80% of workers are unionised and collective agreements on wages, working conditions, working time and other aspects of the labour market dominate. Whereas in other countries the social partners only have the possibility to increase worker protection, several paragraphs in the Swedish Employment Protection Law can be undercut if the union in question agrees. This possibility of opting out of parts of the employment protection legislation provides the Swedish labour market with a system of "negotiated flexibility".

The social partners are also involved in the provision of unemployment benefits and labour market activation programmes. On the one hand, they provide "job security foundations" which support public employment agencies in providing security for workers and enhancing labour market mobility. On the other hand, the social partners cooperate closely with the government in providing unemployment benefits and activation programmes, with a strong emphasis on the latter. The joint approach of the government and the social partners guarantees security for most workers in case of redundancy.

The Swedish system is often described as being similar to the Danish one, but in fact has stricter employment protection legislation. Future reforms therefore focus on increasing flexibility rather than security – Sweden is approaching the flexicurity model from the other direction than the UK.

Source: Dominique Anxo, "Contribution to the EEO Autumn Review 2006: Flexicurity, Sweden," European Employment Observatory, http://www.eu-employment-observatory.net/resources/reports/Sweden-FlexicurityAR06.pdf (2006).

What is clear from this analysis is that the UK system is highly effective at getting people back into work. Indeed the fact that current state provision does not adequately protect people's finances is, in part, a conscious decision, both to ensure people return swiftly to the labour market and to encourage private provision. However, this is not an unmitigated good. Economic theory suggests that, particularly for more skilled people, job search time is important to allow better matches between employers and employees.[36] Out-of-work support that prices people out of searching for an appropriate job tends to result in less well paid employment for the individual and less appropriate employees for the employer. Such systems also create problems with job retention.

36 George J. Stigler, "Information and the Labour Market," *The Journal of Political Economy, vol. 70 no. 5* (1962).

CURRENT PRIVATE PROVISION: MIND THE GAP?

There is a wide range of private products available to people who wish to protect themselves against the risks outlined above. Broadly, these fall into four main categories: Mortgage Protection Payment Insurance (MPPI), Critical Illness insurance (CI), Income Protection (IP) or Permanent Health Insurance (PHI) and Involuntary Unemployment Insurance (UI).[37]

Box 2.5: The main forms of private insurance in the UK

Mortgage Payment Protection Insurance (MPPI)

- Also called accident, sickness and unemployment insurance
- Typically covers monthly mortgage payments for 12 months
- Covers any combination of accident, sickness and unemployment
- For one or more partners in a household
- And can include premium or endowment payments

Critical Illness (CI)

- Provides single lump sum payment
- Payment on diagnosis of pre-specified conditions
- For individuals, often in association with life insurance

Income Protection (IP) or Permanent Health Insurance (PHI)

- Provides monthly income until a return to work, retirement, mortgage is paid off
- For prolonged sickness and disability
- Covers individuals only

Involuntary Unemployment Insurance (UI)

- Covers redundancy and sometimes sickness
- Provides fixed payment until a return to work, retirement, or mortgage is paid off.

Source: J Ford, R Burrows, D Quilgars and D Rhodes, Mortgage insurance: its role in the mortgage safety-net (University of York, CML Housing Finance, 2004a).

37 Janet Ford et al., *Homeowners Risk and Safety-Nets: Mortgage Payment Protection Insurance (MPPI) and beyond* (York: Centre for Housing Policy, 2004a).

Each of these has different terms and conditions and caters to different types of borrowers. Box 2.5 sets out the key differences and specific features of each policy.

MPPI provides coverage for a broad range of risks, including accident, sickness and unemployment but only covers a specific debt. UI is similar to MPPI in that its main purpose is to protect against risks associated with unemployment. The other two policies, CI and IP/PHI focus on income shocks associated with accidents or illness. In addition, Payment Protection Insurance (PPI) is available to cover the monthly costs of particular debts (such as car loans or other major purchases) for a given period of time.

TAKE-UP OF PRIVATE INSURANCE: EXPOSING THE GAP

For one of these types of insurance, Payment Protection Insurance (PPI), the market has grown significantly in recent years. Over the last five years, premium income from PPI has risen from £3.2 billion to £5.5 billion.[38] Allied to this, in 1995 the government increased the Income Support Mortgage Interest (ISMI) activation period to nine months. This was intended to avoid the assumed crowding-out effect on private insurance take-up. By extending the period of nil payment, policy-makers believed they would ignite a new wave of private insurance provision and take-up.

However, take-up of most forms of insurance has remained relatively low. Table 2.1 sets out current rates of take-up for the main forms of insurance.[39] For ease of use, we will describe this kind of insurance collectively as Income or Payment Protection Insurance (IPPI).

38 Stuart King, Speech to the Westminster and City 15th Annual Conference on Creditor Insurance, "The Way Forward for MPPI and PPI," March 14, 2007.

39 Gwilym Pryce and Margaret Keoghan, "Determinants of Mortgage Protection Insurance Take-up," *Housing Studies vol. 16 no. 2* (2001), 179-198.

Table 2.1: Take-up of IPPI in the UK

	% of all with any insurance	% of all borrowers
MPPI only	20	12
CI only	22	13
PHI only	5	3
UI only	<1	<1
MPPI/CI/PHI/UI	5	3
MPPI/CI	15	9
MPPI/PHI	3	2
MPPI/UI	4	2
CI/PHI	9	5
CI/UI	2	1
UI/PHI	<1	<1
MPPI/PHI/UI	2	<1
CI/PHI/UI	2	1
MPPI/CI/UI	4	2
PHI/CI/MPPI	7	4
No cover at all	-	40
Only one insurance	48	28
Multiple insurance	51	30

Source: Janet Ford et al., "Mortgage insurance: its role in the mortgage safety-net," Housing Finance 61 (2004b), 36.

Table 2.1 shows that almost 60% of borrowers have some form of insurance, but this means that approximately 3.5m people have no cover at all. The table also shows that, while MPPI and CI are the most popular policies, 28% of all borrowers have only one type of policy. This carries risks for borrowers, as each policy has limited cover.[40] Although a borrower may have a policy, they may still be at risk for uncovered eventualities.

In addition, it is estimated that the necessary level of MPPI take-up to maintain a steady level of home-ownership in the UK and prevent individuals from repossessions is 50-55% of all mortgagors, due to individuals' typical financial circumstances not necessarily a recession,[41] but Table 2.1 shows that 2004 take-up is around 30% (either as a standalone product, or in conjunction with other forms of insurance).[42] Furthermore, only 11% of borrowers have UI in some combination of products and less than 1% have it as their sole form of insurance.

Product differentiation means that a combination of policies is required to secure full coverage. To best examine the cover of private insurance, Ford et al separate the four types of policies into two groups: unemployment and health policies.[43] Table 2.2 provides the distribution of take-up between these two groups of policies.

Table 2.2: Pattern of IPPI cover

	All borrowers (%)	Those with insurance (%)
Health[a]	37	62
Unemployment	7	12
Health and Unemployment	16	26
No cover	40	--

a Health includes accident and sickness, critical illness cover and cover for permanent disability.
Source: Ford et al, 2004a op cit.

40 Janet Ford et al., "Mortgage insurance: its role in the mortgage safety-net," *Housing Finance vol. 61* (2004b), 45.

41 Janet Ford and Deborah Quilgars, *Financial Intermediaries and Mortgage Payment Protection Insurance* (York: Joseph Rowntree Foundation, 2000).

42 2007 figures emphasise a further downward trend. According to Council of Mortgage Lenders (CML) data, in the first half of 2007 only 18% of mortgages were being sold with MPPI. For further information, see http://www.cml.org.uk/cml/statistics.

43 See footnote 37.

Table 2.2 shows that only 7% of all borrowers are covered for unemployment. Even of those that take-up some form of insurance, only 12% has cover for unemployment. Relatively high levels of cover for health compared to unemployment are puzzling given the existence of the National Health Service. This partly reflects the gap in unemployment protection among middle- and high-income groups.

Other data shows the highest concentration of take-up among under-30s, with take-up decreasing with age.[44] Ford et al identify several reasons for this, one being that certain policies, such as CI, are less expensive at a younger age. But no matter the reason, IPPI is failing to be taken-up by a significant number of borrowers, and that trend seems to be increasing over time.

OTHER FORMS OF PROTECTION

Of course, private insurance is just one way in which people can attempt to protect themselves from the risk of a fall in income. Many people view their houses as a savings plan, particularly for old age but also, increasingly, for other unforeseen eventualities. In a recent survey, 70% of people said they thought property would give them a better return than other products. When shown a range of long-term investments, 44% said they would choose bricks and mortar.[45]

However, property is not necessarily a good investment to protect against a (hopefully temporary) fall in income resulting from unemployment. This is not least as the time it takes to sell a house makes property a relatively illiquid investment. In addition, many people find it difficult to consider downsizing to a smaller home to realise their capital gain. While property may indeed be a good investment, it is unlikely to be an effective protection against the financial fragility set out in Chapter 1.

44 Ford et al., *Homeowners Risk and Safety-Nets*, 48.

45 Scottish Widows, *Savings and Investment Report* (Scottish Widows 2007), 5.

In addition to property, there are a variety of savings products that individuals could use to build up a nest egg in case of unemployment. For example, since the launch of Individual Savings Accounts (ISAs) in 1999, 17m people have invested a combined £220 billion in them. However, while a survey found that 61% of individuals save some of the money they earn,[46] the aggregate savings rate in the UK has fallen to stand at just 2.1%.[47] In addition, those whose finances are most fragile are least likely to save: just under one half of households have less than £1,500 in savings and one quarter have no savings at all.[48]

It is clear, therefore, that the relatively low take-up of private insurance products does not generally reflect individuals finding other sources of protection.

WHO IS AFFECTED?

A report by Scottish Widows found that the average household has a protection gap of £52,000, that is, they have only 61% of the protection they would need should they lose their income.[49] However, this protection gap is not equally spread across groups in society. Those in low paid jobs are likely to find that the out of work benefits they can expect are equivalent to a significant proportion of their in-work earnings. A parent earning up to £27,000 for example can expect that benefits replace around 60% of their income if they lost their job – and this does not take full account of benefits such as free school meals and transport. The box 2.6 illustrates this point.

46 Ibid., 3.

47 "UK household savings lowest since early 1960," *The Independent*, June 30, 2007.

48 Department of Work and Pensions, *Family Resources Survey 2004-2005* (London: HMSO, 2005).

49 Scottish Widows, *Protection Report* (Scottish Widows 2006).

Box 2.6: The threshold for income insurance

Benefits for an average family with two children

JSA for a workless couple with two children is worth £4,900 per year in 2008-09. HB and 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.

As the box shows, families with children who earn less than around £27,000 per year would be able to receive a significant proportion of that income in benefits should they lose their job. For childless couples the figure is around £15,000. It is likely that an additional monthly cost of insurance to protect their income would not be suitable for these tighter budgets given the amount they stand to gain relative to relying on state provision. While it could be that finances are more fragile for these low-income earners (so that a small fall in income has a bigger impact than it would for a middle-income earner), this does suggest that there is less of a widespread, 'blanket' need for private income insurance among this lowest earning group.

However, while a proportion of people may be adequately covered by state benefits, most people will not. In fact, Scottish Widows found that 83% of people may find state benefits inadequate to cover their outgoings if they lost their job.[50] At first sight higher-income households do not seem to be in need of income insurance – they are expected to have more financial assets and be less vulnerable than middle-income households to fluctuations in their income.

50 Ibid., 3.

Looking at empirical data, however, shows that some households with higher incomes are vulnerable as well. The Scottish Widows research showed that the largest protection gap was at the £40,000 to £50,000 annual household income range.[51] The same report found that, "those with higher household incomes have higher protection gaps. This is a result of the larger income that needs to be protected and the additional financial commitments, such as larger mortgages that the household is likely to have."[52] Financial fragility and the need for protection thus seem to be related to debt and other financial liabilities rather than to income levels. A group that is less affected is older people,[53] especially homeowners who have paid back their mortgage and whose children are financially independent. Overall, however, having a higher income does not necessarily mean that people make sufficient provision for a rainy day or their income in retirement.[54]

The risks faced by a household depend not on the level of in-work income they receive, but rather on the level of financial liabilities they face. Since higher-income households are likely to take out a higher mortgage than lower-income households, both groups are at risk. This makes all employees earning more than £27k the target audience for a policy addressing financial insecurity.

CONCLUSION

Chapter 1 showed the insecurity that people feel about their place in the labour market and how this has been driven by the fragility of their finances and the increase in the permanent pay penalty faced by those who lose their jobs today.

This chapter has shown how people are inadequately protected against these risks. The state system of benefits is designed to encourage people back into work as quickly as possible. The implicit assumption is that people should accept the permanent pay penalty in order to find work quickly. This has contributed to the UK's labour market success of the last decade or so.

51 Ibid., 14.

52 Ibid.

53 Elaine Kempson and Adele Atkinson, *Overstreched: People at risk of financial difficulties* (Bristol: Personal Finance Research Centre, 2006), 20.

54 Scottish Widows, *The Scottish Widows UK Pensions Report. A major assessment of pension savings behaviour* (Scottish Widows, 2005), 9; Mike Dixon, *Rethinking Financial Capability. Lessons from economic psychology and behavioural finance* (London: Institute for Public Policy Research, 2006), 14.

But it risks leaving the finances of those who lose their jobs exposed, even if they find a new job relatively quickly. And it may have a detrimental impact on UK productivity overall.

A range of private products is available for people to insure against this risk. But some 3.5m borrowers have no IPPI at all and more than one in four has protection against only one type of risk. This leaves the UK with a potentially significant protection gap. The next chapter analyses the causes of this gap.

CHAPTER 3. EXPLAINING THE PROTECTION GAP

SUMMARY

The UK's protection gap is partly the result of a number of operational and structural problems in the market for private insurance. The two most significant 'operational' issues are an individual's imperfect assessment of her own financial circumstances and prospects, and lack of knowledge of the protection available to her. These problems mean that people are less likely to consider protecting themselves financially and that even when they do, they are less likely to make the most appropriate choices.

Three key structural failings also affect the market. The first is that most forms of PPI are sold in a secondary market: people's primary purchase is of the car or other item, rather than the insurance. This can create a knowledge gap among both buyers and sellers. For UI, there is not even a secondary market: the lack of a 'hook' to engage with workers is a key part of the explanation for such low take-up of this product.

The second structural failing is complexity. The range of policies, terms and conditions for each is dizzying. Having separate insurance for separate loan products also adds to complexity: to be fully covered in the event of income loss, individuals would need many different types of insurance (i.e. one for each major purchase).

Finally, the market faces a problem of adverse selection. This can arise (especially in insurance markets) where those people more likely to need protection are attracted to available schemes, thus driving up insurance premiums and deterring others. Consequently, encouraging a greater proportion of people to take-up schemes is likely to create a virtuous cycle, lowering premiums and attracting others into the market.

These structural problems suggest that action to tackle operational problems alone is unlikely to close the protection gap. Indeed, in some cases structural problems can reinforce the operational failings. For example, the complexity of the market makes it difficult for consumers to gain the information they need to make good decisions. These structural problems must be tackled if people are to be able to adequately protect themselves.

Chapter 2 showed that UK workers suffer from a significant protection gap in the event of losing their jobs, with state provision deliberately focused on preserving work incentives and with take-up of private protection at a low level. So if consumers are facing growing debt and future risks, why aren't they protecting themselves better?

This chapter analyses the causes of this protection gap, demonstrating that key operational and structural problems in the market constrain take-up of relevant insurance products.

OPERATIONAL PROBLEMS

A number of operational problems constrain the take-up of IPPI by individuals. Perhaps the most significant of these is incomplete and asymmetric information. This manifests itself in two main forms:

- **Consumers' judgement of their own circumstances and prospects.** This lack of information makes it difficult for them to accurately judge whether they would benefit from greater financial protection; and

- **Consumers understanding of the options they have to financially protect themselves.** Even when they recognise the need for protection, consumers may not make optimal choices in the market.

Consumers' judgement of their circumstances and prospects

Individuals can be short-sighted when it comes to financial planning and incorrectly assess their own circumstances and prospects. Consequently, they are less likely to prioritise protecting themselves against financial risks. This has, in part, constrained take-up of IPPI.

Scottish Widows found that about 27% of the adult population in the UK has no savings at all.[55] And the FSA has found that 70% of respondents to their survey had no personal provision to protect against a loss of income.[56] Just a small change in circumstances could bring significant financial problems.

55 See footnote 49.

56 Financial Services Authority, *Financial Capability in the UK: Establishing a Baseline* (London: FSA, 2006), 5.

One good example of the many responses the FSA received was from one particular respondent who said,

'I got myself into quite a bit of debt on credit cards and store cards. I was only just managing to make the payments and sometimes I accidentally slipped into the red and added overdraft fees to my worries. I had to ask my parents for help a couple of times.' [57]

Clearly individuals are not adequately protecting themselves against future financial risks. The FSA found that 4m people say they run out of money by the end of their pay period.[58] As Chapter 2 showed, Scottish Widows found that the average household has a protection gap of £52,000, in other words that they have only 61% of the protection they would need should they lost their income.[59]

Several studies have found that individuals make poor financial self-assessments and that consumers can overestimate their ability to withstand a change in their circumstances. A recent survey shows that about 40% of the public feel that they could manage for 12 months after an unexpected drop in income through reduced spending, claiming benefits, borrowing money and/or drawing on savings or investment. Yet only one half of these respondents actually had any provision at that time.[60]

Evidence suggests that this at least partly results from poor levels of financial capability in the UK. The FSA conducted research to establish a baseline measure of financial capability in the UK.[61] It found that levels of capability were generally relatively low, particularly among young adults. For example, although 80% of people felt the state would not provide an adequate income for them in retirement, four in ten of these were making no provision themselves.

Similarly, only one in five purchasers of insurance had conducted an active search for the best product. In part, this is caused and compounded

57 Ibid., 6.

58 Ibid., 10.

59 See footnote 49.

60 Adele Atkinson et al., *Levels of Financial Capability in the UK: Results of the baseline survey* (Bristol: Personal Finance Research Centre, 2006).

61 Ibid.

by low levels of functional numeracy in the UK: more than 7 million adults in the UK lack these skills, which are as basic as checking your change in a shop.[62]

The complexity of finances and financial markets also plays a role in driving consumers' misdiagnosis of their situation. Experts have found that consumers put less effort into their financial decisions as the decisions become more complex and difficult.[63] A good parallel example is with the pensions debate. The Pensions Commission found that the UK pensions system is one of the most complex systems in the world.[64] And the analysis went further to suggest that individuals become more confused as more reforms take place and are less likely to make appropriate savings decisions. In other words, their poor decisions are partly a function of the complexity of the market.

Government is undertaking a range of activity to improve financial capability. For example, the FSA has begun the 'Learning Money Matters' programme, aiming at reaching 1.8m children by supporting teachers to integrate financial education into the everyday curriculum.[65] In addition, parts of the industry have also introduced their own initiatives. And most recently, Otto Thoresen has published a report proposing how best to provide generic financial advice.[66] Despite this, it is clear that low levels of financial capability remain a significant problem.

As well as current financial circumstances, individuals often overestimate their future financial security and underestimate future potential risks. They may not accurately assess the risk of losing their job or the consequences of doing so. Many will acknowledge only that they are making ends meet at present. What happens in the future is often of less concern.

It is common for individuals to discount the future relative to today: a pound today is worth more than a pound tomorrow. But how much more?

62 Leitch Review Final Report, *Prosperity for all in the global economy: World class skills* (London: TSO, 2006).

63 John W. Payne et al., "Adaptive Strategy Selection in Decision Making," *Journal of Experimental Psychology: Learning, Memory and Cognition, vol. 14 no. 3* (1988).

64 Pensions Commission, *Pensions: Challenges and Choices* (London: TSO, 2004), 117.

65 Financial Services Authority, *Financial Capability: the Government's long-term approach* (London: FSA, 2007).

66 HM Treasury Press Notice, "Thoresen Review announces consumer pilots of generic financial advice" (London: HMSO, 2007).

There is evidence that many individuals discount the future too heavily (sometimes known as hyperbolic discounting) meaning that they often make sub-optimal financial decisions.[67] Thaler and Shefrin, two behavioural economists, blame this behavioural shortcoming on the consumer's lack of self-control.[68]

One good example of this is that even though household debt has increased significantly in recent years, as Chapter 1 showed, more than four in ten people have not considered protecting against unemployment risk.[69] One survey shows that around one third of respondents admitted to falling into arrears after a sudden loss of income.[70] These individuals chose greater disposable income over protecting for the future. All of this comes despite numerous government campaigns (with both a national and local focus) aimed at encouraging people to consider the long-term more. It is clear that effective provision of information alone will not be enough to tackle this problem.

The analysis presented in this paper therefore suggests that individuals often make poor assessments of their own financial circumstances and prospects and consequently sometimes fail to consider protecting themselves when it might be in their best interests to do so. It shows that the current suite of policy interventions (focused on provision of information and advice) will not be enough to effectively tackle this.

Consumers' understanding of the market in protection

Another key driver of the protection gap is individuals' lack of understanding of the market for such protection. Even when individuals have correctly assessed their financial situation and decided they need protection, they face significant barriers in making the right choices. This will discourage a number of people who want protection from buying it, and mean that some of those that press ahead with the purchase will make an inappropriate choice for themselves.

67 Richard Thaler, "Some Empirical Evidence on Dynamic Inconsistency," *Economic Letters vol. 8 no. 3* (1981).

68 Richard Thaler and Hersh Shefrin, "An Economic Theory of Self-Control," *Journal of Political Economy vol. 89 no. 2* (1981).

69 See footnote 49.

70 See footnote 53.

The complexity of individuals' financial needs and the wide range of products available to meet them makes the market difficult to navigate. This is recognised by the FSA, which states that

'the wide range of choice may reflect the wide range of needs, but still makes negotiating the market difficult without a clear assessment of individual circumstances and an understanding of how to address them.' [71]

Not only do many people not understand the nature of the options available to them, there also appears to be a distinct gap between what consumers *think* they know and what they *actually* know. To quote Donald Rumsfeld for the only time in this paper, the market is characterised by consumers who face a significant number of 'unknown unknowns': they do not know what they do not know.

This 'perception gap' was highlighted in a recent survey for the Office of Fair Trading (OFT). It found that

'most of the consumers [they] spoke to felt they had all the information and explanation they need to make an informed choice about Payment Protection Insurance (PPI)'. [72]

But the same survey found that

'generally, most respondents were unsure as to precisely what PPI covered them for'.

For example, 38% did not know whether their scheme had any exclusions; 62% did not know how long they would have to wait to make a claim after buying PPI; and 53% did not know what their monthly premium was.

In addition, the study showed that the consumers with the highest satisfaction levels where those who were least familiar with the details of their policy.[73] The FSA finds that products are increasing their 'small print'

71 Ibid.

72 Office of Fair Trading, *Annexe B: Research into Customers' Experience of Payment Protection Insurance* (London: OFT, 2006).

73 Ibid.

and this has resulted in more surprises for consumers who expect to be successful with a claim but unknowingly fall within the terms of exclusion.[74] The absence of accessible information prevents the market from functioning as well as it could.

This lack of consumer understanding has a number of causes. Most significant is that the cost (in terms of both time and money) for individuals to gather the relevant information is high relative to the potential benefits they perceive of making the right choice (particularly given the evidence discussed above which shows the widespread lack of financial capability in the UK). Research has shown that consumers use information more readily when it is accessible and takes less time to understand (that is, when there are less costs involved in using the information).[75]

Attempts have been made to tackle this. For example, in February 2007 the FSA launched a two-month educational campaign aimed at PPI consumers. The campaign sought to:

- Inform consumers that PPI is usually optional
- Help consumers find out about the exclusions of claiming the policy
- Make consumers aware that shopping around will often result in a better deal
- Inform consumers what they are entitled to should they cancel the PPI policy or repay the loan early.

Several trade associations have also begun education campaigns. The Association of British Insurers (ABI), for instance, began a campaign in summer 2007 with its newest pamphlet, *A Guide to Payment Protection Insurance*, which explains the PPI market and all the key details a consumer should know before purchasing PPI.[76]

74 Financial Services Authority, *Financial Capability: the Government's long-term approach* (London: FSA, 2007).

75 George Stigler, "The Economics of Information," *Journal of Political Economy vol. 69 no. 3* (1961); Phillip Nelson, "Information and Consumer Behaviour," *Journal of Political Economy vol. 78 no. 2* (1970).

76 Association of British Insurers, "A Guide to Payment Protection Insurance," (Association of British Insurers, 2007). http://www.abi.org.uk/BookShop/ResearchReports/Payment_Protection_Guide.pdf.

But the ABI has found it difficult to catch the audience's attention long enough to make them fully aware of policy details. PPI is a fairly obscure product because of the secondary nature of its market. Around 39% of consumers previously surveyed did not even consider PPI before the point of sale.[77] Because of this, the ABI has found it difficult to ensure that it reaches the right consumers, despite the fact that the pamphlet was well received by regulators. Also, provision of information on existing products does not make them any less complex or confusing: it is this that is a key barrier.

In this way, the nature and structure of the market for IPPI can add to the barriers individuals face. High research costs (partly due to the complexity of the market) for consumers mean that they are less able to choose an appropriate policy, shop around between policies and know their rights for claiming on the policy. For example, evidence shows that only 12% of PPI holders shopped around before choosing their policy.[78] A series of mystery shopping studies conducted by the FSA found that the 'small print' is often located in obscure places on websites, only given after prompting via telephone and explained in complicated jargon.[79]

One result of this confusion is the tendency, discussed in Chapter 2, to take up one IPPI product, but not the necessary combination to protect against all major risks. Instead consumers take up, for instance, MPPI, to protect their mortgage payments but do not take up a product to protect against the consequences of illness or unemployment for their other debts. Evidence shows that only 30% of borrowers have a sufficient combination of policies to protect against most risk.[80]

The OFT has argued, in relation to PPI, that poor practice among a minority of providers, combined with problems of financial capability, may create another barrier for individuals. They found that a number of PPI sellers would either include the price of PPI in the loan quote or would not mention anything about the exclusions of the PPI policy, and that even fewer would provide (or could provide) details regarding exclusions.

77 See footnote 72.

78 Ibid.

79 Office of Fair Trading, *Annexe E: Summary report of mystery shopping* (London: OFT, October 2006).

80 See footnote 40.

This can be particularly true of sales over the Internet, and the industry recently conceded the need to do better here.[81]

While sometimes these examples may be due to poor conduct, other times it is due to improper or inadequate training of sales staff. For example, the Joseph Rowntree Foundation found that the intermediaries of mortgage products often lack the knowledge necessary to accurately assess the eligibility of the consumer and provide appropriate advice.[82]

Similarly, the Resolution Foundation found that staff members in commercial providers were largely inexperienced in dealing with generic financial questions, which most consumers require during the purchasing process.[83] Staff members are often unaware of the details of competitors' products and cannot discuss the broader market knowledgeably. This situation lowers consumers' chances of gaining satisfactory advice and making good purchasing decisions.

The industry has admitted to these faults and has begun work to improve its sales standards. Furthermore, the FSA has developed a Treating Customers Fairly policy, which requires firms to adhere to minimum selling standards.[84] Its four main principles are:

- Capable and confident consumers
- Simple and understandable information for, and used by, consumers
- Well-managed and adequately capitalised firms that treat their customers fairly
- Risk-based and proportionate regulation.[85]

81 Financial Services Authority Press Release, "Firms agree to change the way they sell PPI over the internet, " http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/084.shtml.

82 See footnote 41.

83 Alan Goodman, *Generic Financial Advice: Evaluating commercial responses* (The Resolution Foundation, 2006).

84 Financial Services Authority Press Release, "FSA determined to see better practice in PPI sales, " http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/003.shtml.http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/003.shtml.

85 Samuel Tymms, "Treating Customers Fairly: Speech to ASIM Annual Conference," 19 May 2006, http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0519_st.shtml.0519_st.shtml.

However, the underlying cause of this problem is directly related to the secondary nature of the market for many of these products, discussed more fully below. Where a product such as PPI is not the main focus of the transaction between the buyer and seller (the main focus being the mortgage, car etc.), it will necessarily attract less attention from both. Neither will be specialists and this increases the likelihood of poor decision making by individuals or poor advice from sellers.

STRUCTURAL FAILINGS

In addition to the operational problems analysed above, the market is also characterised by structural failings. As already shown, in some cases these structural failings exacerbate operational problems. Consequently, while it would be possible to alleviate the operational failings to an extent, action is also required to tackle these structural issues if UK workers are to have access to adequate financial protection.

Secondary and missing markets

Perhaps the most critical structural failing is that the market for most types of insurance tied to particular debts is a secondary market. In other words, it is not the insurance that people are shopping for, it is the goods or service with which the insurance is associated. That is, people are shopping for a mortgage rather than for Mortgage Protection Payment Insurance (MPPI), or for a car rather than for Payment Protection Insurance (PPI). In such cases, the insurance premium is generally a relatively small proportion of the purchase price for the primary product.

The evidence shows that, largely as a result of its secondary nature, consumers give relatively little consideration to IPPI products at any point in the purchase process. For example, a survey on PPI sales found that only 49% of respondents had thought about buying cover before their purchase.[86] As a result, the OFT found that 98% of PPI is sold at the point of sale for the debt (though the figure is slightly lower for mortgage debt).[87] They concluded that, 'PPI is a product which is sold not *bought*'.

86 Office of Fair Trading, *Annexe B: Research into Customer's Experience of Payment Protection Insurance*, 29.

87 Office of Fair Trading, *Payment Protection Insurance* (London: HMSO, 2006), 45.

The secondary nature of the market leads directly to a lack of shopping around by consumers, which makes it less likely that they will make optimal choices. It also means that they are far more likely simply to say no without fully considering what the product is, as their focus is on their original purchase rather than the insurance. In this way it is clear that the secondary nature of the market both constrains overall demand for insurance and distorts what demand there is.

While the market for most forms of IPPI is a secondary market, the market for more general UI is in many respects, missing. The market lacks a 'hook' (which, in the case of PPI, is the major purchase or, for example, a car) to get consumers interested and actively considering such protection. This means that relatively few people are even aware of such products, let alone actively consider taking them out. Again, this structural problem is compounding an operational problem: people do not seek out information to make informed choices as the (lack of) structure to the market leaves them disengaged.

Complexity

The complexity described above is a structural as well as an operational failing. Complexity in this sense can come from two sources. The first is the fact that the specific nature of policies tied to a particular debt means that individuals need a range of products in order to be properly covered. For example, individuals may need an insurance product to cover their mortgage costs should they be unable to work, a separate product to cover a car loan, another to cover a major domestic purchase and so on.

This need for a number of products adds to the task faced by individuals and results in a phenomenon known as 'choice overload', where too much choice can be seen as overwhelming, 'lessening both the motivation to choose and the subsequent motivation to commit to a choice'.[88] This 'paradox of choice' may arise because the costs of effectively researching a large number of complex choices is greater than that of researching a small number of simple choices and because people may be more worried about making the wrong choice.

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

There is an important interaction between complexity and financial knowledge. One study argued that 'those with above-average financial knowledge reported significantly less overload when given fewer investment choices, which confirms previous research that plan design is important'.[89] However, their evidence also indicates that 'individuals with below-average knowledge may find the investment decision overwhelming regardless of the plan features'. Clearly, simplicity of choice is not a substitute for financial capability.

The second source of complexity is the range of terms, conditions and exemptions available for each particular type of policy. This can make individual policies intended to cover the same debt objectively difficult to compare even given strong knowledge and motivation. For example, one study found that, while £3.9m had been spent on marketing travel cover in 2004,[90] a much smaller £635,000 was spent on advertising by creditor insurance companies.[91] Similarly, the OFT has argued that, while many company websites had appropriate information, it was often difficult to find, particularly with regard to policy exclusions.

Complexity need not necessarily be unambiguously bad. It may reflect a diversity of products to meet the needs of a diversity of consumers, giving them choice. However, the evidence presented in this paper suggests that the current market has moved beyond ensuring consumers have choice. Rather, current complexity discourages some from taking up insurance they would benefit from and may lead to others making poor choices about which products to take up. In addition, the complexity of the market has resulted in a small minority of unscrupulous firms and individuals selling inappropriate products to consumers. For example, the FSA has argued that some firms in the market do not give clear and straightforward information about the product, can fail to clearly discuss restrictions on claims and sometimes do not collect data about the potential buyer (information important to ensure the consumer has the best advice to make the right choice).[92]

89 Arnold Agnew and Lisa Szykman, *Asset allocation and information overload: the influence of information display, asset choice and investor experience* (Boston, MA: Centre for Retirement Research, Boston College, 2004), 2.

90 Office of Fair Trading, *Payment protection insurance market study: the emerging issues* (London: OFT, 2006), 11.

91 OFT, *Research into Payment Protection Insurance in the UK*, by London Economics (London: HMSO, 2006), 106.

92 GfK NOP, *The sale of payment protection insurance – phase III mystery shopping results* (London: FSA, 2007).

It would, of course, be possible for companies and regulatory authorities to work together to better embed best practice in selling across the market and attempt to stamp out bad practice. However, the critical problem is that this would not get round the first complexity issue (that consumers need a wide range of protection products to be covered unless they take out 'general' unemployment insurance) or that the markets will always be secondary markets when it comes to products tied to particular debts (and, indeed, missing markets in the case of the more general unemployment insurance). These structural problems are a critical issue and in many cases drive a number of the 'operational' failings discussed above.

This suggests that there is a clear case, alongside action to tackle the operational and structural failings discussed in this chapter, for considering the options for better supporting a market for private insurance for unemployment risk (as opposed to insurance tied to a particular debt).

Asymmetric information

A third structural problem in the area of the market insuring against unemployment is one of adverse selection. This can arise (especially in insurance markets) where those people more likely to need protection are attracted to available schemes. This tends to raise insurance premiums, as the provider is required to generate more revenue to cover its more risky clients. That process in turn, can lead to low-risk customers being gradually deterred from taking up insurance that they might otherwise have wanted as premiums rise. Unchecked, this process of adverse selection can undermine the insurance market for certain types of insurance.

In many areas of insurance the provider has ways of discerning the salient characteristics of a customer. For health insurance, the provider often requires substantial information on past medical history so that it can determine how risky each customer is and charge a premium that is appropriate. This is much more difficult in the case of insurance against unemployment risks.

CONCLUSION

Take-up of IPPI products has been constrained by a number of factors. Most critically, individuals have a tendency to misjudge their current financial circumstances and be overly optimistic about their ability to cope if their finances take a turn for the worse. This means that too many people fail to even consider their options for financial protection.

At the same time, knowledge about the options available is limited and the costs of acquiring sufficient knowledge, in terms of both time and money, are relatively high. Consequently, even those who do consider their options and conclude they need greater protection may be put off from doing so altogether and those who do decide to go ahead are more likely to make sub-optimal choices.

These failings derive in part from individuals' attitudes to financial issues in general and the UK's relatively low levels of financial capability. However, the structure and nature of the market for protection against the financial consequences of unemployment mean that they are not likely to be enough on their own.

Even if financial capability was to rise significantly and all individuals were to put a higher value on future security than they do currently, take-up would remain constrained - specifically, if such insurance remains a secondary market. Consequently, there are few 'hooks' to attract consumers for the most general products and the more specific products tend to be 'add ons' to other purchases and thus given relatively little consideration by consumers (or, indeed, sellers). In addition, the sheer complexity of the market can put individuals off and add to the information barriers to optimal decision-making.

The clear conclusion from this analysis is that these structural barriers – both the lack of a clear 'hook' and the overwhelming complexity – need to be tackled if the UK's protection gap is to be narrowed or closed.

CHAPTER 4. A MODEL OF FLEXICURITY FOR THE UK

SUMMARY

There are four key challenges to be met if the UK is to increase take-up of insurance against the risks of unemployment, while maintaining economic flexibility: developing a British form of flexicurity. They are:

- **Maintaining work incentives.** Ensuring those making claims are encouraged to look for work and supported in doing so (as companies already do for similar products) and effectively managing the transfer onto benefits.

- **Agreement on need.** Ensuring people effectively assess their financial situation, the risks they face and the options for protection.

- **Quality of offer.** People must have access to a simple product or products in which they can have trust.

- **Increase in take-up.** An effective lever to improve take-up will also be needed (as Chapter 3 showed, take-up has suffered in the past from the secondary nature of the market).

In practice, this means that any action must be backed by improvements in financial capability and work by the government, industry and employers to lead a discussion (as with pensions) on the issues and the need to tackle them. Following on from this, there is a need to give consumers greater confidence in the market and information to navigate it by government and industry working together to develop common standards for a simplified, high quality, time-limited product for unemployment risk.

The key challenge is to increase take-up. Incentivisation, through tax breaks for individuals and employers, would be one possibility. But experience, particularly from pensions, shows this is likely to prove expensive with relatively little increase in take-up. Another option would be to compel everyone to take such insurance out, but this is likely to be politically unpopular and also poorly targeted.

A better option would be to automatically enrol all new employees earning more than £27,000 per year in a protection scheme unless they choose to opt out.

Evidence from elsewhere suggests this is likely to significantly boost take-up with far less Exchequer cost. This is likely to be the best route to a British form of flexicurity.

This chapter examines the options for tackling the UK's protection gap and ultimately recommends a new scheme to mitigate the risks of unemployment or ill-health. This scheme is designed to give British workers greater security against the financial consequences of losing work while maintaining the economic flexibility that has been a central determinant of the labour market strength of the last decade. It builds a British form of flexicurity that does not involve the high levels of taxation seen in some Scandinavian countries (politically unpalatable here) but which fits the conditions of our Anglo-Saxon economy.

It is clear that any national scheme would need to be based on a product which was comprehensive in terms of the risks it insured against. This suggests a product which takes the strongest elements of the current policies on offer and brings them together into a single model, providing a combination of coverage for a broad range of risks (including accident, sickness and involuntary unemployment). It also suggests that the benefits it offered would need to be easy to for the consumer to understand and straightforward for the provider to calculate. They would also need to be effective in mitigating the risk of financial disaster and allowing scope to seek suitable employment. On this basis, we would recommend benefits calculated as a percentage of income, rather than relating to financial commitments. A product based on the latter would require extensive data gathering on the part of the provider, which would add significantly to costs. We estimate that a figure of around 60% to 70% of income on leaving employment would satisfy the above criteria.

INCREASING ACCESS TO FLEXICURITY

Before such a scheme could be introduced, three pre-conditions will need to be met.

- **Agreement on need.** Individuals must recognise their financial need to protect themselves. This means an improved assessment of their own financial prospects and an understanding of the options for protection;

- **Quality of offer.** Even if they recognise the need to protect themselves financially, people must have access to a simple product that they trust in order to do so;

- **Increase in take-up.** An effective lever to improve take-up will also be needed (as Chapter 3 showed, take-up has suffered in the past from the secondary nature of the market).

Agreement on need

It is clear that a fundamental barrier to take-up of IPPI policies is the lack of understanding by individuals of the need to protect themselves and, coupled to this, relatively low levels of financial capability in the UK. The first step in tackling the UK's protection gap must, therefore, be to build agreement that there is a significant problem here that needs to be tackled.

A good example of building this type of consensus is the recent debate on pensions. The Pensions Commission, through pro-active engagement with government, industry, employers and employees, built agreement on the problems surrounding inadequate retirement protection and the broad direction that reform would need to take. It was a long process; spanning three separate reports, numerous meetings, consultations, and conferences over four years. The clear independence of the Commission was a critical factor.

A similar national debate needs to take place regarding the financial fragility of many individuals and families. Critically, the debate needs to be elevated above political blame games on the level and risk of debt. Instead, it needs to focus on the real risks that individuals face and how to ensure that they can adequately and fairly protect themselves. A level of independent thought, likely to increase buy-in to the analysis of the problem and solution set to the general public, would aid this process. Now is the right time to begin this exercise, with the threat of an economic downturn bringing the level of household indebtedness and low levels of saving into sharp focus.

Following on from this, a broad-scale national agreement must translate into individuals agreeing that they themselves face financial fragility and risks and need to do something about it. This is a key step: often recognition of a general problem (such as the UK's savings rate being too low to provide for everyone's retirement needs) does not translate into acceptance that this is a problem for particular individuals and that they themselves need to take action (that is, acceptance that I myself have to save more, rather than just agreement that, as a society, we need to save more). There must be a clear, strong link between the financial information, individual risk and the need to take action.

The first step to tackling this is to raise general levels of financial capability. Chapter 3 set out some of the action the government is already taking to try to do this; it is critical that any strategy is successful. Steps also need to be taken to break inertia and reduce myopic decision-making.

As noted earlier, teaching financial capability in schools is a potent and useful tool, yet the drawback is the significant lag-time involved. Not only does early financial education require continued support throughout the student's education, but also the impact will not be noticeable until the students leave school and take on greater financial responsibilities. It is clear, therefore, that effective engagement of today's adults is equally critical (not least as 70% of the 2020 workforce have already left school).

Broad engagement with government, employers and employees is necessary to build agreement of the problems, and to identify potential ways to tackle them. Engagement will raise awareness, but additional marketing will be necessary to reach the tipping point where the majority accept that action must be taken. Employees must feel associated with the risks involved and understand that they must take action, not society 'in general'. In order to convince individuals that they must take action to protect themselves against unemployment they must foresee the risks and relate them back to their own circumstances.

Of course, building this agreement on need at a national and individual level will not be enough in and of itself. Individuals also need to be able to effectively navigate what, as previous chapters have shown, is an immensely complex market at present.

Quality of offer

Building consensus on the extent of financial fragility and the need for individuals to tackle it can only be the first step to tackling the UK's protection gap. Following on from this, individuals must be satisfied that they have access to fair and good quality products to protect themselves. This must be conveyed in a simple, accessible way.

At present, as Chapter 3 showed, the market for private insurance products against the risk of unemployment is bedevilled by complexity. This often prevents consumers from accessing the market or being able to make informed decisions within the market. In addition, there are clear problems in parts of the market with inappropriate selling and communication techniques. One way to tackle these issues is to develop a core product with common standards. This has been tried in a number of different areas, and Box 4.1 discusses the evidence from some of these.

Box 4.1: Developing quality standards

There have been a number of attempts to introduce quality standards for financial products in the UK. The first was the introduction of CAT standards in 1999. These set minimum standards for Charges, Access and Terms (CAT) initially for Individual Savings Accounts (ISAs), launched at the same time, that chose to follow them. The principle has since been extended to mortgages and other financial products. In addition, the Council of Mortgage Lenders has successfully improved product quality of MPPI through the Sustainable Home-Ownership Initiative which saw the introduction of baseline standards.

There is evidence that CAT standards have set an effective interest rate floor for ISAs and increased the proportion of mortgages with no minimum indemnity guarantee and no redemption charge after fixed rate periods.[a]

But it is equally clear that a dizzying array of products (whether ISAs, mortgages or other financial vehicles) remains with a wide range of varying terms and conditions (standards cannot be set down for everything) and that consumers remain confused and unsure.

It would appear, therefore, that the development of quality standards can help consumers to navigate a market and can also drive a general improvement in the standards of products. But they are not a magic bullet and will not be enough on their own to raise consumer engagement and take-up.

a Cruikshank Report, Competition in UK banking, (HM Treasury, 2000).

The evidence suggests that the process of developing such standards can have an effect in helping to drive up standards in a market and reducing costs. There is therefore a clear case for the government, consumer groups and the industry to work together to develop effective and credible quality standards for a new product. This would increase consumer confidence in the market.

It is clear, however, that development of quality standards and marks and a new comprehensive product with these core standards are likely to have a relatively limited effect on their own. Such an approach cannot be a solution to the UK's protection gap alone; rather it can play a role as part of a fuller approach. Critically, this fuller approach must include action to tackle the secondary nature of the market (one of the key structural failings of the market discussed in Chapter 3) and provide a 'hook' to boost take-up.

Increasing take-up

For take-up of private insurance to rise among the target audience, reaching agreement on the need for such a rise at both societal and individual level, as well as increasing the quality of products on offer (and individual's confidence in them), will be critical.

But the analysis in this paper suggests that this alone will not be enough. As well as by the issues described above, take-up is currently also constrained by the very nature of the market: in particular, its secondary nature and the lack of an effective 'hook' to encourage people to actively considering taking it up. These are the 'structural' problems identified in Chapter 3.

There are two main ways to tackle these. The first is through use of financial and non-financial incentives; effectively encouraging take-up. The second is through a degree of compulsion. Within the latter, we can distinguish between 'hard' and 'soft' compulsion, leaving a total of three options for increasing take-up to explore.

OPTION 1: INCENTIVISATION

The first option is to more effectively incentivise take-up of insurance. Incentives can be financial or non-financial. Financial incentives (for the employee, employer or provider) often take the form of a tax relief or an allowance, or a tax credit. Non-financial incentives are linked to education, using information, awareness raising and persuasion to encourage take-up.

At present, there are few financial incentives for taking up insurance against the risks of unemployment. When the insurance is claimed, however, and the money is used to pay a debt, this form of income is tax exempt.[93] In contrast, if it is not used to pay off a debt, it can be subject to income tax. Similarly, there are few attempts to incentivise people in non-financial ways, with little government action and, as Chapter 3 set out, relatively little spending on promotion by private providers themselves.

Financial incentives

While there are few financial incentives to encourage take-up of private insurance, such incentives have been used in other policy areas and other countries. Box 4.2 discusses the evidence on their effectiveness.

93 Rosanna Spero, "Beginners' Guide to Protection," (Scottish Widows), http://www.scottishwidows.co.uk/financial-toolkit/guides/protection/page4.html.

Box 4.2: The impact of financial incentives

Pensions in the UK

To encourage people to save more for their retirement, the government put in place financial incentives to encourage pension savings. Reflecting tax rates, people paying the basic rate get 22% of their savings back while higher rate tax payers get 40%. However, lack of awareness of what this means in practice seems to limit effectiveness: only 17% of basic rate tax payers and 28% of higher tax payers knew the correct tax level when asked what they thought they were personally entitled to. As a consequence, the Pension Policy Institute concluded that, 'tax incentives have not closed the "savings gap"'.

In a similar vein, in 2003/04 the government offered a 1.6% rebate on their National Insurance Contributions to workers who opted out of the State Second Pension. Again, this met with limited success: only one quarter of workers have opted out (and many of these had already done so).

Incentivising private pension savings in Germany

The German government tried to use tax incentives to promote a new private pillar within the pension system. The *Riester-Pension* came into effect 1 January 2002 and offered an allowance as well as a tax relief to people signing up to private pension savings. The allowance is split into basic allowance (€38 per year in 2002) and child allowance (€46 per year in 2002). The maximum level of tax relief is to be increased to €2,100 in 2008. Despite these incentives, only one quarter of eligible workers took the offer at an annual cost to the government of €551m.

The Savings Gateway in the UK

In 2004, a pilot scheme offered a group of lower-income households £1 from the Government for each £1 they saved, with a monthly limit of £25 and overall maximum of £375. About 60% saved enough to get the maximum financial support from the government, but evaluation showed that many of these were considered more likely to save money in the first place.

The evidence seems to suggest that financial incentives would only bring a relatively low increase in take-up of insurance against the risks of unemployment. However, the cost to the taxpayer would be relatively high. Box 4.3 gives an illustrative example of the potential impact.

Box 4.3: An illustration of the effects of a tax relief for full coverage with current products

This Box illustrates the potential costs of incentivising 10% of the currently non-insured (amounting to 350,000 people) to insure themselves. Assuming an average gross income of £30,000 per year (not unreasonable given the target group has incomes over £27,000) and a desired replacement rate of 65%, £19,000 per year would need to be covered.

Current market costs suggest this would cost each consumer around £850 per year. Granting a basic tax rate relief (22%), the government would reimburse insured individuals annually by £187. Taking into account the deadweight cost of paying relief to those already insured, offering such incentives would cost the government around £1.4 billion. The deadweight component of this would be around £1 billion.

But the government might also save money, because it would not have to pay JSA to the people who would claim on their unemployment insurance. If overall 1.6% of newly insured workers are made redundant each year (the current rate), then around 40,000 people would not be initially claiming out of work benefits each year. Given the average duration of a JSA claim is 16 weeks, even if success rates fell significantly, most of these would find work before their insurance ran out. On reasonable assumptions, up to £50m per year could be saved in reduced benefit claims, barely denting the £1.4 billion cost.

Overall, then, even taking into account potential benefit savings, tax relief appears to be a significant cost for relatively low gain.

Why, then, are financial incentives so popular if the impact is so small? A strong argument for the introduction of a tax relief for this sort of insurance is that it leaves the final decision about what to do to the individual. It is not mandatory and so take up is voluntary. Thus it does not provoke the rather general criticism of infringing upon individual freedom.

Another advantage is that it is quick and simple to introduce and to adjust rates if either take-up is too low or cost too high: it is a refinable tool.

This lack of structural change is a key selling point. It is also usually politically acceptable, as it is both voluntary and focused on incentives rather than disincentives: carrots are always more popular than sticks.

However, it is clear that there are significant downsides too. In part, the failure of financial incentives to significantly raise take-up in a cost-effective way is because, while they do increase the attractiveness of insurance, they fail to target the key barriers to take-up: low levels of financial capability, hyperbolic discounting and, critically, the secondary nature of the market.

For example, such incentives rely on individuals being able to assess the market and the relative merits (including the impact of tax relief) of taking a particular action. Low levels of financial capability and, indeed, interest in long-term financial decisions means that adding another complication (that is, calculating entitlement to tax relief) is likely to leave people more disengaged rather than less. The secondary nature of the market is critical here: there simply is not a hook to adequately engage individuals and only large scale (and, in the current fiscal climate, unaffordable) incentives are likely to change that.

In addition, a general feature of tax relief is that it is regressive, i.e. benefiting the better off most. Capping the tax relief at the basic rate of 22% could help address this concern. What could not be prevented, however, is that better off households tend to take up tax relief more than lower income households. So, overall, a tax relief will redistribute from lower or middle-income households to higher income households. Finally, as Box 4.3 showed, incentivising take up comes at a large cost and with a high level of deadweight cost.

Looking at one household more closely illustrates on a practical level why financial incentivisation is not likely to work in the case of current IPPI products. Insuring a family with three children and a household income of £55,000 for both a mortgage and general income under the current system costs £1,200 per year.[94] If this family pays back a mortgage by £18,000 per year, their monthly budget after these repayments and tax will be relatively tight. Paying an extra £100 per month for insurance only covering a handful

94 This is the deal offered by Ant Insurance, the *Which?* Insurer of the Year 2007 and thus should provide one of the best deals available on the market.

of eventualities does not seem very attractive. Offering a tax break of 22% does not change much of the picture – the household still has to pay a considerable amount out of their own pocket.

In a nutshell, the evidence shows that financial incentives are unlikely to increase take-up significantly and can increase the problem of complexity. It runs the risk of redistributing from middle-income households to higher-income and, importantly, comes at a high deadweight loss.

Another route for financial incentives would be to use them to encourage employers to offer insurance as part of their workers terms and conditions (that is, targeting the employer rather than the employee). Already, around two thirds of employers offer Critical Illness cover to their employees.[95] One option would be for them to be financially incentivised to offer (or support) private insurance against the risk of unemployment too. However, this is unlikely to be viable not least as the point at which employees would benefit would be the point at which their employment relationship ended. It is unlikely that employers would see it as in their interests to take the financial incentives and encourage such insurance among their workers.

Non-financial promotion

Non-financial promotion can take the rather general form of raising awareness or more specifically persuading workers to insure or to save. Raising awareness campaigns are often organised around broad themes, such as financial insecurity or an increasing debt burden on households. They make suggestions as to how to solve the issue, but the emphasis lies on raising a problem and making it known.

Persuasion, however, focuses more on the solution: it actively tries to convince people to take a certain action. Non-financial promotion builds on education, on the provision of information, but in addition tries to 'win people over'. Key to both is tying national action (such as media campaigns or government information) to local action (engaging people individually, perhaps through community groups). Box 4.4 discusses some examples.

95 Jamin Robertson, "Critical illness not fit to replace income protection," *Employee Benefits*, January 1, 2005, http://www.employeebenefits.co.uk/item/641/23/317/3.

Box 4.4: Examples of non-financial promotion

Raising awareness: The Child Trust Fund

The Child Trust Fund offered a voucher from the government of £250 to parents who start a savings account for their children. Initially the scheme suffered from low take-up; as recently as January 2006 around one third of vouchers had not been used to open an account. However, since then a combination of a media campaign and a Child Trust Fund Week in January 2007 have been run, in which local organisations ran events (from formal provision of information to informal chats over a cup of coffee) to raise awareness. This approach, linking national campaigns to local initiatives, has helped to increase take-up and raise awareness, so that 98% of eligible parents are aware of the scheme.

Persuasion: Combined Pension Forecasts

To persuade people to save more for their retirement, employers, pension providers and the Pension Service have cooperated to produce Combined Pension Forecasts. These project income in retirement – combining the state pension, occupational pension and private pensions – given the current saving rates of each individual worker. The aim is that those who are not saving enough would see that they needed to save more to ensure an adequate income in retirement. However, the forecasts had only a limited impact; not least as it tended to be those already saving who paid the most attention to the forecasts.

In the case of a new form of unemployment insurance, both government and industry could lead such incentivisation. It would need to be backed up by local action, including integrating it into existing initiatives on financial capability and inclusion.

As in the case of financial incentives, a strong argument for non-financial promotion initiatives is that they are not mandatory. They are also significantly less expensive. Again though, the evidence shows their effects to be rather limited.

This is largely because, in order for this mechanism to work, consumers have to be informed. They have to be able to assess their own financial situation and the products offered. If this basic level of awareness and capability does not exist, consumers will not make the link between an awareness campaign, their own situation and what to do about it. The problem here is that non-financial incentives are often not effective because their target audience is the least likely to respond to them.

OPTION 2: SOFT COMPULSION

The second option identified in the research is of 'soft' compulsion. Rather than encouraging take-up through significant financial incentives, take-up would be driven by a degree of compulsion. In practice, this would involve employees with income above the proposed income threshold of £27,000 being automatically enrolled in a scheme when they take up employment unless they actively asked to opt-out. Since both middle and higher income households are at risk, all employees earning above this limit could be automatically enrolled.

Under this option, employers would be required to offer such an option to their workers in the same way as applies in the case of pensions. Workers would have the opportunity to access independent financial advice to help them determine the best choice for their personal circumstances: crucially, as with pensions currently, the employer would not be responsible for providing such advice personally.

International evidence suggests that such an approach would be likely to significantly increase take-up, partly through making participation easier and partly through the power of 'inertia' (the significant increase in take-up seen in similar 'soft compulsion' schemes suggests that low take-up does not necessarily reflect the revealed preference of individuals). Box 4.5 discusses some of this evidence.

Box 4.5: The international evidence on soft compulsion

There has been extensive use of automatic enrolment measures for 401(k) pension plans in the United States over several years. Evidence from these suggests that such approaches increase employee participation rates significantly, using consumer inertia to increase saving.[a]

In one particular case, new employees, after three months, were automatically registered for a plan at a pre-selected contribution rate, with the option to opt out. Evidence shows that this system of Quick Enrolment increased take-up amongst new employees threefold. Among existing employees, there was a 10% to 20% increase in take-up. Another study found that participation rates were two to six times higher among those who were automatically enrolled.[b] It is clear that automatic enrolment significantly improves take-up of pensions, and it could have similar effects for some form of unemployment insurance.

A related successful US savings programme is Save More Tomorrow, allowing employees to sign up in advance to saving part of their next pay rise.[c] Initial take-up was high at 78% and four out of five of these continued to participate. As a result, savings increased from 3.5% to 13.6% over 40 months. This success is due to the psychological insights of behavioural economics. Rather than having to forgo today's income to save (which people usually do not want to do), they instead agree to forgo part of their future pay increases (so they will still be better off after their pay rise, but also be putting money aside).

An alternative to auto-enrolment is to force 'active decisions'. One study reported results from a trial in which employees were given a 30-day deadline to decide whether or not they wanted to enrol in a 401(k) plan.[d] The "active decision" approach raised enrolment after 3 months from 40% to 70%.

a James Choi, David Laibson and Brigitte Madrian, "Reducing the Complexity Costs of 401(k) Participation Through Quick Enrollment (TM)," *Working Paper* (The Wharton School, University of Pennsylvania: Boettner Center for Pensions and Retirement Research, 2006).

b Peter Orszag, "The Automatic 401(k): A Policy Perspective," (presentation at US-UK Dialogue on Pensions, AARP Retirement Security Project, Washington DC, July 26, 2005), http://www.aarp.org/special_static/usukpensionsdialogue/remarks.html.

c Richard Thaler and Shlomo Benartzi, "Save More Tomorrow (TM): Using Behavioural Economics to Increase Employee Saving," *Journal of Political Economy 112:1* (2004), 2.

d James Choi, David Laibson, Brigitte Madrian and Andrew Metrick, "Optimal Defaults and Active Decisions," *NBER working paper 11074*, (2005).

Evidence from the UK also suggests that automatic enrolment has the potential to significantly increase take-up. Research by the American Government Actuarial Department into the UK pensions system found that new employee participation rates within firms that use automatic enrolment were 90%, compared to 62% without auto-enrolment. And the Confederation of British Industry and Mercer Research found that automatic enrolment increased participation rates to 93% from 48% in firms that only use communication campaigns to encourage take-up.[96]

As this evidence and that from Box 4.5 shows, auto-enrolment would be likely to significantly increase take-up of an IPPI product. Indeed, this is the model currently in the process of being applied to pensions, following the recommendations of the Turner Commission.

Not only would such an approach increase take-up by overcoming the 'inertia' barrier, it has the potential to reduce the average cost of a policy through both economies of scale and the provision of a non-sales-based distribution route (which would reduce the need for insurance companies to invest in marketing, advertising and sales). As shown above the costs for insuring are at a very high level at the moment, thus bringing them down significantly could also act to increase take-up. This might have a greater impact than a financial incentive – and at the same time not come at a deadweight loss.

With premiums at significantly lower levels, cost would provide less of a disincentive and employees who judged themselves to be less at risk would be more likely to maintain their membership of the scheme.

This would create a virtuous circle in that pooling the risk amongst a broader base of the working population would be likely to reduce premiums even further. An employee who does not judge herself to be at great risk of losing her job might not insure under the current system when it is very expensive to buy comprehensive cover. If, however, the premium goes down because of lower marketing costs and increased membership, she would be more likely to accept her automatic enrolment.

96 Department for Work and Pensions, Speech by Ian Patton to AARP's US-UK Dialogue on Pensions, "Automatic Enrolment in the UK," 20 July 2005, http://www.aarp.org/special_static/usukpensionsdialogue/remarks.html.

So the option of soft compulsion leads to a virtuous circle of lower costs. If the costs for every insured employee come down because of economies of scale and less marketing and sales expenses, it will pay for more workers to insure.

There would a benefit for government in such an approach to, in that it would mean a lower bill for JSA.

There are, however, downsides to this option as with any scheme. The first is that there is a clear risk of imposing a burden on business from needing to ensure new employees are enrolled in a policy and administering opt out decisions, as well as even potentially choosing a preferred company scheme/s (though employers would not be involved in providing financial advice to individual employees, in the same way that they do not do so for company or individual pension schemes).

Some of this burden could be mitigated if the HMRC were instead to perform the administrative functions (paralleling recent changes to tax credits, where administrative duties have similarly been transferred from employers to HMRC). While this would impose an administrative cost on the taxpayer and not completely mitigate the burden on employers, this is likely (partly, again, through economies of scale) to be lower than if done through employers and help to build their acceptance for such a scheme.

A second potential downside could be lack of public acceptability. Put simply, incentivisation is likely to be much more palatable politically than soft compulsion, even if there were an option to opt out. The example of pensions shows that it is possible to overcome these objections. But to do so would require the other challenges already discussed (particularly agreement on the problem at both society and individual level) to be met. It is this that would create the culture and societal attitude to make soft compulsion politically acceptable.

A related concern is that this would be seen as government withdrawing from the provision of a welfare state for a significant numbers of employees. In fact, JSA would continue to form an effective safety net for a significant proportion of the public, while at the very least means-tested benefits would remain for those who did not find work during the payment of their insurance benefits.

In addition, a form of soft compulsion may require a degree of incentivisation to increase acceptability. To make the parallel with pensions again, currently people who opt out of the State Second Pension (SSP) pay a lower rate of National Insurance Contributions (NICs). A similar approach could be applied here, with those remaining opted in to insurance against the risk of unemployment either benefiting from tax relief or even paying a slightly lower rate of NICs. Clearly, however, this would increase the cost of this approach to the taxpayer and this will be a challenge, particularly in the current tight fiscal climate.

A third potential objection is that those who are most likely to need increased protection (the 'target audience' discussed earlier) might be most likely to opt out, perhaps citing lack of affordability as a reason. However, the evidence in Box 4.5 suggests that this concern is likely to be ill founded, that it is precisely those that would be the target for this scheme that would not opt out.

OPTION 3: HARD COMPULSION

A final option would involve 'hard' compulsion, essentially the creation of a universal national unemployment insurance system. Every employee would be required, through his or her employer, to be a member of an insurance scheme.

This could, in some ways, be seen as fairer. After all, everyone would have to take out protection rather than just those at most risk. It would ensure that everyone, including all 3.5m people currently without protection, was insured against the risks they face. This would not only help to tackle the insecurities felt by individuals, but could also help to protect the UK against the potential consequences of an economic downturn.

Such an approach would also add to the economies of scale discussed above and so help to drive down prices even further. In addition, it would make the scheme much simpler to administer with everyone automatically enrolled. This could reduce the bureaucratic burden on employers and the state, with no need to filter out those earning less than £27,000 and no need to offer, process and administer the option of opting out.

However, this option suffers from serious and, perhaps, insurmountable downsides. Perhaps the most serious is that it targets everyone, rather than just those who would benefit from greater protection. Those who had chosen to protect themselves in other ways, such as through savings and investments, would be required to take out protection they did not need.

This lack of targeting is likely to make hard compulsion a difficult sell (to both individuals and employers). The argument that this was just another tax would be more justified, since everyone would be required to pay for insurance, whether they needed or wanted it or not. Similarly, while there may be less paperwork per person associated with the removal of the option of opting out, requiring everyone to be in a scheme means that the volume of people (and hence administration) would be significantly higher, increasing administrative costs.

MAINTAINING HIGH EMPLOYMENT

For such a scheme to be a success, the interaction between the insurance and work incentives would be critical. An objective would need to be maintenance of the UK's successful record of high employment, one of the benefits of flexibility. The present state system for maintaining high employment, as Chapter 2 set out, is based on sharp financial incentives (driven by a low replacement rate) for individuals to find new work, and active labour market support through the Jobseeker's Allowance (JSA) and New Deal systems.

The risk of increased take-up of private insurance is that it could undermine both, and any new scheme would need to be structured in a way that avoided these pitfalls. If a scheme were to give those who lose their job a higher proportion of their in-work income while out of employment (even if time-limited), the financial incentive to find a new job (for this time limited period) would be reduced. Similarly, access to an income from insurance would leave people ineligible for the means-tested JSA and active labour market support that comes with it.

The risk, put bluntly, is that people who lose their job would not actively seek a new one while they have access to income from private insurance. Only once they accessed the benefits system after this period has elapsed would they begin to search for work. And, because of the scarring effect of a period of unemployment, they would be less likely to find a new job at this point than if they started searching as soon as they left their previous employment.

It is possible to overstate this risk – for many people the drive to find new employment would be present irrespective of these other factors. However, a sensible policy approach should mitigate this risk while providing greater security to workers. There are several ways to do so.

The first is to prevent claimants of the scheme from sitting idle while receiving their benefits. Under this approach, known as Active Labour Market Policies (ALMP's), claimants of private unemployment insurance would be expected to actively participate in improving their future employment chances from day one. There would need to be pathways for claimants to seek out and learn about employment opportunities and to train, re-train and up-skill, so as to make themselves a more competitive candidate in the labour market.

Already, there are several examples of best practice among employers who provide unemployment insurance in conjuncture with ALMP's. Penna, a human capital management consultancy, provides Tesco with outplacement services. Penna helps those that have lost their job at Tesco to find new employment. The programme has been extremely successful with a 98% take-up rate and a success rate of 67% of those that used the service.[97] Another good example of best practice in the private sector is AKS Consultants' work with a factory that was closing down. Within 4 weeks of AKS services, three quarters of all employees had found a new job.[98]

These examples of outplacement services demonstrate that if a programme is implemented correctly, the recently unemployed can quickly find new work. It is not hard to imagine a larger-scale system, in which all

97 Penna Consultancy, "Tesco's…a flexible outplacement solution", http://www.e-penna.com/casestudies/Case%20study%20-%20Tesco%20-%20Web.pdf.

98 AKS Consultants, http://www.aksconsultants.com/index.htm.

claimants of unemployment insurance receive outplacement services and are expected to actively seek work immediately upon, or as close to, losing their job.

An active claimant will be further motivated to finding a new job if there is a visible and robust time-constraint on her claim. Knowing that the benefits of unemployment insurance will last only a short period would provide the impetus for the individual to 'get up and do something'.

The average length of unemployment lasts six months[99] and the average length of adult training courses is seven months.[100] JSA benefits only last for 6 months for young people and 12 months for over 25s, and 86% of unemployment benefit claimants are off benefits in less than twelve months.[101] Therefore, it would be reasonable to propose that the benefits provided by a new unemployment insurance scheme should last somewhere between six and twelve months. Anything longer than twelve months (where the New Deal steps in for those on state benefits), and the scheme would run the risk of eroding work incentives.

By providing claimants with pathways to work and a strict time constraint, the risk of losing work incentives would be significantly reduced. Individuals would have both the tools to find new work at their disposal, and a clear timeframe in which they must find a suitable job. Given the fall in income that would result from transferring onto the benefits system after the insurance had run out, a strong incentive to seek and take work would remain in place. It would be a decision for government as to whether people leaving the unemployment insurance scheme would be eligible for JSA, or whether they would pass straight on to means-tested state benefits. It is certainly not obvious that JSA would be required, given a model in which ALMP's were in place while the insurance was being paid out.

In order to prevent unnecessary over-insurance, it would make sense to cap the amount of payout that would be made and this is discussed below

99 Office of National Statistics, *Labour force survey: unemployment by age and duration* (08 November 2007), http://www.statistics.gov.uk/STATBASE/xsdataset.asp?More=Y.

100 Average length of two courses, Childcare and Computing, sample size 70. Data from http://www.direct.gov.uk/en/EducationAndLearning/AdultLearning/GetLearning/index.htm

101 Office of National Statistics, *Claimant county by age, duration and sex* (November 2007), http://www.statistics.gov.uk/downloads/theme_labour/LMS_FR_HS/WebTable11SA.xls.

A NEW NATIONAL INSURANCE SCHEME

From the discussion above, it is possible to develop the outline of a model for a new scheme of unemployment insurance:

- Every employee earning over £27k per annum would be automatically enrolled in a new scheme.
- Employees would have the right to opt out of the scheme.
- The scheme would be provided by current private sector providers through employers.
- Employers would have a duty to provide access to a scheme.
- The benefits provided would be time-limited to ensure the maintenance of a competitive economy. Such a time-limit would be between six and twelve months.
- The combination of limited marketing costs and broad pooling of risk would reduce costs significantly.
- The scheme would provide benefits of an agreed percentage of previous income, likely to be in the range of 60% - 70%;
- Products would need to have a set of clear and transparent terms and conditions in order to qualify as an eligible scheme.

There are a number of other considerations that need to be taken into account when designing the scheme.

The first is ensuring that the risk profile of the insured population is kept within reasonable limits. This suggests two further scheme characteristics. First, employees would only become eligible for the scheme once they have (a) passed their employer's probationary period and (b) have been in employment at least six months. A similar hurdle would need to apply to employers. Firms would need to have been acting as a going concern for at least a year before their employees became eligible for enrolment. Insurers would also need to be able to assess the risk of unemployment in any given industry and even to be able to refuse insurance for certain categories of occupation.

Second, to avoid the problem of over-insurance, schemes would need to develop an upper limit for payouts. This would need to be the subject of extensive modelling in order to balance the trade off between being effective for the vast majority of the UK's workforce, while still proving attractive to those on higher incomes. We estimate that this may be in the region of £100k.

Third is the question of portability. Would the scheme apply to the individual or to the particular job? In the former case, the policy would need to be transferable, so that as a person moved from job to job, their insurance would travel with them. In the latter case, the insurance would be specific to the individual period of employment.

This raises the fourth issue, which is the basis on which the risks would be underwritten. Would it be preferable for risks to be calculated on a flat-rate basis, or would insurers still require considerable personal information in order to establish a more specific risk profile for each employee? Given that the risk of unemployment in any given case is likely to result from a combination of an individual's personal circumstances and the position of their employer in a market place, it seems likely that the insurance industry would prefer to reach a more specific calculation for each employee.

Fifth is the question of the relationship between the scheme and the tax system. There would certainly be an argument for paying the insurance premiums before tax as is the case with pension contributions. However, as discussed above, the evidence for the effectiveness of financial incentives in influencing take-up of benefits is mixed to say the least.

Six, government would need to decide whether those who had claimed under a national unemployment insurance scheme would be eligible for JSA once their insurance ran out. For the purposes of the benefits system and the New Deal, would their unemployment be deemed to have started at the point where they left employment or at the point at which they came into contact with the benefits system. There is a strong argument in favour of the former, in that individuals not in work would not reap the benefit of the New Deal until they had been unemployed for a considerable amount of time.

Finally, any scheme would need to address the implications of a major recession. The larger the pool of insured, the greater the potential risk to the insurance industry from a serious downturn in the economy. Each insurer would need to ensure that they were adequately protected against such an eventuality.

CONCLUSION

A number of challenges need to be met if the UK is to develop its own brand of flexicurity, combining flexibility and security by increasing take-up of insurance against the risks of unemployment. But this paper argues that all of these challenges can be overcome.

The first is to maintain work incentives, so that people do not use their period of insurance pay out as a break from work and only begin looking for a new job once they transfer onto means-tested benefits. The best way to mitigate this risk is to ensure that any insurance period is time-limited (to, perhaps, six months) and to ensure work activation measures are effectively encouraged (the third pillar of the 'golden triangle' of flexicurity in Denmark).

The second is to build agreement on need. Here, lessons can be learned from the consensus for action built by the Pensions Commission through effective communication of the evidence base and engagement with people and the media. At the same time, there is a clear need to build individual awareness (so that this is not just seen as a national problem, but one that does affect me personally) through improvements in financial capability and efforts to improve awareness and disseminate information and advice.

The third is to improve the quality of the offer, so that individuals have access to a product that is not just good quality, simple and low cost, but credibly seen to be so. Here, there is a clear case for the government and the industry to work together to develop a new "best practice" product; to agree common quality standards and a simple way of communicating those standards and the products that meet them to the public.

The final challenge is to boost take-up by tackling the secondary nature of the market, the lack of an effective 'hook' for consumers. Meeting the other challenges should help to increase take-up, but is not likely to go far enough or, in particular, reach far enough into the group most at risk at present. Incentivisation through, for example, tax relief, would increase take-up somewhat. However, the evidence suggests it would do so at a high cost and with a high level of deadweight cost (that is, much of the benefits would go to those who were already protecting themselves in any case).

This suggests that some form of compulsion should be considered. Full-scale 'hard' compulsion (requiring everyone to take out the product) is unlikely to be politically achievable or, indeed, desirable. Perhaps its key downside is that it would require even those that did not need protection (such as those on low incomes whose out of work benefits would represent a considerable proportion of their in-work income were they to lose their job) and those who had other forms of protection (such as savings) to take out insurance.

A better option might, therefore, be a form of auto-enrolment in such a scheme for those with incomes above a threshold of around £27,000, with the option to opt out. This is similar to the approach currently being introduced for pensions in the UK. Evidence from elsewhere in the world suggests that it has the potential to significantly increase take-up and at a lower financial cost than incentivisation alone.

It is in this way, with a balanced package of consensus building, maintenance of work incentives, market reform and consideration of auto-enrolment that the UK can begin to build its own brand of flexicurity. This is critical if general support for economic liberalism and globalisation is to be maintained and if we are to ensure that the next economic slowdown does not tip millions of households into financial crisis.

Box 4.6: Anglo-flexicurity

Despite the strong labour market the UK has seen over the last decade, British workers are feeling more insecure. Many of those on moderate to high incomes are financial vulnerable. They often have large financial commitments and should they lose their job and therefore income, state benefits will replace only a very small percentage of their previous income. They are unlikely to be able to maintain their lifestyle and avoid going further into debt, facing the possibility of repossession.

For those for whom the welfare state provides little real protection (those earning over £27,000) there must be a better option to protect themselves against the loss of income. As shown in Chapter 2, the private insurance market is not sufficient. There is low take-up and the structural failings of unemployment insurance will prevent the insurance market in its current form to close the protection gap.

Therefore we propose a more holistic approach of insurance against the risk of unemployment. By generally protecting individuals against income loss due to unemployment, we can diminish the complexity of the current insurance market, ease the public purse by reducing JSA claims, and increase financial security for those at risk.

Because of the structural failings of the private insurance market for IPPI products more than just incentivisation must take place. A system of **'soft-compulsion'** is the best solution.

In this system, there should be **automatic enrolment** for those over the £27,000 annual income mark, which will increase take-up significantly and bring along with it benefits from economies of scale, reducing premium prices. As with the current pensions system, employees should become eligible for the new form of unemployment insurance after six months of employment or the end of their probation period, whichever is the later.

And to avoid mis-selling and inappropriate take-up, automatic enrolment should be matched with the option to **opt-out**, so that individuals are not forced to use the product if they do not need it or want it.

In order to maintain the strong labour market the UK currently enjoys, the new model must balance labour flexibility with financial security. Work incentives must be very apparent to the unemployed so that they do not remain idle on benefits for extended periods of time. While on the other hand, this flexibility must be balanced with the need to stabilise their financial circumstances so that the unemployed do not experience permanent pay reductions and other detriment due to income loss.

To strike this balance, we take lessons from the European model of flexicurity but in a British context, avoiding high taxes. Those in receipt of the insurance must be required to **actively seek new employment**, and this must be met with support to help them along the way as shown in Chapter 3.

To avoid the tendency for unemployment inertia, benefits must be **strictly time-limited**. Providing significant income replacement for a six to twelve month period will allow the claimants to retrain, upskill and find a suitable and sustainable new job, but also give them a timeline in which they must do it.

By truly protecting against loss of income, improving financial security and maintaining labour market flexibility will create a unique model of Anglo-flexicurity. This can be best achieved through a system with 'soft-compulsion', including automatic enrolment and the option to opt-out.

CONCLUSION

People today feel increasingly insecure. This is despite the fact they are no less likely to lose their jobs than previous generations of workers and despite the historic strength of the labour market over the past decade.

Some have suggested that this is the price we have to pay for our economic success; that the flipside of economic flexibility is uncertainty. They suggest that the only alternative to the relatively liberal underpinnings of the success of the Anglo-Saxon economies over recent years is the high unemployment and economic inflexibility that they argue characterises many Continental European economies.

This paper has attempted to find another route; mitigating the insecurities felt by people, but without sacrificing the flexibility that has left the UK in a strong economic position. This seeks to build on the idea of flexicurity prevalent in a number of Scandinavian economies. The challenge is to do this without the higher levels of general taxation, which fund such an approach in those countries. In other words, the task is to build a system of flexicurity for an Anglo-Saxon economy.

The conclusion of this research is that there is a way to bridge the gap between these visions of the economy, to build a British form of flexicurity. The way to do this is to significantly increase access to insurance against the risks of unemployment among those facing the greatest financial fragility (identified as middle-income earners with incomes of above £27,000).

At present a number of barriers constrain take-up of such products, but this paper has identified ways they can be overcome. The first step is to increase awareness and recognition of the protection gap in the UK. This needs to be a joint effort – government, employers, industry and trades unions – learning from the national debate surrounding pensions begun by the creation of the Turner Commission.

Coupled to this, action is needed to ensure this recognition of the national problem translates into individual action. Here there are two key challenges. The first is to improve financial capability so that people can accurately assess their own financial circumstances and the risks they face. This is likely to be a generational challenge, with action to improve numeracy standards at school and embed financial education within Maths tied to action to ensure adults are able to improve their financial knowledge and access appropriate financial advice.

The second is to improve the offer to the public. This means the government and the industry working to develop a new product to both improve quality and provide consumers with a 'standards mark' that guarantees a decent quality product with relatively low costs (as has been done in other areas of financial services).

All of this is a pre-requisite for improving take-up of private insurance. However, the secondary nature of the market for such products at present means that, unless this structural problem is addressed, take-up will remain constrained, particularly among those most at risk.

One way to tackle this would be through greater incentivisation, that is, providing financial incentives for individuals and employers to take out and provide such insurance. However, the evidence from other policy areas, such as pensions, suggests that this is likely to prove expensive with high-level deadweight costs; it risks costing a lot of money without reaching the target group, those most at risk.

Consequently, this paper recommends consideration of a system of 'soft' compulsion, enrolling all new employees earning more than £27,000 in a time-limited income protection scheme unless they choose to opt out. Evidence from elsewhere, such as pension plans in the US, suggests that this could significantly increase take-up, particularly among the target group.

Key features of this scheme would be:

- Every employee earning over £27k per annum would be automatically enrolled in a new scheme
- The scheme would be provided by current private sector providers through employers
- Employers would have a duty to provide access to a scheme
- The benefits provided would be time-limited to ensure the maintenance of a competitive economy. Such a time-limit would be between six and twelve months
- The combination of limited marketing costs and broad pooling of risk would reduce costs significantly
- The scheme would offer an agreed percentage of previous income, likely to be in the range of 60% - 70%
- Products would need to have a set of clear and transparent terms and conditions in order to qualify as an eligible scheme
- New employees would be eligible once they have (a) passed their employer's probationary period and (b) have been in employment at least six months
- New employers would be eligible once they have been acting as a going concern for at least a year

- Insurers would be able to refuse insurance to certain employers or categories of occupation
- An upper limit for payouts likely to be a set percentage of salary, estimated to be in the region of £100k
- Premiums to be paid after tax
- From the perspective of the benefits system, eligibility for benefits to be judged on the basis of the point of unemployment, rather than the point of claim
- Requirement for insurers to show adequate protection against the risks of recession.

The insecurity felt by workers today is a growing problem. It is not enough to say that this is an inevitable consequence of economic flexibility and globalisation; allowing insecurity to grow unchecked risks undermining popular support for both.

The key, therefore, is to find a model that maintains this flexibility while providing greater security for workers. This paper aims to provide a blueprint for just such a model, ending the false choice between flexibility and security.