

ANGLO-FLEXICURITY II:

Insuring against unemployment in the UK

Dr Henry Kippin

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EXECUTIVE SUMMARY

This report is the second stage of a two-part exploration of a fresh approach to national unemployment insurance (UI), in which people can insure themselves against loss of income due to unemployment. Our earlier report – *Anglo-flexicurity: A safety net for UK workers* – was researched and written during late 2007 and early 2008, a period when the British economy was in what transpired to be the final two of 63 consecutive quarters of economic growth, and just before the economic meltdown that ensued. That report looks remarkably prescient in retrospect, arguing that, despite a decade of strong growth and increasing labour market flexibility, many workers felt uneasy about their personal and family finances, and their future economic prospects.

One explanation for the upward drift of feelings of job insecurity in the post-war years can be found in the increasingly serious consequences of unemployment for individuals over that period. Since the National Insurance Act of 1946, median income levels in the UK have diverged significantly from the level of unemployment benefit provided by the state. Replacement ratios have, in other words, fallen over decades – particularly for childless people. Meanwhile, greater access to mortgage finance and consumer credit over recent decades, and particularly in the past 10 years, has increased people’s financial exposure – a trend that is likely to outlive the current recession.

This latter phenomenon has led to what some in the insurance industry have called a “protection gap”. That gap is largest among middle-income people. These long-term trends in perceived vulnerability are now being reinforced in the current recession, as the rising tide of unemployment engulfs the high-skilled occupations. This makes it likely that we will see growing disaffection with current forms of support over the next few years and an increasing desire for change.

But what can be done about this long-term growth in financial insecurity? For many obvious reasons, the role of protecting middle- and higher-income people against the risks of unemployment should not fall to the state – not least because it would be hugely costly and require substantially increased taxation. This leads to us to ask questions about why it is that, in the face of such a protection gap, privately provided insurance products have not emerged to fulfil this role.

The SMF's Anglo-flexicurity project has aimed to consider this question from the starting point that the state's role should look to unblock market failures and facilitate a market-based solution where possible. This report argues that some key market failures prevent the spontaneous development of such a product for a mass market, including:

- individuals' tendencies to excessively discount future risks and rewards (known as "hyperbolic discounting"), and hence to underestimate the risk of unemployment in the future;
- the likelihood that people in more risky occupations will demand more insurance than those in relatively secure employment, thus driving up the costs for all, and pricing less risky employees out of the market (adverse selection); and
- the lack of a point of sale for an income protection policy.

These problems suggest a need for government involvement to enable the market to provide a solution to the protection gap and growing perceptions of vulnerability, and offer an adequate financial safety net for UK professionals. This research offers a blueprint for that involvement. The report draws on evidence from European-style welfare systems that have private sector components, notably Denmark, as well as some of the current thinking from US scholars. It holds that a market-based system can be both cost-effective for the government and offer individuals more comprehensive cover against increasing financial vulnerability.

A NEW NATIONAL UNEMPLOYMENT INSURANCE FRAMEWORK

This report makes the case for a voluntary system of privately provided UI, and assesses some of the possible implications of the system, both in terms of cost to the individual, risks to providers and revenue implications for government. Some of the key elements of the proposal are as follows.

- **Automatic enrolment** is a key aspect of the proposal and an essential part of the broad pooling of risk across individuals and industry sectors that would allow the scheme to operate cheaply and securely. The model presented in this report is based on automatically enrolling employees within an annual salary band of between £27,000 and £60,000. This reflects the most obvious “protection gap”: people in this band have been identified as being some of the most financially vulnerable. For those below this income level, the replacement rate of state benefits is higher. For people above this income band, financial liabilities are typically lower relative to their income than for middle-income groups. Consequently, it is assumed that those outside the band would have a less obvious need or desire for UI. There may also be sections of the workforce that would choose to opt out of such a scheme, for a variety of reasons.
- A **default policy** – similar in concept to that available under the Personal Accounts pension provision from 2012 – would provide unemployment benefit at 60% of an individual’s previous salary, for a period of 6 months. The scheme would be portable between different employers.
- **Employers** would be the initial point of access to the scheme, providing new employees with information on the unemployment insurance policy. This solves a key

problem with such a product: that unlike when consumer goods are bought, where insurance can be sold as part of the package, there is no obvious point of sale for insuring one's livelihood. Once enrolled, there would be no further administrative burden on employers.

- Our calculations suggest that around **five million employees** could be automatically enrolled in the scheme under these assumptions. By thickening the market through auto-enrolment, it is possible to minimise problems of adverse selection and thus reduce premium levels for all participants in the scheme to very reasonable levels. The analysis of this report suggests that employees would typically pay monthly insurance premiums at around 1.1% of gross salary, or around **£35 per month**.
- Typically, unemployment results in a substantial reduction in income for middle earners, due to the income-replacement rates associated with the state's safety net. The reduction in taxes (both direct and indirect) paid alongside the state's liability to pay unemployment-related benefits means that the cost of middle-earner unemployment for the Exchequer is high. We estimate that facilitating an Anglo-flexicurity-style UI scheme could save the Exchequer around **£500 million per year**.
- Since individuals would, by receiving unemployment insurance payments, be excluding themselves from eligibility for those state benefits, it would be reasonable to expect some form of compensation for those taking up the scheme. Tax relief on individuals' contributions would, by the estimates contained in this report, ensure that the Anglo-flexicurity scheme is approximately **revenue neutral** for the Exchequer.

For individuals, Anglo-flexicurity looks to provide a safe, simple and accessible means of entry into the insurance marketplace. A broad

membership can achieve a high level of financial protection alongside low-cost premiums, allowing people to better manage their own “protection gap”. In the event of unemployment, it would afford people the time and the means to find a job commensurate with their skills and experience instead of having to take the first opportunity that comes along.

This carries significant potential productivity benefits for the UK labour market through improved job search for high-skilled individuals. There are also important macroeconomic benefits to the scheme. Enhanced automatic stabilisers would help to dampen shocks to the economy, such as the current recession.

Anglo-flexicurity therefore constitutes a radical reappraisal of unemployment insurance. For middle and high-income people, it should not be the role of the state to deliver such insurance. Indeed, in the fiscally constrained policy environment of the coming decade, the focus must be on policy solutions that are at least costless for the Exchequer. Rather, the state’s role is to facilitate and enable a solution – in this case, a solution provided by the private insurance market, based partly on the idea that if people can protect themselves, then they should.

To advocate such an approach however, we must be sure that the figures add up, and the plans make sense. This report aims to do just that: to calculate the viability of such a scheme and to find out what it would mean for the Exchequer and the individual. This report does not provide definitive answers, but provides the stepping stones by which Anglo-flexicurity might be developed from a set of ideas into a concrete policy for a twenty-first-century problem.

CHAPTER 1: RETHINKING UNEMPLOYMENT IN A NEW ECONOMIC CLIMATE

In March 2008, before the current economic crisis began, the Social Market Foundation published *Anglo-Flexicurity: A Safety Net for UK Workers*. The report engaged with an emerging tension within the British labour market – that of economic flexibility versus individual insecurity. Flexibility from labour market deregulation and economic growth; insecurity because, despite strong growth, many people still felt uncertain about their incomes and their future employment prospects. Rather than insecurity decreasing within a growing economy, as might be expected, the report presented data indicating the opposite: that economic strength had been accompanied by heightened feelings of unease about personal and family finances.¹ So why might this be?

First, a clear but troubling by-product of strong British economic performance has been an explosion in levels of personal spending and debt. This has been facilitated by increasingly available access to easy credit. As a result, more and more people have financial commitments – such as mortgages and credit card payments – that would be difficult to maintain if they lost their jobs. Second, unemployment benefits are structured in such a way that losing one's job may cause a huge drop in income. The UK has among the lowest average salary replacement rate of OECD countries, at around 10% of the average wage, compared to a European average of around 58%.² This is principally the result of wage growth over time, causing median incomes to diverge steadily from the main unemployment benefit, which has risen only in line with inflation. This trend means that unemployment benefit – the state-provided safety net – no longer plays the role it was set up to play when introduced in 1948. Figure 1.1 shows how real incomes have risen since 1979.

1 Brendan J. Burchell et al., *Job Insecurity and Work Intensification* (London: Joseph Rowntree Foundation, 1999).

2 Author's own calculations, "Benefits and Wages 2007": www.oecd.org/document/33/0,3343,en_2649_34637_39619553_1_1_1_1,00.html#summary.

Figure 1.1: Real incomes, 1979–2006



Source: Adapted from Mike Brewer et al., *Poverty and Inequality in the UK* (London: Institute for Fiscal Studies, 2008), 8.

Third, a flexible labour market has meant that a high proportion of those unemployed will find new jobs, but often at a lower salary or occupational level.³ This is a permanent pay penalty that can have harsh implications for individuals and for the state. For the employee, “unemployment has a scarring effect for both future employment and future earnings;”⁴ meanwhile, the broader impact is that the UK labour market may not be maximising the expertise of its workers.

The SMF report argued that these findings highlight a “protection gap,” wherein “neither state provision nor take-up of private insurance [is] matching up to the scale of financial fragility individuals face.”⁵ In short, workers who lose their jobs are at risk more than ever before, and few are adequately protected against this eventuality.

3 Mary Gregory and Robert Jukes, *The Effects of Unemployment on Subsequent Earnings: A Study of British Men 1984–94* (Oxford: Centre for Economic Performance and Institute of Economics and Statistics, 1997).

4 Wiji Arulapalam, Paul Gregg and Mary Gregory, “Unemployment Scarring”, *The Economic Journal* 111 (2001), 582.

5 Stephen Evans et al., *Anglo-Flexicurity: A Safety Net for UK Workers* (London: Social Market Foundation, 2008), 6.

Fast forward a year, and the overall picture has moved on dramatically. The UK economy has entered a downturn and, at the time of writing, nobody is able to predict when the current economic turbulence will end. The most recent forecasts from the IMF suggest that UK output will shrink by 4.1% this year and that it will fall again in 2010.⁶ For workers, fears about losing jobs are becoming alarmingly real, with few professions proving to be recession-proof. In the financial sector, lending has dried up, house prices are collapsing and easy access to credit has become a thing of the past. It is difficult to find any kind of silver lining within this universally gloomy scene; but if one does exist, it is the opportunity to be creative about public policy in a time of stretched resources. In short, we must address the challenge of updating an unemployment system designed more than 50 years ago with a twenty-first-century model.

The idea behind Anglo-flexicurity is to explore a social market approach to unemployment protection within this context.⁷ The social market approach involves harnessing the market to achieve more effective solutions to emerging public policy challenges, of which the protection gap is a good example. It is about recognising the potential of markets to deliver positive economic and social outcomes, but acknowledging that market solutions do not necessarily arise spontaneously. Often, state involvement is needed to help overcome market failures and allow effective solutions to operate.

This report explores the potential of a national, privately provided unemployment insurance scheme to offer a way of combating individual insecurity and risk, and of better securing livelihoods in the long term. It is a follow-up to the previous report and looks at the costs of implementation of the scheme. It draws on international comparisons and suggests an approach that would help those who

6 International Monetary Fund, *World Economic Outlook: Crisis and Recovery* (Washington: IMF, 2009), 10.

7 Throughout the text, "Anglo-flexicurity" is used to denote the concept as a whole; unemployment insurance (UI) refers to the specific product that Anglo-flexicurity is designed to provide.

are increasingly at risk, and who are the least well protected by existing state safety nets.

REVISITING THE PROTECTION GAP

In recent years, more and more people and institutions – including, recently, the British government⁸ – have begun to recognise that the growing personal protection gap is a problem that needs to be addressed. According to a recent study from the Association of British Insurers (ABI), a protection gap emerges “when households do not have sufficient insurance or other coping strategies to match the loss of income resulting from unemployment, illness or loss of life.” Accordingly, “the protection gap can be defined as the shortfall of actual income to required income, after considering insurance, savings, second incomes and other forms of financial support such as state or employer benefits.”⁹

This shortfall is a result of changing trends in the way we live, work and spend our money. And, perhaps perversely, it was a consequence of 10 years of increasing consumer confidence. In a 2006 report on the subject, Scottish Widows noted that “Britain is in the middle of a spending boom,” and that “between 1994 and 2006 the level of UK household debt has tripled from £400 billion to over £1.2 trillion which equals nearly £50,000 for each household.”¹⁰ Why did this happen? Because a healthy labour market has meant more disposable income, rising house prices and a willingness to incur higher levels of personal debt.

At the same time, a flexible, growing economy until recently gave lenders the confidence to increase personal lending, catalysed by an

8 For example, ABI Assistant Director of Health and Protection Nick Kirwan said in January 2009: “We are pleased that the Government has acknowledged the growing protection gap in the UK.” See Nick Kirwan, “Association of British Insurers”: www.abi.org.uk/Newsreleases/viewNewsRelease.asp?nrId=17158.

9 Association of British Insurers, *Coping With the Crises: Household Protection Needs* (London: ABI, 2008), 6.

10 Scottish Widows, *Scottish Widows UK Protection Report* (Edinburgh: Scottish Widows, 2006), 2.

explosion in structured financial products. In retrospect, this was a noxious mix, based on a combination of collective overconfidence and unregulated financial innovation. Yet it is this mix that has precipitated a consumer boom of unprecedented proportions.

The UK housing market was symptomatic of this surge in financial confidence. Before 2007 it appeared to be in rude health, delivering consistent returns to investors, and consistently rising prices for homeowners. Despite often prohibitively high prices, homeownership remained desirable and – crucially – possible, through the extension of cheap credit to potential investors. As US economist Robert Shiller has argued, this was a classic “bubble”:

During a housing price bubble, homebuyers think that a home that they would normally consider too expensive for them is now an acceptable purchase because they will be compensated by significant further price increases. They will not need to save as much as they otherwise might, because they expect the increased value of their home to do the saving for them. Furthermore, the expectation of large price increases may have a strong impact on demand if people think that home prices are very unlikely to fall, and certainly not likely to fall for long, so that there is little perceived risk associated with investment in a home.¹¹

Throughout the bubble years, people took on increasing financial liabilities without ever realising the extent of the risk associated with them. Inevitably, this has precipitated a failure to properly insure against these risks. While some recognised the risks associated with financial vulnerability,¹² there was a failure on a number of levels to mitigate against them. In 2004, for example, a report published by the

11 Robert J. Shiller and Karl E. Case, “Is There a Bubble in the Housing Market?”, *Brookings Papers on Economic Activity* (2004).

12 See Janet Ford, Deborah Quilgars and Roger Burrows, *Homeowners, Risk and Safety Nets: Mortgage Payment Protection Insurance (MPPi) and Beyond* (London: Office of the Deputy Prime Minister, 2004); Mark Stephens, Mike Dailly and Steve Wilcox, *Developing Safety Nets for Home Owners* (York: Joseph Rowntree Foundation, 2008).

Office of the Deputy Prime Minister warned that “borrowers face a range of risks that may impact on their ability to sustain homeownership. Unless managed by an effective safety net, mortgage arrears and possession may follow.”¹³

Despite this recognition, however, homeownership – and the mortgage lending that underpins it – has been actively encouraged by the government since the late 1970s, and actively sought by British workers. According to the Joseph Rowntree Foundation, almost 70% of British households are homeowners¹⁴ – perhaps the apex of an aspirational trend that was accelerated during the mid-1980s by the Thatcher government. And although the remaining 30% of non-homeowners may not be exposed to these high levels of mortgage debt, the overall debt to disposable income ratio continued to rise through 2007, according to government figures.¹⁵

It is worth remembering here that it is not only homeowners who are facing increased financial vulnerability. This is reflected in the aforementioned ABI report, which breaks down the protection gap according to three distinct strands:

- the Debt Gap – the cost of servicing debt;
- the Essentials Gap – the cost of essential expenditure such as rent, food and heating;
- the Lifestyle Gap – the cost of maintaining the current standard of living, including activities such as socialising, holidays and saving.¹⁶

13 Ford, Quilgars and Burrows, *Homeowners, Risk and Safety Nets*, 5.

14 Stephens, Dailly and Wilcox, *Developing Safety Nets for Home Owners*, 12.

15 Department for Business Enterprise and Regulatory Reform, *Household Debt Monitoring* (London: BERR Consumer and & Competition Policy Directorate, 2007), 5.

16 Association of British Insurers, *Coping With the Crises*, 6.

Clearly then, financial vulnerability is about more than just mortgage repayments, even if this has been the principal media focus.¹⁷

In addition, the current economic climate has led to increased concerns over financial vulnerability. In late 2008, the Genworth Index reported that “the proportion of people who expected the financial position of their household to get worse within the next 12 months more than doubled in 2008 compared with 2007,” from “14 to 32 percent.”¹⁸ Although Europe-wide, the survey generally reflects public sentiment in the UK, where only 8% of people felt “financially secure,” compared with 22% who felt financially vulnerable.¹⁹

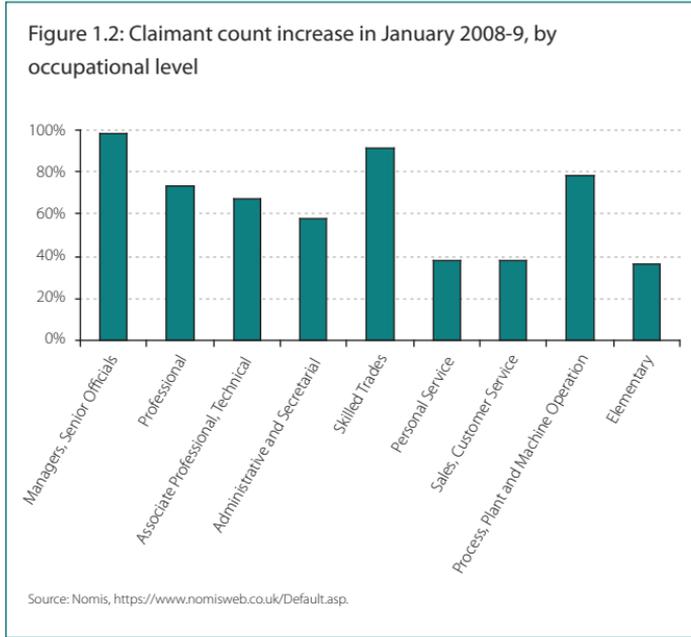
It appears that, a year on from our previous report, the protection gap is a bigger issue than ever for British workers. The economic crisis has brought two new developments, however. First, financial vulnerability is now a state for millions, not just a possibility. As unemployment figures show, more people are losing their jobs and, at the time of writing, there is little evidence within the UK’s economic trajectory of an imminent change to this picture. Second, the demographics of unemployment are changing. We are seeing people losing jobs across the professional spectrum and throughout the salary range. Figure 1.2 shows how there has been a disproportionate increase in Jobseeker’s Allowance (JSA) claims from people in higher skilled occupations over the past 12 months – with only the construction industry (represented by “Skilled trades” and “Process, plant and machine operatives”) breaking the downward trend from the (high-skilled) left to (lower-skilled) right of the figure. This is a qualitative shift from previous recessions, when the initial victims were those in industrial jobs and those on low incomes. This necessitates a

17 The government has also put considerable resources into preventing mortgage default. See, for example, HM Treasury, *The Homeowner Mortgage Support Scheme* (London: HM Treasury Press, 2008).

18 “The Genworth Index: Measuring Consumer Financial Vulnerability in 12 European Markets”, *Genworth Financial* (2008), 7. Note that this is a Europe-wide figure, based on a survey of 12 European countries.

19 *Ibid.*, 8.

similarly qualitative shift in the way we think about unemployment, and a rethink of the safety nets currently available.



RE-EVALUATING THE UK'S SAFETY NETS

Anglo-flexicurity: A safety net for UK workers argued that existing unemployment safety nets were, for many, increasingly inadequate. State benefits have, it argued, been very successful in incentivising people back into work by offering only minimal out-of-work financial support; but, for many, this can come at the cost of a “permanent pay penalty” and a potentially increased likelihood of losing another job in the future.²⁰ Among the most affected are those professionals earning a mid- or high-level salary, as they face a huge drop in income if they become unemployed.

²⁰ Evans et al., *Anglo-Flexicurity*, 29.

Of course, many of these professionals can afford to create their own safety nets through privately provided protection insurance (PI). This can be linked to a variety of triggers such as loans and credit, or accident, health and life cover. The report found, however, that serious issues undermine the current market for PI, which is reflected in a relatively low general take-up rate across the genre.²¹ The market is crowded, confusing and overlapping – making it difficult for people to insure themselves comprehensively, and at reasonable cost.

The upturn in unemployment has, to an extent, acted as a catalyst to public debate on the type and level of safety nets available.²² One good example is a recent discussion in the *Observer*, which asked the question: “Should redundancy protection be compulsory for mortgage holders?” A representative of the insurance industry argued that payment protection insurance (PPI) could “wipe the slate clean” in the event of unemployment, providing “the one measure that can prevent families from sinking further into debt.” It should therefore be made compulsory for those taking out a mortgage. The consumer rights group *Which?* argued against this, rejecting the idea of a one-size-fits-all approach, and highlighting the “overpriced” nature of PPI.²³

The interesting point here is that both sides of the debate highlight the need for a greater awareness of personal risk, and adequate protection against it. Public debate has moved on: we now argue not whether the protection gap (or, in a broader sense, financial vulnerability) is becoming an issue, but how it should best be addressed in the future. This surely reflects a growing understanding within the wider public sphere about the nature of risk, and the balance of power and responsibility between individuals, financial

21 *Ibid.*, 39.

22 Janet Ford and Deborah Quilgars, “Falling Home Owners? The Effectiveness of Public and Private Safety Nets”, *Housing Studies* 16:2 (2001).

23 “*Observer Money: Question of the Week: Should Redundancy Protection Be Compulsory for Mortgage Holders?*”, *Observer*, 18 January 2009.

institutions and the state. UK commentator Will Hutton advocates for greater awareness in this area, urging that greater creative thinking is needed to “reduce decisively the risks [we] confront.”²⁴

At the heart of this creative thinking will be the relationship between the state and the private sector. And already, some commentators are realising that traditional ideological divides over the form and function of social security are disappearing. A good example of this is a recent article by Tim Harford in the *Financial Times*, in which he argues:

[T]o most thoughtful people, unemployment benefit embodies a painful trade-off. It's the mark of a civilised society, clubbing together to provide assistance to those in need. It is also, regrettably, an incentive to remain unemployed. ... It is particularly pernicious if the skills of the jobless decay, and unemployment becomes unemployability.

This is a fairly traditional perspective, based on tacit agreement between providing a safety net for those who most need it, and encouraging people to rejoin the labour market as quickly as possible. The current economic climate challenges this viewpoint, however. When re-employment is both more difficult and potentially less financially rewarding, there is an even more painful trade-off. As Harford notes:

[U]nemployment benefit does not merely pay people to stay out of work; it also protects them from rushing into an unsuitable job. It is nothing to celebrate if unemployed engineers cannot afford to spend three months finding a job for which they are qualified, but are forced to work as estate agents to put food on the table.²⁵

24 Will Hutton, “Heed the Visionaries Who Can Ease the Pain of Recession”, *The Observer*, 30 November 2008: www.guardian.co.uk/comments/free/2008/nov/30/recession-credit-crunch-economy.

25 Both quotes from Tim Harford, “Is Unemployment Benefit a Good Thing After All?”, *Financial Times*, 6 December 2008. For an interesting discussion on the effects of over-qualification on the labour force (a potential consequence of “bumping down” due to increasing unemployment), see Malcolm Brynin, “Overqualification in Employment”, *Work, Employment & Society* 16:4 (2002).

The quotation demonstrates that perceptions of what a safety net does (and should do) are changing. For skilled professionals working in specific types of jobs, there is a need for assistance through periods of unemployment that do not necessarily impose pay penalties, or fundamentally alter carefully developed careers and livelihoods.²⁶ Yet it is equally clear that the responsibility for this cannot solely fall on the state. Existing welfare schemes are designed with the most needy (and thus the lowest earners) in mind, and this should remain the case. More generous protection across the board would impose a heavy financial burden, especially during periods of economic downturn. It would also suffer from problems of free-riding – constituting potentially huge moral hazard problems.

At the same time, we must recognise the inadequacy of existing private sector solutions to the problem. Insuring oneself against loss of income is currently a process set within a flawed market, offering inadequate choices to consumers. What is now increasingly imperative is an approach that keeps in mind the original values and compromises of the UK unemployment benefit system, but that explores ways in which its safety can be enhanced to reflect the dynamics of a new economic environment.

A SOCIAL MARKET APPROACH TO UNEMPLOYMENT INSURANCE

It is within this context that this report proposes a new approach to unemployment insurance. A social market approach maintains that market mechanisms constitute a powerful way of delivering public goods, but also that, unless those mechanisms are appropriately limited or supplemented, they are prone either to fail or to generate unacceptable outcomes. The government should thus play a key role in facilitating the effective working of markets, helping to unblock market failures and provide proper regulatory frameworks.

26 For a discussion of the positive effect of unemployment insurance on future job stability, see Konstantinos Tatsiranos, "Unemployment Insurance in Europe: Unemployment Duration and Subsequent Employment Stability", IZA Discussion Paper No. 2280 (2006).

A social market approach can draw on more than 15 years of thinking on issues of unemployment and the welfare state. In 1993, for example, Robert Skidelsky argued that the time was right for an approach to UK unemployment that moved beyond the antagonisms of the 1980s: represented, on the one hand, by a Thatcherite policy that would “free up markets as much as possible and accept whatever level of employment and unemployment they ground out,” and, on the other, by a goal of full employment that “was identified with lax monetary and fiscal policies and unworkable incomes policies.” The way ahead was, he argued, “the reinstatement of full employment as a goal of economic policy; a full employment pursued not by Keynesian demand expansion but by active supply side policy.”²⁷ This approach arguably formed a key aspect of inter-party consensus on the issue until the recent economic crisis.

Social market thinking has also focused on the relationship between labour market flexibility and individual financial security. In a 1997 SMF paper, David Smith argued that, within the context of a changing labour market, policymakers should look to build upon and work around increased flexibility, rather than “turning the clock back, in the belief that reintroducing inflexibilities into the labour market would produce a warm glow of security.”²⁸ The sentiment is far-sighted, even if some of Smith’s policy recommendations are now showing their age.²⁹

Anglo-flexicurity sits within this tradition, arguing that neither a statist nor a free market approach is adequate, or even possible. What should be foregrounded instead is a strategy that seeks to address inadequacies within both state and market safety nets, unpicking their

27 Robert Skidelsky and Liam Halligan, *Beyond Unemployment*, Social Market Foundation Occasional Paper No. 5 (London: Social Market Foundation, 1993), 5.

28 David Smith, *Job Insecurity Versus Labour Market Flexibility*, Social Market Foundation Contributions to Policy No. 2 (London: Social Market Foundation, 1997), 37.

29 Opposing the minimum wage and the implementation of European work-time directives, for example.

key failures and proposing a systematic, joined-up approach. It is already clear that the state benefit system can no longer fulfil the role ascribed to it in 1946. We should therefore look to other things the state can do to allow the market to provide a solution to the protection gap.

In 2008, *A Safety Net for UK Workers* introduced some areas in which structural and operational issues have inhibited the development of an effective unemployment insurance marketplace. One such area involves individual behaviours; other structural failings include market complexity, the lack of a point of sale for a comprehensive insurance product and information asymmetries. It is worth considering these barriers in turn.

Accounting for individual behaviour

The central paradox that originally informed this research was one of labour market strength versus individual insecurity. At a time of steady growth, consumer and lender confidence increased, which meant that people had more to lose should things go wrong. It is obvious that, for skilled professionals at least, state benefits would provide little protection in this eventuality – so why have more people not insured themselves privately?

Structural problems within payment and income protection insurance (PPI and IPI) markets are very much to blame, but also in evidence are the adverse effects of consumers' own behaviour. There are numerous examples. On the one hand, a complex marketplace can induce "choice overload," whereby people are put off by the sheer volume of choices in front of them. As a result of this, consumers can fall prey to overpriced products as a result of inertia-selling; or they simply stay out of the marketplace altogether. As the SMF report noted, a "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.³⁰

Coming to terms with this is part of a wider understanding of how individuals behave within public life. This was the subject of a major SMF report published in 2008 on behavioural change, which noted that:

[The idea of] “rational economic man” ... has informed economic thinking throughout the twentieth century, and ... operates on the presumption that the behaviour and choices of individuals can be modelled as if individuals are rational maximisers of self-interest, making considered decisions, based on the financial resources and information available to them.³¹

This is patently not the case in many circumstances. Individuals make choices as a result of frustration and misunderstanding as well as with a clear, rational head. This can lead to a failure to make good long-term decisions, but also to get to the point of decision-making in the first place. As our earlier publication observed, individuals are prone to “discount the future too heavily (sometimes known as hyperbolic discounting) meaning that they often make sub-optimal financial decisions.”³² Many people therefore do not insure themselves simply because they underestimate future risks – though these sentiments are changing within the current economic climate.

Addressing structural failings in the insurance marketplace

Our earlier report identified three major structural reasons why the market has failed to provide adequate protection for UK workers. First,

30 Evans et al., *Anglo-Flexicurity*, 57.

31 Jessica Prendergrast et al., *Creatures of Habit? The Art of Behavioural Change* (London: Social Market Foundation, 2008), 18.

32 Evans et al., *Anglo-Flexicurity*, 51. The quote references Richard Thaler and Shefrin Hersh, ‘An Economic Theory of Self-Control’, *Journal of Political Economy* 89:2 (1981).

and related to the behavioural issues above, is the issue of complexity. The PPI marketplace is diverse, covering a range of payments (for example personal loans, credit cards, mortgage payments), with a multitude of terms, conditions and special offers. Often there is overlap between insurances, and inconsistencies across comparable products. This makes it difficult for people to insure themselves affordably, with multiple policies pushing up costs.

The more financially literate are better able to negotiate their way through this marketplace, but even this is not a guarantee against bad selling and other structural factors. The market displays a lack of competition in key areas, and there is no obvious point of sale and source of information to help people to insure themselves comprehensively. This is because insurance products are frequently sold alongside credit, leading to PPI especially being “a product that is generally sold to customers, rather than one they actively choose to buy.”³³

Second, a lack of competition at the point of sale has been a driver of multiple campaigns and investigations into PPI over recent years.³⁴ Most recent findings from the Competition Commission support the notion that market failure exists in this area:

[W]e concluded ... there was a point-of-sale advantage associated with selling PPI combined with a credit product. ... This means that providers of stand-alone PPI without access to consumers at the point of sale are at a competitive disadvantage.³⁵

Selling PPI alongside credit is a “hook” that does not exist in the same way for commercial unemployment insurance products. As a result,

33 Financial Services Authority, *The Sale of Payment Protection Insurance: Thematic Update* (London: FSA, 2007), 10.

34 The most high-profile of these is probably Which?, “Campaigns – Payment Protection Insurance: About the PPI Campaign”: www.which.co.uk/campaigns/payment-protection-insurance/about-the-ppi-campaign/index.jsp.

35 Competition Commission, *Market Investigation into Payment Protection Insurance* (London: The Stationary Office, 2009), 9.

people are more likely to protect specific payments and neglect income protection. This is arguably to their financial detriment in some cases.

The third major structural market failing is the problem of adverse selection. This occurs as a result of asymmetric information, between insurer and insuree. This phenomenon occurs when the most high-risk individuals cause insurance premiums to be pushed up across the board, pricing lower-risk people out of the market. This leads to a rise in costs, thereby further driving more people out of the market, until ultimately it collapses. The process is triggered when “firms have difficulty judging the riskiness of those who demand insurance coverage”³⁶ – for instance, offering insurance cover to people in high-risk jobs, without realising they are so volatile. The spate of redundancies in the UK banking sector during 2008 illustrates how this can occur unexpectedly.

There are many different ways of assessing risk in commercial insurance schemes. For example, health insurers would look at existing medical conditions and motor insurers would look at previous behaviour and claims. Unemployment insurance is more difficult to price, as the policy is based not only on the characteristics of the customer, but also on the risk of external impacts on the given employment sector. This makes asymmetric information – and therefore adverse selection – more of a pressing issue.

PROTECTING INDIVIDUALS WITHIN A FLEXIBLE LABOUR MARKET

Anglo-flexicurity must address these problems in a way that dovetails with existing British welfare and labour market policies. It must offer better financial protection, without running against the grain of a

36 Robert Puelz and Arthur Snow, “Evidence on Adverse Selection: Equilibrium Signalling and Cross-Subsidization in the Insurance Market”, *Journal of Political Economy* 102:2 (1994), 237.

flexible labour market and a welfare system that relies on numerous, interconnected back-to-work incentives. As David Smith noted in 1997, this has been a challenge for policymakers for some time:

Kenneth Clarke, the [then] Chancellor of the Exchequer, set out in his Mais lecture in 1994, his ambition of combining European-style welfare protection with a US – style flexible labour market. The question is whether the two are, or can ever be, compatible.³⁷

This report picks up the baton in meeting this challenge. And, ultimately, it argues that combining better welfare protection with a flexible labour market *should* be possible. Rather than dramatically increasing the welfare burden for the state, however, an alternative solution is to be found in a social market approach. This looks to unblock market failures and provide a proper framework for action, combining the resources and expertise of the insurance industry with the regulatory checks and balances government can provide.

ANGLO-FLEXICURITY: INSURING AGAINST UNEMPLOYMENT IN THE UK

Our previous report set out a broad framework for a new national unemployment insurance scheme. The following points recap and expand upon this:

- *A national unemployment scheme for UK professionals:* Anglo-flexicurity is a comprehensive unemployment insurance (UI) scheme, designed to protect people for whom existing state and private safety nets are inadequate. It is aimed at (but not exclusively for) skilled professionals, addressing market complexity by offering a single, affordable and comprehensive means of insuring against

37 Smith, *Job Insecurity Versus Labour Market Flexibility*, 36.

loss of income. It does this by suggesting a “joined-up” solution to the bottlenecks discussed above – caused by a variety of market failures and human behavioural biases.

- *A scheme that automatically enrolls its members:* Anglo-flexicurity should benefit as many UK employees as possible, and in the most affordable way. Auto-enrolment would “thicken” the membership base, which is key to pooling risk and thus reducing the overall cost of insurance premiums. The auto-enrolment scheme would include individuals earning annual salaries of between £27,000 and £60,000.³⁸ Employers would be the conduit for this, triggering enrolment through a central clearing house. From this point onwards, UI would be portable, a contract between the individual and the insurer that develops according to personal circumstances.
- *A scheme that would offer generous protection over a suitable duration:* Anglo-flexicurity is designed to give unemployed individuals the time and the means to get back into the job market at the right level – in a position commensurate with their skills and experience. The scheme would offer a default package for simplicity, comprising a benefit of 60% of previous salary for a period of 6 months, beginning 31 days following the date of unemployment.³⁹ Providers would be free to offer variations on the default product after individuals had enrolled in the scheme.
- *A scheme that offers tax incentives to its members:* Anglo-flexicurity would offer tax relief on individuals’ premium

38 This is the target audience for two main reasons. First, those with higher incomes are often at risk due to larger mortgages and financial liabilities. Second, because these larger monthly outgoings, higher salaried employees will be less well protected by existing state benefits. A £27,000–£60,000 band has been selected here to reflect market research suggesting that this is currently the most pertinent protection gap. It is also clear that – while this might be possible in practice – extending the upper salary band in our model would make the scheme appear unaffordable to lower/medium earners. See *Scottish Widows, Scottish Widows UK Protection Report*; Evans et al., *Anglo-Flexicurity*, 44–5.

39 According to the Work Foundation, there is a “compelling case for some increase” in out-of-work benefits, “perhaps moving to 60 percent of net earnings in work”. See Ian Brinkley et al., *Hard Labour: Jobs, Unemployment and the Recession* (London: The Work Foundation, 2008), 36.

payments, both as a means to keep costs down for its members, and as a recognition that the UK government would save on unemployment benefit liabilities. This gives individuals the opportunity to pay for their own safety net, without also insuring the Exchequer.⁴⁰ For the state, this effectively means contracting out part of its unemployment benefit system; without necessarily breaking the implicit contract that underpins National Insurance.

- *A flexible set of ideas, offering future solutions for the UK government:* Anglo-flexicurity has the potential to offer multiple benefits to its stakeholders. For the individual, it would offer a simple and affordable safety net. For the government, it offers a cost-effective way of addressing a growing problem, as well as providing macroeconomic benefits by strengthening automatic stabilisers during future economic downturns. There are also microeconomic benefits from the scheme. It would facilitate better matching of the right professionals to the right jobs, with attendant productivity benefits.

There are clear benefits to proposing Anglo-flexicurity, but there are also many questions to answer about its implementation. This report argues that its stakeholders may have much to gain, and we can be optimistic about the idea in many senses. Researching new policy ideas inevitably throws up as many challenges as solutions, however, and questions over the viability and affordability of the scheme have provided a counterpoint throughout the research process. In this case, the challenge is to show how potential benefits for the UK workforce as a whole will impact upon stakeholders on a personal level. And overall, the question is how to turn the private

⁴⁰ This is different from the terms of the current private UI and IPI marketplace. Premiums are generally paid from taxable income, and benefits count as tax-free income. So, if people are paying tax on the "way in", the potential benefits come tax-free.

insurance approach into a workable reality – to maximise the benefits, and minimise the problems.

The remainder of this report will explore how this might be done. It will ask how a national unemployment insurance scheme might be designed and regulated, and how much it would cost for the stakeholders involved. It first of all directly addresses the comments made by Kenneth Clarke mentioned above, with a comparative analysis of European and US approaches to unemployment and social protection. It will then look to apply these lessons to a UK context, suggesting ways in which Anglo-flexicurity could address the protection gap, while recognising the myriad challenges involved in doing so.

CHAPTER 2: COMPARATIVE APPROACHES TO UNEMPLOYMENT AND LIVELIHOODS

This chapter offers some comparative perspectives on unemployment insurance and social security. It looks first at European approaches to flexicurity, followed by some contemporary American thinking on issues of unemployment, personal financial risk and protection of livelihoods. The chapter will pay particular attention to the Danish model of unemployment insurance, which our previous publication suggested could provide inspiration for UK thinking. The Danish model is widely held as a European success story, combining a strong and flexible labour market (FLM) with generous benefits and active labour market policies (LMPs). This is part of a golden triangle that will be explored in greater depth below.

US approaches to welfare and social security are qualitatively different from their European counterparts. Unemployed American workers have historically been offered less unemployment support – in terms of benefits, re-skilling and incentives to return to work. This is a gap currently being explored in innovative ways by three high-profile scholars – Robert Shiller, Jacob Hacker and Raj Chetty – whose work will be introduced later in the chapter.

It is clear that Anglo-flexicurity can learn from these different approaches. The Danish model provides evidence of what works within a European context, and shows how the state and private sector can interact effectively. US literature, meanwhile, offers some contemporary thinking on increased personal financial risk – and ways to combat this within a huge and very flexible labour market. Comparing these approaches gives us the opportunity to frame Anglo-flexicurity within current and ongoing public policy debates, and to let existing solutions inform our own policy development process.

THE CONCEPT OF FLEXICURITY

Flexicurity is currently at the forefront of European thinking on labour market and social security reform. According to the European Commission, the concept is “about striking the right balance between flexible job arrangements and secure transitions between jobs so that more and better jobs can be created. The idea is that flexibility and security should not be seen as opposites, but as complementary.”⁴¹

Flexicurity reflects the imperatives of Europe’s globalised economies – in which companies must be responsive to changing international conditions and changing international demand. Mobility of capital between one use and another is vital for a productive economy, but this flexibility of resources implies insecurity for employees. And while a flexible labour market might produce better job prospects in the medium term, this can come at the cost of great personal upheaval and an increased sense of insecurity.

Flexicurity approaches therefore attempt to mitigate the human costs associated with a globalised, flexible market economy. They look to protect people in employment through better training and development schemes, and support people who lose their jobs by offering generous benefits combined with active labour market policies.⁴² So, on the one hand there is a focus on fostering dynamic and responsive industries; on the other, a recognition that the by-products of such a focus must also be considered. Proponents of this approach argue that the costs of implementing flexicurity schemes – principally the costs of unemployment benefit – are outweighed by the benefits. These are said to include “enhanced labour market dynamism, higher employment and productivity.”⁴³

41 European Commission, Directorate-General for Employment, Social Affairs and Equal Opportunities, *Towards Common Principles of Flexicurity: More and Better Jobs Through Flexibility and Security* (Luxembourg: Office for Official Publications of the European Communities, 2007), 12.

42 These include retraining and incentive schemes to re-enter the labour market.

43 European Commission, Directorate-General for Employment, Social Affairs and Equal Opportunities, *Towards Common Principles of Flexicurity*, 24.

A EUROPEAN MODEL

The principles of flexicurity represent a distinctively European consensus, based on the idea of a strong social contract between the state and the individual. As Per Kongshøj Madsen has noted, this has evolved gradually over time. It is “not the result of a well-defined grand scheme, but the outcome of a long historical development with strong elements of path dependency.”⁴⁴ What this means is that a series of negotiated deals between social partners that are vital to flexicurity are already part of public discourse, such as high taxation versus generous social security, or easy “hiring and firing” versus active re-employment strategies.

This level of “mutual trust”⁴⁵ allows people more willingly to accept enforced changes in their careers, as they are compensated through access to a high level of unemployment benefit and a suite of initiatives designed to help them get back into work. For employers (who must help pay for these initiatives) a well-trained and readily available workforce provides adequate compensation in itself.

As one would expect, variations in flexicurity approaches exist around Europe. In Austria, for example, a severance pay system is in effect one in which employers contribute to an employee account that can be drawn from in the event of unemployment. In Sweden, career transition agreements have been put in place that offer “counselling, guidance and career reorientation”⁴⁶ to help get people back into work. In Belgium, career breaks are encouraged that “improve people’s work-life balance and . . . give them a chance to upgrade their skills and retrain.”⁴⁷ Each of these schemes corresponds to a unique national system of economic planning and social provision, but the

44 Per Kongshøj Madsen, “How Can It Possibly Fly? The Paradox of a Dynamic Labour Market in a Scandinavian Welfare State”, CARMA Research Paper, 2 (2005), 8.

45 Ton Wilthagen and Frank Tros, “The Concept of ‘Flexicurity’: A New Approach to Regulating Employment and Labour Markets”, *Transfer, European Journal of Labour and Research* 10:2 (2004), 178.

46 European Commission, Directorate-General for Employment, Social Affairs and Equal Opportunities, *Towards Common Principles of Flexicurity*, 21.

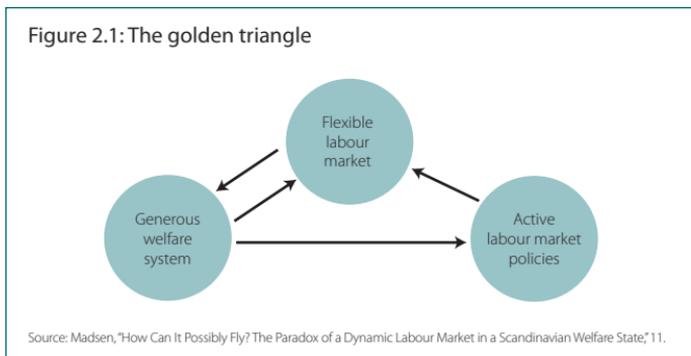
47 *Ibid.*, 15.

commonalities are clear: they all attempt to smooth the transition between unemployment and work, and back again.

Although the concept of flexicurity is Dutch in origin, the most widely cited case study is the Danish model. Its success is, according to Madsen “due to its unique combination of flexibility, social security and active labour market programmes.”⁴⁸ These are commonly represented as a “golden triangle” (see figure 2.1):

- Flexible labour market: this is characterised by a high volume of people moving in and out of employment, reflecting a high turnover and an economy responsive to economic trends.⁴⁹
- Active labour market policies (ALMPs): these are policies that assist and retrain newly unemployed workers. They also provide strong incentives to get back into work quickly, through compulsory job-search programmes.
- Generous welfare system: this provides a relatively comprehensive safety net for unemployed workers, at a high salary replacement rate over a long period.

The arrows represent the likely path of a Danish worker – i.e. from employment to welfare, then back into employment either immediately, or via training and ALMP programmes.



48 Madsen, "How Can It Possibly Fly?" (author's original italics and brackets removed).

49 This is called "high external numerical flexibility" in the literature.

Comparison of the Danish model with the UK is instructive. Both Denmark and the UK have relatively strong and flexible labour markets, but the divergence between levels of welfare support, particularly for childless individuals, is huge. In Denmark, a worker might expect unemployment benefit to replace up to 90% of his or her salary, for a period of up to four years (see table 2.1). In the UK, the average figure is much less, according to a recent report from the Bevan Foundation:

The UK has very low levels of expenditure on social security and on labour market policies [and] ... welfare benefits are below those of many other EU member states. In terms of active labour market policies, the UK spends just 1% of GDP, a proportion matched only by Bulgaria and Romania and well below that spent by countries such as Denmark, where 4.9% of GDP is allocated to employment support programmes.⁵⁰

Table 2.1: Unemployment insurance across Europe

Country	Denmark	Sweden	Germany	UK
Type	Voluntary	Voluntary	Compulsory	Compulsory
Number of Funds	32	37	1	1
Monthly Membership Contribution € (1)	55	11	96	240 (12)
Net Replacement Rate (%) (2)	61	77	61	45
Maximum Entitlement Period (3)	4 years	600 days	12/18 months	6 months
Coverage Ratio (%) (4)	83	85	68	86
Recipient Ratio (%) (5)	85	85	47	20

Source: Jochen Clasen and Elke Viebrock, "Voluntary Unemployment Insurance and Trade Union Membership: Investigating the Connections on Denmark and Sweden," *Journal of Social Policy*, 433–51. See footnote for explanation of figures.⁵¹

50 Bevan Foundation, *My Job, My Future: Summary of a Dialogue With Young Workers on Flexicurity in a UK Cohesion Region* (Tredegar: Bevan Foundation, 2008), 5.

51 [1] UK figure is "total NI contribution for somebody earning an average weekly full-time salary in the private sector", based on DWP and HMT figures. [2] Figure is for a single person. [3] includes activation periods; [4] portion of the labour force covered by UI; [5] recipients of UI as share of all unemployed. For a full breakdown of how these figures have been calculated, see Jochen Clasen and Elke Viebrock, "Voluntary Unemployment Insurance and Trade Union Membership: Investigating the Connections on Denmark and Sweden," *Journal of Social Policy* 37 (2008), 438.

Underpinning the British model is fairly broad political agreement that an active labour market needs strong incentives – so that if people become unemployed, they are encouraged and actively helped back to work as quickly as possible. Low benefit levels are necessary to strengthen work incentives and are complemented by a raft of ALMPs that have been progressively developed over the past decade.

What the Danish model shows is that the combination of low salary replacement levels and ALMPs need not necessarily be the only way to sustain a flexible labour market. Indeed, for high-skilled people, very low replacement rates can be detrimental to both the individual and the economy as a whole. Strong incentives to get back to work as soon as possible in whatever job happens to be around discourage people from taking the time to find an appropriate job match, thereby exacerbating the chances that an individual will face a pay penalty. By contrast, offering newly unemployed people comprehensive protection and re-skilling can have positive micro- and macroeconomic benefits. The following section will explore how the Danish model achieves this – crucially, with a role for both the state and the private sector.

DANISH UNEMPLOYMENT INSURANCE

The Danish model employs a system of unemployment insurance combining state and private sector resources. It is built around a series of “member controlled, private unemployment funds” – commonly called *A-kasse* – which are “tightly regulated” and heavily subsidised by the government.⁵² Unlike other forms of social security in the country, unemployment insurance is voluntary. To receive any benefits in the event of unemployment, workers need to have been enrolled in a fund for at least a year, and to have worked for at least 52 weeks within the previous three years. In return for this commitment, up to 90% of

52 Donald O. Parsons, Torben Tranaes and Helene Bie Lilleor, *Voluntary Public Unemployment Insurance*, CESIFO Working Paper No. 1010 (London: CESIFO, 2003), 46. *A-Kasse* are subject to random audits and annual checks from regulators, and financial links between unions and funds are carefully scrutinised.

previous salary may be claimed up to a DK3,515 (£427) limit per week,⁵³ for a maximum duration of four years.

The system is sustained by high enrolment rates across professions. unemployment insurance (UI) has historically been administered through trade unions, and fund membership reflects high unionisation across most sectors of the Danish labour market. According to 2007 figures, for instance, national insurance fund membership and unionisation rate both stood at between 80 and 85%.⁵⁴ Despite the fact that union-fund links have been progressively liberalised since the 1980s⁵⁵ (so that UI need no longer be specific to profession, and union membership is not a prerequisite for joining a fund), fund membership levels remain high. This volume of membership allows a state subsidy – member contribution ratio of approximately 2:1 at current levels of unemployment,⁵⁶ so individuals are effectively subsidising approximately one-third of their own benefit.⁵⁷

BOX 2.1: UNIONISATION AND UNEMPLOYMENT INSURANCE

There is a substantial literature emerging on the relationship between unionisation rates and unemployment insurance fund membership in Europe. This focuses on the strong correlation between voluntary UI schemes – known as Ghent systems – and national union membership.⁵⁸ In fact, comparative European data shows that the three countries still maintaining a Ghent system – Sweden, Denmark and Finland – have

53 "Social Security Programmes Throughout the World": www.ssa.gov/policy/docs/progdesc/ssptw/2008-2009/europe/denmark.html.

54 Leif Christian Hansen, *Inside the Black Box of Denmark's Flexicurity* (Dublin: National Economic & Social Council, 2007).

55 Parsons, Traaen and Lilleor, *Voluntary Public Unemployment Insurance*, 5.

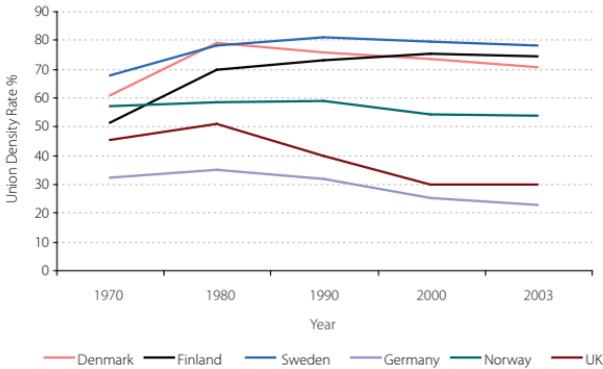
56 Based on personal communication with Danish insurance provider.

57 Note that individual membership fees can also be set against tax. See Clasen and Viebrock, "Voluntary Unemployment Insurance and Trade Union Membership", 442.

58 It is worth noting that high unionisation rates are a product of several factors, not just UI regimes.

maintained distinctively high unionisation rates, withstanding the general trend of a diminishing relevance of trade unions elsewhere in Europe.⁵⁹ Those countries (like the UK) with compulsory UI exhibit far lower levels of unionisation, as figure 2.2 shows.

Figure 2.2: Union density rates across Europe



Source: Figures adapted from Jochen Clasen and Elke Viebrock, "Voluntary Unemployment Insurance and Trade Union Membership: Investigating the Connections on Denmark and Sweden," *Journal of Social Policy*, 435.

Interestingly, the correlation between unionisation rate and UI take-up has been consistent, despite progressive liberalisation, removing the need for workers to be union members in order to access UI. According to Clasen and Viebrock, however, this has not completely removed the association between the two: "The formal separation between trade union and unemployment insurance does not always correspond with public perceptions of unemployment insurance as a component of the total benefit package gained by joining a trade union."⁶⁰

Clearly people still associate UI with union membership – with obvious knock-on benefits for the trade unions in the countries

⁵⁹ Clasen and Viebrock, "Voluntary Unemployment Insurance and Trade Union Membership", 434.

⁶⁰ *Ibid.*, 448.

concerned. There is also a sense that enrolment in UI is linked to union membership in other implicit ways, due to the fact that day-to-day administration and advertising is carried out through these union channels. This may be a case of Michael Lipsky's "street-level bureaucracy" at work, whereby the delivery-level officials can have "wide discretion over the dispensation of benefits or the allocation of public sanctions."⁶¹

Although British unions would have much to gain from the adoption of a Ghent system, the TUC at least is committed to working within the existing compulsory national insurance boundaries.⁶² This makes it unlikely that Danish flexicurity could be replicated in the same way in the UK.

Contemporary Danish UI officially operates as a stand-alone retail product, available from banks and post offices as well as through the traditional union channels. This means that insurance providers can tap into existing channels of communication during their marketing campaigns, and can attract individual members without burdening employers or other third parties. Member–insurer interaction is also well streamlined, with new members initially required to attend a face-to-face meeting, but with subsequent correspondence and administration utilising the internet and mobile technology.⁶³ This contributes to low overheads, as well as being more convenient for members. The ubiquity and ease of enrolment is one reason why take-up remains so high.

Another incentive for members is the *Efterlon* scheme. This is a bolt-on⁶⁴ to unemployment insurance that provides an extra payout upon

61 Michael Lipsky, *Street Level Bureaucracy* (New York: Russell Sage Foundation, 1980), xi. The inference of street-level bureaucracy is in this case from Lyle Scruggs, "The Ghent System and Union Membership in Europe 1970–1996", *Political Research Quarterly* 55 (2002).

62 Based on personal communication with a senior Trade Union Congress (TUC) official.

63 Based on personal communication.

64 Since 1999, this has been an optional extra, requiring a larger membership fee than the UI only package. Between its introduction in 1979 and this point, it was part of the overall *A-kasse* package and was not charged separately.

retirement – providing incentives for workers to make consistent contributions over a long period. According to Parsons et al., *Efterlon* has a significantly positive effect on membership, as it “provides an incentive for all workers over 40 to belong to a fund, and, because of the investment aspect of [fund] benefit eligibility, for younger workers who belong to a fund to remain members despite falling unemployment risk prior to the *Efterlon* pay-in period.”⁶⁵ In effect, long-term members of a UI scheme are rewarded with the opportunity to retire early with benefits equivalent to their previous UI benefits for the first two-and-a-half years, and a flat rate of 82% after that.⁶⁶ For those in less risky professions, *Efterlon* provides an incentive for them to maintain their contributions to a scheme that may otherwise seem unnecessary and expensive. Initially, this was part of the package of UI, offered at no extra cost to members. However, supplementary charges were introduced in 1999, and fewer people now contribute to *Efterlon* as well as UI as a result.⁶⁷ Nevertheless, it remains a strong incentive for people in “safer” professions to sign up for UI.

BOX 2.2: KEY CHARACTERISTICS OF DANISH UNEMPLOYMENT INSURANCE

- Voluntary, privately provided unemployment insurance.
- Combination of state subsidy and individual contributions.
- Strict government regulation of insurance schemes.
- Historical and enduring links with Danish trade unions.
- *Efterlon* scheme for long-term members.

Ultimately, the scheme reflects a culture wherein Danish citizens are prepared to contribute relatively large amounts of their income towards their own financial security in return for a well-defined and

65 Parsons, Tranaes and Lilleor, *Voluntary Public Unemployment Insurance*, 6. The authors note that stringent eligibility criteria apply here, such that an individual “must have been a U-Fund member for 20 out of the last 25 years. ... For someone wishing to retire at 60 that means joining *Efterlon* no later than age 40.”

66 I.e., retiring at 60, rather than 65

67 Clasen and Viebrock, “Voluntary Unemployment Insurance and Trade Union Membership”, 444.

generous set of benefits. This in turn stems from a working culture characterised by constructive relations between the state, trade unions and employers.⁶⁸ The Danish model is unique, yet has significant lessons for the application of flexicurity in the UK. The following section will assess some of these.

WHAT CAN WE LEARN FROM DANISH FLEXICURITY?

There are three clear lessons that can be taken from the Danish application of flexicurity. First, the “golden triangle” (see figure 2.1) shows that a flexible labour market can be maintained even if out-of-work benefits are high. Far from constituting a barrier to re-employment, the high salary replacement rates of Danish UI act as part of a package of policies designed to incentivise work, but also to match the right skills with the right jobs.⁶⁹ With a similar approach to re-skilling and intelligent incentivisation, there is no reason why a similar approach cannot be developed for the UK.

Second, the Danish model shows us that the private sector can be an effective partner in providing universal unemployment protection, given the right conditions. *A-kasse* are privately provided products that operate within a regulatory environment designed by the government. Consumers have choice and stability, and are able to easily understand the system within which they are choosing their protection. This should be a template for any public–private system designed with the UK in mind.

Third, the Danish experience shows us that people are willing to contribute towards their own financial safety net, given a system that is easily navigable, and that provides clear consumer benefits. We have already seen that, in the UK, the market for protection products is crowded, opaque and piecemeal, and simply not geared towards

68 Madsen, “How Can It Possibly Fly?”, 26.

69 Tatsiranos, “Unemployment Insurance in Europe”.

providing simple and effective solutions for people who need them. Comparative analysis of these two marketplaces shows a clear way forward for any meaningful UK solution to the protection gap – simplify, clarify and make accessible.⁷⁰

Of course, the UK has developed a different set of social and political contracts from those that exist in Denmark and any proper consideration of the flexicurity model needs to take this into account. Two aspects are again germane.

First, the flexicurity model relies on a fundamentally different relationship between employers, unions and the state from the one that exists in the UK. High UI enrolment rates reflect high rates of union membership across employment sectors, allowing wide pooling of risk and hence low insurance premiums. In the UK, on the other hand, the spread of union coverage is far less broad. Danish unions act as a fixed – and trusted – point of sale, but this requires a level of understanding and flexibility⁷¹ between unions and employers that is not replicated across the board in the UK (where trades unions are traditionally more politicised than in Denmark).⁷² Any comparable UI system would therefore need an alternative delivery mechanism.

Second, Danish flexicurity relies on a broad political consensus that is accepting of high levels of income taxation (around 41% of the average worker's wage) and of large contributions to individual savings and pensions (usually between 9 and 20%).⁷³ As Steffen Ganghof

70 This dovetails with recommendations of the Sandler Review in 2001, which looked at the UK savings industry in the wake of pensions mis-selling scandals in the 1990s. The report cited "complex charging structures" and a "lack of transparency" as key problems in the industry, and recommended a "suite of safe and simple savings products" in place of the existing options offered to the public. See Lisa Bachelor, "The Sandler Review: Point-by-Point", *Guardian*, 9 July 2002: www.guardian.co.uk/money/2002/jul/09/saving.sandlerreview; HM Treasury, *Medium and Long-Term Retail Savings in the UK: A Review*, by Ron Sandler (London: HMSO, 2002).

71 What Madsen calls the "principle of negotiated trade-offs"; see Madsen, "How Can It Possibly Fly".

72 Interestingly, the NHS and UNISON hosted a joint conference in November 2008 as part of their collaborative *Restructuring the Public Sector: A Flexicurity Approach* project.

73 This range is based on Evans et al., *Anglo-Flexicurity*, 35; and personal communication with a Danish insurance provider.

notes: "The Danish income tax ratio (revenue as a percentage of gross domestic product) has long been the world's highest, averaging around 30% during the past 15 years."⁷⁴ High levels of individual contribution are therefore well enshrined within Danish political culture. The contrast with the UK – where public appetite for higher taxes is, if anything, stretched and likely to be tested further in years to come – is obvious. This further highlights the need for a market-based solution.

There is much to admire about the Danish approach to flexicurity, and also some practical suggestions for UI reform in the UK. The scheme demonstrates how private sector resources and expertise can be brought to bear, and also shows that, given the right incentives, information and long-term benefits, people are prepared to contribute to their own safety nets above and beyond the bare state minimum. There are also key differences, the most important of which concerns the relationship between UI and the trade unions. Anglo-flexicurity would need to replicate a similar coverage level, to overcome the risks associated with adverse selection, but it would currently not be possible to administer such a scheme through trade unions. Chapter 3 will set out some potential ways to address this.

LIVELIHOODS, RISK AND UNEMPLOYMENT IN THE US

Creative thinking on issues of risk and livelihoods has been spearheaded in recent years by Robert Shiller. In his 2003 book *The New Financial Order*, the author explores the idea of livelihood insurance (LI) as a means to managing everyday risk for American citizens. He advocates this as part of a suite of reforms designed to promote a more stable and democratic financial order – arguments that carry particular resonance in the wake of recent events. These

74 Steffen Ganghof, "The Political Economy of High Income Taxation: Capital Taxation, Path Dependence and Political Institutions in Denmark", *Comparative Political Studies* 40:9 (2007), 1060 (author's own brackets).

ideas have recently been called “visionary” by UK economist Will Hutton.⁷⁵ Broadly:

[L]ivelihood insurance would serve as a vital institution in a newly democratised financial order, making the same kind of risk management available to individuals planning their lives that is available today only to corporate managers planning their company strategies.⁷⁶

Shiller advocates a comprehensive system that insures people against economic shocks – such as sickness and unemployment – but also against the slow erosion of income through gradual decline within a particular profession. He advises a menu of LI policies from which people might choose according to their occupational field, level of education and other personalised variables.

This is, of course, a call for fundamental change within the US social security marketplace that would require huge regulatory input and a system of consistent, regular risk assessment. It would also require a high enrolment rate to be workable. While there are clear questions around the policy specifics (including how it would be financed and regulated, and how premiums could be kept low enough in a market-based system),⁷⁷ LI provides some innovative thinking about how long-term macroeconomic stability can be fostered through facilitating greater individual financial responsibility.

Shiller’s ideas are interesting because they propose a market-based strategy for protection over the lifetime of a career. LI is concerned with sustaining career paths as well as mitigating against brief shocks,

75 Hutton, “Heed the Visionaries Who Can Ease the Pain of Recession”.

76 Robert J. Shiller, *The New Financial Order: Risk in the 21st Century* (Princeton/Oxford: Princeton University Press, 2003), 109.

77 Interestingly, Shiller sees high individual premiums as a warning and an incentive for people within risky professions, nudging them to “anticipate job losses before they occur”. See Robert J. Shiller, “Commentary: Whatever Happened to Wage Insurance?": www.project-syndicate.org/commentary/shiller35.

and the author makes a comparison with “another risk management device already in place at universities – academic tenure.”⁷⁸ The focus is thus on protecting careers, rather than specific jobs. If salary levels drop through unemployment, LI will insure against this. If household income levels are reduced for other reasons – illness or accident, for example – then LI will kick in to protect against this. Such thinking constitutes a shift in the way we understand insurance, moving away from a system that is built around one-off risk, and towards a model that contributes towards long-term stability and security.

An alternative perspective on protecting livelihoods has been offered by Jacob Hacker, who has proposed a “universal risk insurance” (URI) that would insure against four key shocks: unemployment, disability, illness and family death. Hacker’s proposal is for a state-administered scheme that would replace lost income on a sliding scale. So, if a family’s income were to drop by 35%, URI would compensate for a proportion of the shortfall. Broadly, the scheme aims to be:

a framework of insurance that covers all working Americans, that moves seamlessly from job to job and state to state, and that deals with the most severe risks to family finances, regardless of whether they fit neatly into existing programme categories.⁷⁹

Hacker proposes a programme that focuses on potential drops in income, but that also skews protection towards those who will need it most. So, “higher income Americans do receive protections, but only if their incomes drop substantially. Protections for middle and lower-income Americans kick in more quickly and are more generous.”⁸⁰ This has logistical implications, as the scheme would need adequate means of ensuring replacement levels are correctly calculated as they vary over time.

78 Shiller, *The New Financial Order*, 111.

79 Jacob S. Hacker, *Great Risk Shift: The New Economic Insecurity and the Decline of the American Dream* (Oxford: Oxford University Press, 2006), 191. See also Jacob S. Hacker, *Universal Risk Insurance* (Washington, DC: New America Foundation, 2007).

80 Hacker, *Great Risk Shift*, 192.

In effect, URI is a piece of speculative thinking on structural reform in the US that takes the idea of LI and adds some detail in several key areas. For example, Hacker envisages that his nationwide programme would be administered by the Internal Revenue Service (IRS), and universalised through automatic enrolment via employers. He costs out the scheme at an annual US\$35 billion, although it is unclear as to how this would be financed.⁸¹

Both LI and URI represent forward thinking on issues of livelihoods and risk within a fundamentally different context from that of European flexicurity. They look to establish portable protection mechanisms within an environment where health and social security are already privately provided, and labour market flexibility is well established. And although neither Shiller nor Hacker are proposing ready-made, workable solutions, they are offering creative thinking on how governments and the private sector might together address long-term labour market insecurity.

Anglo-flexicurity is closest to the nascent concept of LI, as it puts forward a way for individuals to protect their livelihoods, rather than specific purchases or credit products. However, neither Shiller nor Hacker really elaborates on how their own scheme would get over the market failures identified already in this report. Most importantly, how would their schemes be costed, given the multiple variables that could trigger LI or URI? In suggesting some practical solutions for the UK, this report aims to move the debate forward in this area.

OPTIMAL UNEMPLOYMENT INSURANCE?

Another useful perspective emanating from the US is that of Raj Chetty at the University of Chicago, who has focused on developing calculations for “optimal” levels of unemployment insurance.⁸² He

81 Hacker, *Universal Risk Insurance*, 51.

82 Chetty's work has also been recently flagged by Harford in 'Is Unemployment Benefit a Good Thing After All?'

suggests that the relationship between benefit levels and unemployment duration is not as clear-cut as some may assume; and that more generous benefit does not necessarily mean a longer period spent on welfare. He finds that other variables come into play, such as whether a family has savings to fall back on, or whether they can readily access credit. If not, he argues, generous benefits are likely to increase unemployment duration.⁸³

Chetty frames this as the “liquidity effect” versus moral hazard, and derives a formula for an optimum general level of UI. Overall, he concludes:

The central intuition is that UI benefits affect search behaviour⁸⁴ through two channels: a welfare-enhancing “liquidity effect” and a welfare-reducing moral hazard effect. The ratio of the liquidity effect to the moral hazard effect is a sufficient statistic for the welfare gain of raising the benefit level in a general environment. ... I estimate that the liquidity effect accounts for 60 percent of the marginal effect of UI benefits on durations. ... This estimate implies that a benefit equal to 50 percent of the pre-unemployment wage is near optimal in a UI system that pays constant benefits for 6 months.⁸⁵

His conclusion chimes with that of this report. Chetty suggests a similar (though slightly lower) salary replacement rate⁸⁶ and a similar payout duration, and also appears to suggest that such a scheme is suited to families on middle or higher incomes (who are more likely to have access to liquidity in the early days of unemployment).

83 Raj Chetty, “Moral Hazard Versus Liquidity and Optimal Unemployment Insurance”, *Journal of Political Economy* 116:21 (2008).

84 I.e., how newly unemployed workers go about searching for new jobs.

85 Chetty, “Moral Hazard Versus Liquidity and Optimal Unemployment Insurance”, 221.

86 A recent article by Lentz concurs that the optimal replacement rate for (European) UI should be “between 43% and 82%”. See Rasmus Lentz, “Optimal Unemployment Insurance As an Estimated Job Search Model With Savings”, *Review of Economic Dynamics* 12 (2009).

The UK arguably occupies a position somewhere in between the US and the European systems. On the one hand, it shares a flexible labour market with the US, but it is more European in its approach to health and social security safety nets, and certainly more concerned with progressive incentives for returning to work. This chapter has demonstrated that, further to what Kenneth Clarke stated in the Mais lecture in 1994, there is much to gain from this “in-between” position. Yet this is only true if we can draw out the best of both worlds. It is not enough to say that the UK already has more labour market flexibility than do most European countries, and more security than the US, since the combination of the two still leaves a discernible proportion of UK workers financially vulnerable.

CONCLUSION: LESSONS FROM COMPARATIVE APPROACHES

The task now is to draw out the lessons from this comparative analysis, and apply them to the bottlenecks we identified in chapter 1. Key points to take forward are as follows:

- 1 The Danish model shows that privately provided, voluntary unemployment insurance can work in a contemporary context. Moreover, this need not work against the principles of a flexible labour market economy.
- 2 Danish UI works well because there exists a central point of sale. Although trade unions are not the only conduit to purchasing UI, there is a strong cognitive link between the two for Danish employees. This makes UI simple to join, broadens the pool of members, allowing better pooling of risk, and thus makes the scheme cheaper.
- 3 It is clear, therefore, that the Danish system cannot be replicated in the UK. Here, the relationship between employers, employees, unions and the state is qualitatively different, so Anglo-flexicurity needs to imagine a different point of sale and means of enrolment. It is equally clear



that the Danish salary replacement rate of 90% would be too high for a non-subsidised UK scheme.

- 4 The key lesson from the US is to think of UI not in the traditionally narrow sense, but in terms of livelihoods. Anglo-flexicurity should advance the idea that people are insuring their livelihoods, not just a specific job or eventuality.
- 5 The scheme should thus propose a comprehensive and portable approach. It should place less emphasis on immediate back-to-work conditionality, and, rather, focus instead on giving people the time and space to search for appropriate employment or retrain – to the benefit of both themselves and the economy as a whole.
- 6 Finally, these comparative examples show us that, in a voluntary scheme, strong incentives may be needed for people to insure themselves properly. A low premium should be the key incentive, but *Efterlon* provides an example of how additional long-term benefits could augment a national UI scheme.

CHAPTER 3: ANGLO-FLEXICURITY: PRESENTING A NEW SAFETY NET

This report has thus far sketched out the space in which Anglo-flexicurity should sit. Chapter 1 demonstrated the need for such a scheme; chapter 2 showed how other countries have met similar needs within different contexts and what other solutions experts have proposed. This chapter will present some ideas as to how Anglo-flexicurity might be made to work, beginning by asking how and why people would join the scheme.

Who gets unemployment insurance? This chapter will explore the “front-end” of Anglo-flexicurity, looking at the way the scheme might interact with members. It asks what automatic enrolment would mean, and looks at some comparative examples of the use of “soft compulsion” in national savings schemes. The Danish model showed that people might need a strong incentive to join a voluntary scheme. This could simply be the provision of an obvious safety net, but that would be insufficient for some people. To this end, the chapter looks at some additional means of creating incentives for Anglo-flexicurity, including the provision of tax relief on contributions, and at what the public policy justification for such incentives would be.

AUTOMATIC ENROLMENT

Soft-compulsion has increasingly come to the fore as a strategy for encouraging wide public participation in savings and pensions schemes. It provides a means to capture a broad market, and to deliver a service to people who might otherwise be unaware or unable to take advantage of it of their own accord. The rising popularity of the idea has mirrored a surge of interest in behavioural economics – a sub-genre that addresses issues of public policy and personal finance from the perspective of how people actually

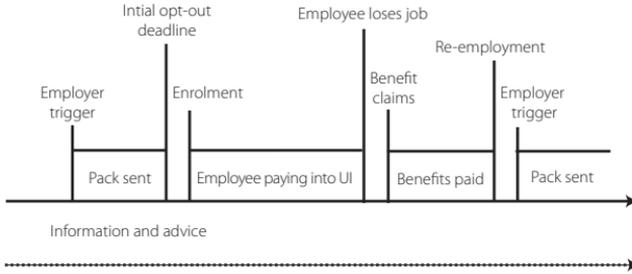
behave rather than how standard economic theory suggests that they should.⁸⁷ Rather than envisaging consumers and citizens as inherently rational decision-makers, this perspective seeks to understand the behavioural traits that govern how people really act. By understanding how and why people make the decisions they do, we are more able to suggest ways in which these decisions might be influenced in their own interest.

Our previous publication suggested that soft compulsion through automatic enrolment should be a central element of Anglo-flexicurity. It argued that auto-enrolment would mitigate the effects of consumer inertia, and could substantially bring down implementation costs by means of protection against adverse selection. “The option of soft compulsion,” it argued, “leads to a virtuous cycle 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.”⁸⁸ This is tested out in chapter 5, where the number of “active and eligible employees” (AEEs) within the scheme are estimated. If this number increases evenly, risk is increasingly shared across sectors. This has the effect of pulling down the average UI premium. Figure 3.1 shows how an employee might proceed through the enrolment process; it demonstrates the potential ease of enrolment for employees, and the cyclical nature of the scheme: an individual finding a new job after unemployment would be automatically re-enrolled after a probationary period agreed with their employer. Information and advice would be available throughout this process, both via employers and central government. Chapter 4 will suggest some ways in which this could be organised.

87 For a good overview, see Prendergast et al., *Creatures of Habit?*; Richard H. Thaler and Cass R. Sunstein, *Nudge: Improving Decisions About Health, Wealth and Happiness* (New Haven: Yale University Press, 2008).

88 Evans et al., *Anglo-Flexicurity*, 76.

Figure 3.1: The process under an automatic enrolment scheme



Source: Adapted from James J. Choi, David Laibson and Brigitte C. Madrian, Reducing the Complexity Costs of 401(k) Participation Through Quick Enrolment. National Bureau of Economic Research Working Paper 11979 (2006), 29.

International evidence on automatic enrolment suggests that the policy could be very effective within certain frameworks. In a US pilot for example, participation in 401(k) savings plans was increased massively through the introduction of employer auto-enrolment. According to Thaler and Sunstein:

[P]articipation rates under the opt-in approach were barely 20 percent after three months of employment, gradually increasing to 65 percent after 36 months. But when automatic enrolment was adopted, enrolment of new employees jumped to 90 percent immediately and increased to 98 percent within thirty-six months. Automatic enrolment thus has two effects: participants join sooner, and more participants eventually join.⁸⁹

Research from the Department for Work and Pensions (DWP) in the UK has shown that auto-enrolment has more of an effect among people who are less likely to join a scheme.⁹⁰ Some of these people – for example those at the end of their working lives, or those with “jobs-for life” in the case of UI – would perhaps not benefit from automatic enrolment. These people, argues the Financial Services Authority (FSA),

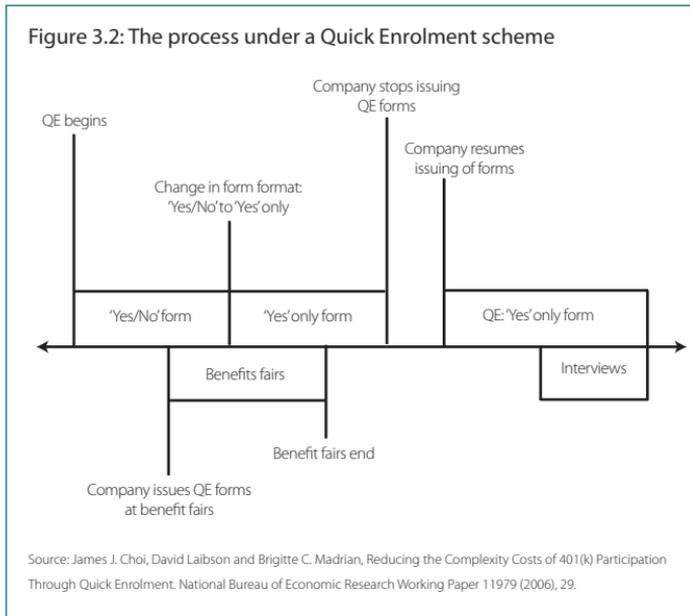
89 Thaler and Sunstein, *Nudge*. The authors reference Brigitte C. Madrian and Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behaviour* (Cambridge, MA: National Bureau of Economic Research, 2000).

90 Department for Work and Pensions, *Personal Accounts: A New Way to Save* (London: The Stationary Office, 2006), 51.

would need to have access to good-quality information and advice in order to make informed choices appropriate to their circumstances.⁹¹

QUICK ENROLMENT

One contemporary alternative to auto-enrolment is “Quick Enrolment” (QE) – a trademarked approach developed for the US savings market. QE and auto-enrolment share the aim of enrolling a high percentage of scheme members, but QE relies on making choices easier, rather than using soft compulsion. The process of Quick Enrolment is depicted in figure 3.2.



According to Choi et al., QE “gives employees the option of enrolling in [a] savings plan by opting into a default contribution rate and asset allocation pre-selected by the employer.”⁹² The idea is that it strips away

91 Financial Services Authority, *Security in Retirement: Towards a New Pensions System - The Government's White Paper on Pension Reform*, FSA Response (London, 2006), see esp. 3–4.

92 James J. Choi, David Laibson and Brigitte C. Madrian, *Reducing the Complexity Costs of 401(k) Participation Through Quick Enrolment*, National Bureau of Economic Research Working Paper 11979 (2006), 3.

complex (and potentially confusing) layers of choice, instead presenting employees with a scheme that has already been tailored to their requirements. For its adherents, QE “addresses both the libertarian and paternalist objections to automatic enrolment. For libertarians there is no “coercion” into the default. For paternalists, affirmative elections reduce the legal risks from choosing a less conservative default asset allocation.”⁹³

QE would certainly offer a less coercive way to enrol members into a national UI scheme – but this would come at a twofold cost. First, the procedure would impose a significant burden on employers, both in terms of providing the choice mechanisms for employees, and of the necessary information and advice that would have to be made available. In fact, QE has been trialled in large corporate companies, and was designed with these settings in mind. Second, the procedure would inevitably have a “much smaller participation effect” than automatic enrolment.⁹⁴ This is acceptable for a savings scheme, but would have more serious selection issues for an insurance policy.

AUSTRALIAN SUPERANNUATION

The Australian superannuation (“super”) scheme is an example of a national scheme that relies on compulsory contributions, rather than on enrolment incentives. It has three tiers: “provision of an adequate public safety net,” “compulsion of self-provision” (i.e. compulsory contributions) and “encouragement of self-provision” (through voluntary contributions).⁹⁵ The system currently requires employers to contribute a “minimum of 9% of ... earnings [for] ordinary hours of work into [a] super account each quarter.”⁹⁶ The fund can be chosen by

93 Ibid.

94 This is because QE presents employees with a default yes/no decision, rather than assuming enrolment as a default option. As such, the scheme involves less “herding”, but cannot necessarily overcome some of the behavioural issues noted in chapter 1.

95 Association of Superannuation Funds of Australia, *Blue Skies: ASFA’s Blueprint for a National Retirement Income Policy* (Sydney: ASFA, 1998).

96 “Australian Taxation Office”: www.ato.gov.au/individuals/content.asp?doc=content/00098979.htm.

employees themselves, and fairly strict rules govern the terms under which they can access their benefits.

Recent research indicates that members' attitudes towards superannuation are reasonably favourable. For example, 60% of people thought its fee structure was reasonable, 86% reported good communication and information between the scheme and its members and 80% of members were "satisfied" with their personal superfund scheme.⁹⁷ This is perhaps surprising given that the scheme is compulsory – something which has been the subject of criticism.⁹⁸

Australian "super" is considered here because of its regulation of access to benefits. Overall, great care is taken to ensure that benefits remain accessible only at the point of retirement. There are some exceptions, but, according to the Australian Tax Office, "early access to preserved superannuation benefits can only occur in very limited and tightly restricted circumstances, including severe financial hardship or on compassionate grounds."⁹⁹

A similar proviso could be incorporated into comprehensive UI – allowing members to access a proportion of benefit even without becoming unemployed. This would provide an additional safety net that could cope with times of financial stress – such as medical or dental fees, or transport costs after an accident – without the member claiming benefit in full.

LESSONS FROM UK PENSION REFORM

In the UK, the government's pension reform plans have automatic enrolment at their heart. In 2005, the Pensions Commission (known as

97 Matt Balogh, "Reports – ASFA": www.superannuation.asn.au/Reports/default.aspx, 9.

98 See for example Michael Drew and Jon Stanford, "Why Is Superannuation Compulsory?", *The Australian Economic Review* 37:2 (2004).

99 Australian Tax Office, *Beware of Illegal Schemes to Withdraw Your Superannuation Early* (Canberra: Australian Taxation Office, 2006).

the Turner Commission) sought to address the issue of inadequate pension provision by looking directly at the reasons why people have not contributed more to private schemes. It pointed to “inherent behavioural barriers to people making rational long-term savings decisions without encouragement,”¹⁰⁰ and highlighted automatic enrolment as a potential solution.

The debate predating this recommendation is interesting. On the one hand, public opinion was generally dubious about being forced to contribute. On the other, there was widespread desire for encouragement that overcame inertia and misunderstanding of the marketplace. According to the original report:

... attitudes to compulsion are ambivalent. While many people say they want to “have to save,” many respond adversely to the idea of compulsory savings. And there is a danger that compulsory savings contributions may be seen as equivalent to taxation, reducing people’s willingness to support an adequate system of flat-rate state pension provision.¹⁰¹

The Commission proposed a solution whereby employees would be auto-enrolled into a private pension scheme through their employer, but with the means to opt-out at any stage. The report justified this as a solution that could:

... overcome the barriers to rational decision-making, cost efficiency and the declining employer provision which undermine a purely voluntary system, while leaving individuals ultimately free to make their own decisions in the light of their own preferences and circumstances. It will therefore be both a better so-

100 Pensions Commission, *A New Pension Settlement for the Twenty-First Century*, by Adair Turner (London: The Stationary Office, 2005).

101 *Ibid.*, 3. SMF research on behavioural change similarly indicated that people are often “keen to be presented with a solution” to these kind of (often financial) issues. Prendergrast et al., *Creatures of Habit?*, 86.

lution in principle than pure compulsion and more capable of generating consensus and lasting support.¹⁰²

A recent survey by the Association of British Insurers (ABI) suggests that this optimism is not misplaced, and that significant numbers of employers already practise automatic enrolment or similar schemes. Indeed, 29% of those currently paying into a private pension indicated that their employer used automatic enrolment. Of those employees with experience of automatic enrolment, 93% thought it was a good idea, and even without direct experience, only 18% of people thought it was a bad idea.¹⁰³

Automatic enrolment may also have an impact on potential gender distribution within the scheme. According to the Fawcett Society,¹⁰⁴ women are less likely to opt in to pension saving schemes, due to a combination of lower earnings, fewer hours (i.e. more part-time work) and a greater tendency to work in small and medium-sized enterprises (SMEs).¹⁰⁵ The Society has welcomed automatic enrolment as a means to boosting the percentage of women contributing to private pensions.

There are clear lessons for Anglo-flexicurity from the pensions experience, not least in a restatement of the need for concerted action to overcome inertia, confusion and over-complicated enrolment procedures. However, we should remember that pensions and insurance are two different products, and two different marketplaces. A pension is effectively a long-term savings plan, where, upon retirement, the individual gets back whatever has been put in during their working life (plus growth). An insurance policy, on the other hand, provides protection against unplanned events such as accident, illness or sudden loss of income. Using

102 Pensions Commission, *A New Pension Settlement for the Twenty-First Century*, 156.

103 Association of British Insurers, "The State of the Nation's Savings": www.abi.org.uk/BookShop/ResearchReports/SONS%202008%20FINAL%20LR.pdf, 21.

104 The Fawcett Society is "the UK's leading campaign for equality between women and men". It regularly publishes responses to government proposals, along with independent reports and analysis of gender issues. See for example www.fawcettsociety.org.

105 Fawcett Society, *Fawcett Society Response to the Pensions White Paper 'Security in Retirement: Towards a New Pension System'* (London: Press Release, 2006).

soft compulsion to encourage savings therefore has an obvious long-term benefit, and a material guarantee upon retirement. It is perhaps more difficult to articulate why people should be compelled to protect against eventualities they feel might never occur.

This taps into the idea of risk perception, which is particularly relevant to those “safe” sections of the workforce, such as careers in the public sector. It is likely that teachers or GPs, for example, may not find it worthwhile to remain members of a scheme that would protect against unemployment. That is if, indeed, they felt the need to protect themselves at all.

Two observations are relevant here. First, we must recognise that those people in the very safest professions may well opt out of the scheme with good reason. In the case of teachers or civil servants, this may well represent a rational decision based on the low probability of job-loss. What Anglo-flexicurity is offering is a better safety net for those people spread across the middle of the bell-curve – those for whom unemployment is a less predictable eventuality.¹⁰⁶

Second, we must recognise that soft compulsion is best employed in conjunction with other choice incentives. The Danish *Efterlon* scheme (discussed in chapter 2) is a good example of how offering a set of tangible medium-to-long-term benefits can have an effect on enrolment rates in the immediate term. There are also lessons to learn from existing commercial practices.

THINKING ABOUT INCENTIVES

The insurance industry uses a range of incentives to attract new customers, some of which may be applicable to Anglo-flexicurity. The strongest incentive is, of course, affordable premiums. And as we have

¹⁰⁶ In fact, UI is particularly focused on those people who may perceive job safety in the future, but be unable to deal with the consequences of unexpected shocks. The bell curve analogy is drawn from Nassim N. Taleb, *The Black Swan: The Impact of the Highly Improbable* (London: Penguin Books, 2007), see especially chapter 15.

seen, promoting these depends upon the development of a broad pool of scheme members, including a significant proportion with “good” risk.¹⁰⁷ Those insurers offering lower premiums are therefore likely to enjoy a broad share of the market, or be highly specific as to the types of people (i.e. selecting by profession, health or previous behaviour) they will insure. Table 3.1 illustrates the disparity in premium levels.

Table 3.1: Comparing insurance provision

Provider	Product Name	Wait Period (days)	Premium(£)
Best Insurance	MPP Insurance	0	18
Barclays	Mortgagecare	61	51
Bristol & West	MPP Insurance	30	52.50
Leeds B.S.	Mortgage PPI	31	60
Abbey	Paymentcare	28	64.65

Source: The table is generated from an FSA search engine, using the following command: “You chose to compare payment protection insurance for unemployment. You chose to see standalone products with products from particular lenders. You want to cover a monthly mortgage repayment of £1,500. You want the payment protection insurance to run for 20 years. You are 30 years old.” Accessed at www.fsa.gov.uk/tables/bespoke/PPI. Note that specific terms and conditions apply to each policy – this table is not intended necessarily to compare like with like, but to show the variations that exist across the marketplace.

Not all insurers are able to offer a consistently low insurance premium using consistent terms and conditions. To maintain a customer base, they are compelled to encourage membership using other incentives.¹⁰⁸ These are “bolt-ons,” unlikely to seduce anyone making a measured long-term comparison of premium levels, but providing a carrot for people who are undecided between ostensibly similar policies. As previous SMF research indicates, rationality is not

¹⁰⁷ In general, Good = low risk; Bad = high risk.

¹⁰⁸ For example, a back-to-work service offered by helpucover.co.uk (a British subsidiary of French bank BNP-Paribas), offering an employment workshop and CV review service to its members. See www.helpucover.co.uk/product/income-protection/page/back-to-work/. Aviva (formerly Norwich Union) offers £75 per night of hospital benefits up to a maximum of 90 nights as part of its income protection policies. See Norwich Union, “Income Protection Solutions”: www.healthcarezone.co.uk/individual_products/ip_solutions.htm, 7.

always the main driver of individual behaviour, and commercial marketing strategies are well placed to engage with these individual idiosyncrasies.

The most obvious membership benefit should be a low premium, and Anglo-flexicurity should work towards this as the best way to attract employees to the scheme. The less complicated the incentive structures are, the better. To this end, we should emphasise that a key driver of the scheme is to deliver a comprehensive, value-for-money product, which would potentially sweep away the need for the glut of other specific insurance products. For example, taking out UI may require a monthly premium of, say, £40, but if this removes the need for a loan payment protection and an accident and illness policy, then it would represent good value for money.¹⁰⁹ This would need to be put across strongly in any information and advice regime.

In terms of specific incentives, an interesting option is offered by a cash-back scheme. This would work along the lines of *Efterlon*, with long-term policyholders having access to a cash pot upon retirement, or perhaps an augmentation to their existing private pension scheme. If UI is not claimed within a member's working life, a maximum annual payout – equivalent to, say, 30% of final or average salary – could be accessed as a lump sum upon retirement.

Another option would be to use a no-claims principle, bringing down the cost of individual premiums in a similar way to that used for motor insurance.¹¹⁰ This would gradually reduce monthly premiums according to individual circumstances, with potentially significant rewards for high-risk individuals who do not make regular claims. In

109 Of course, the triggers for each of these insurances are different, but each is based on compensating for the effect of a loss of income on specific outgoing. Protecting the income as a whole would mean these costs were covered within the UI premium – provided the correct benefit level was set for the individual.

110 A "no-claims" benefit is offered by UK provider Sesame, rewarding 24 months without MPPI claims with a 10% increase in monthly benefit. See, for example, "Sesame": www.sesame.co.uk/DocumentViewer.aspx?portalName=base&disposition=default&elementId=2439.

general, one would envisage a UI scheme that took into account how the probability of unemployment changes through the duration of a working life. Those moving towards the end of their careers would see their premiums decrease, and perhaps dovetail in some way with private pension contributions or an *Efterlon* scheme.

The idea of joined-up thinking on the relationship between UI and pension contributions has been a frequent suggestion during the research process. A common question is: could UI contributions link in some way to Personal Accounts pensions? On the face of it, this is a sound idea. Those less risky members of the scheme would benefit from long-term UI contribution through an augmented pension; meanwhile, the potentially expanded membership pool for both UI and Personal Accounts would make for cheaper UI premiums.

Although this would represent a truly comprehensive, livelihoods-focused approach, there are questions over the administration and costing of such an initiative. How would potentially different pension fund and UI providers interact with one another? And, what impact would sharing resources have on scheme costing? These are issues beyond the scope of this report, but provide food for future policy development. At the forefront of our minds throughout this process should be simplicity and accessibility for the consumer.

INCENTIVISING ANGLO-FLEXICURITY THROUGH TAX RELIEF

Tax relief is both a strong incentive for taking up UI membership and, arguably, a fair trade-off for individuals who provide their own voluntary safety net. Why? First, providing tax relief would reduce individuals' monthly premiums. The amount would depend on the size of the premium, and would help those with a potentially larger UI burden, thus making the scheme more cost-effective for more people. Second, and perhaps most importantly, tax relief mitigates against the effect of double-insuring: that is, it implicitly recognises that

individuals, by paying for their own unemployment insurance, are absolving the state from its obligation to pay unemployment benefits in the event of job loss. By allowing premiums to be paid out of pre-tax income, the state would recognise this trade-off. Tax relief on premium payments would work as described in box 3.1.

BOX 3.1: TAX RELIEF ON UNEMPLOYMENT INSURANCE CONTRIBUTIONS

An employee earning £32,000, after taking into account a personal tax-free allowance of £6,035 a year, will have a total taxable income of £25,965. So from the total gross salary, £5,193 will be deducted in income tax and £2,919 in National Insurance. This is a total deduction of £8,112, leaving a net income of £23,888.

A £45 monthly UI premium (for example) will cost this employee £540 per year. Paying this out of gross income brings total taxable income down to £25,425. After deductions for income tax and National Insurance, the employee's net income is £23,995.

Tax relief on UI premiums effectively saves the employee £108 per year, which can be deducted from the annual insurance premium of £540. This leaves an effective annual premium of £432, reducing the monthly premium to £36.

So, although the employee would be paying £540 per year on insurance premiums, he or she would save £108 a year in tax relief. This makes the net result an outgoing of £432.

Box 3.1 shows the benefit of UI tax relief to the scheme member, reducing a £45 premium by £9 in this case. Such a system would require minimal administration by individual employees, as premium

payments are deducted from wage packets before they are even seen by the individual.¹¹¹ One useful comparison here is with childcare vouchers. These are privately provided and purchased by employers for individual employees. They are treated as tax-exempt through a “salary sacrifice” system, allowing individuals effectively to personalise an element of their social security provision according to their personal and family needs.¹¹² The question of the costs and benefits of tax relief to the Exchequer are discussed further in chapter 5.

HOW WOULD FAMILIES ENGAGE WITH UI?

Many of our financial decisions are made as part of a couple or a family. Employment is personal, with individual jobs producing individual levels of remuneration – but what we do with our wages is frequently less individualised. Indeed, many of the big financial decisions we make are in conjunction with a partner, with the most obvious example being mortgages or rent. Anglo-flexicurity must therefore operate at a family or household level. So how could this be achieved?

If UI is to make sense for families, there must be a sense that it can insure against the big monthly outgoings, such as mortgage or rent payments, personal loans and childcare bills. Some of these outgoings are already subject to multiple forms of protection insurance, and if UI is to mark a move away from the shortcomings of current provision, it must not only simplify and clarify, but provide equivalent levels of protection.

There is scope for creativity here. For a couple both of whom are enrolled within the default national scheme, the terms of their insurance could be personalised without their having to opt out. This

111 Of course, this comes at a cost to the Treasury, which is losing revenue as a result. The implications of this will be discussed in later chapters.

112 For more information on how the scheme interacts with other tax and benefits initiatives, see HM Revenue and Customs, “Interaction of Tax Credits and Childcare Vouchers: Question, Answers and Examples for Employees”: www.hmrc.gov.uk/childcare/interaction-tc-cv.htm.

might mean choosing a level of cover that is shared between the two of them (for example, a maximum benefit payout), and splitting the premium. This might actually improve the risk profile for insurers. It is unclear at this stage how this would effect pricing, but insuring a couple together might well bring costs down for the insurer – particularly if one partner is a significantly “better” risk than the other.

If enrolment in the scheme is too low, one would expect private insurers to encourage this kind of lower-risk, discounted pricing. Should enrolment be above expectations, the overall risk of the scheme would be good, pushing prices down and allowing for a greater degree of variability in personal premiums. This speaks to the affordability of the scheme for families, as well as individuals.

SELF-EMPLOYED AND CONTRACT WORKERS

Automatic enrolment will not apply to self-employed workers, who would instead need to opt-in to UI themselves. In practical terms, this would involve the same process that an employer would go through, notifying a clearing house of salary level and receiving an information and enrolment pack. Checks and balances would need to be established regarding consistency of salary and job-security – likely to be in line with existing commercial practices in this area. Aviva, for instance, gives self-employed income protection scheme members “the option to base ... benefit on the annual average of ... pre-incapacity earnings in the three years before [they become] unable to work.”¹¹³

The key difference between Anglo-flexicurity and existing commercial schemes is likely to be cost. At the moment, insuring health and income for the self-employed is fairly complicated and expensive.¹¹⁴ If Anglo-flexicurity were to succeed in generating a broad

113 Norwich Union, “Income Protection Solutions”.

enough base from PAYE employees across the country, there is reason to think that it could offer an attractive and simple opt-in for self-employed workers as well.

CONCLUSION

This chapter has built on chapter 2's comparative analysis and presented some key features of a potential Anglo-flexicurity scheme. It has suggested automatic enrolment as a way of generating a wide pool of scheme members, which would have knock-on positive effects on the affordability of the scheme. The chapter also explored the idea of supplementary incentives, both as a means to broaden membership, and as a way of rewarding long-term scheme members. We can conclude that a mix of incentives would probably be required, especially as long-term members within relatively safe professions need extra incentives to remain part of the scheme. The following chapter will explore some more elements of scheme design.

114 Marianne Curphey, "Cover Me – I'm Going Ahead Alone", *Observer*, 25 August 2002:
www.guardian.co.uk/money/2002/aug/25/workandcareers.observercashsection.

CHAPTER 4: DELIVERING ANGLO-FLEXICURITY: STRUCTURE AND GOVERNANCE

The previous chapter introduced proposals for a new Anglo-flexicurity scheme, and began to offer some suggestions as to how it might be implemented. It asked how and why people would join an UI scheme, and how we can make sure it is as simple and affordable for consumers as possible. This chapter presents a model of how Anglo-flexicurity would be governed. How would private and public representatives work together? How would the individual interact with the scheme? And how would UI be presented to the public?

GOVERNING ANGLO-FLEXICURITY

The structure of Anglo-flexicurity is of crucial importance. It must ensure effective governance and regulation; it must ensure the scheme represents its stakeholders; and, above all, it must be tailored towards producing comprehensive unemployment cover at low prices for UK employees. According to OECD guidelines, “implementation of best practices in corporate and financial governance entails an approximate mix of incentives, balanced between government regulation and self-regulation.”¹¹⁵ This suggests that Anglo-flexicurity should be accountable to its own board of directors, but also to the wider public through Parliament.

Such oversight is particularly important in the current economic climate. The insurance industry’s reputation has taken a knock recently, especially over the Competition Commission’s findings on payment protection insurance (PPI). This is the context within which any design of Anglo-flexicurity must take place, with obvious implications for the scheme’s transparency and accountability.

115 OECD *Guidelines for Insurers’ Governance: Recommendation of the Council* (Paris: OECD, Directorate for Financial and Enterprise Affairs, 2005), 2.

OECD guidelines provide a useful starting point here. On internal governance of insurance schemes, they maintain: “Insurance entities should have appropriate control, communication and incentive mechanisms that encourage good decision-making power and timely execution, transparency, disclosure and ensure regular review and assessment, having regard to the branches of business operated.” Furthermore, “these mechanisms should be tailored to the protection of policyholders, beneficiaries and shareholders.”¹¹⁶ Anglo-flexicurity should be subject to these standards, particularly with regard to the pricing of UI. Contracts between private insurers and the individual must be subject to common principles, and the terms of default schemes subject to regular review. The following sections will suggest some ways in which we can work toward these ideals.

OVERSIGHT AND STRATEGIC DIRECTION

Oversight of Anglo-flexicurity would effectively be a three-stage process, taking in design, implementation and delivery of the scheme. In the first instance, an advisory body would be established, to assist in the design of the scheme and to develop its strategic direction. The make-up of this body should reflect the diversity of stakeholders within the scheme (i.e. from the private and the public sector, and including membership representation), as well as containing the necessary relevant expertise.

The second stage will require this body to begin implementing aspects of the scheme. This means bearing responsibility for overseeing procurement, staffing and wider public awareness campaigns. The transition period would be a crucial stage in development of the project, making it essential that expertise within the advisory board is present in all these areas. Particularly key will be oversight of risk assessment and pricing within the early stages of the scheme. Indeed, in 2006, the FSA criticised a “lack of appropriate knowledge and experience to provide

116 Ibid., 9.

sufficiently informed challenge(s) on risk matters” within some commercial oversight committees.¹¹⁷

The transition from the early stages to implementation of the scheme would probably see the establishment of a permanent board (stage three), which would provide leadership for the scheme in the long term. There may well be overlap between advisory body and board membership, but it could also be appropriate for certain members – for example those with expertise in advertising or procurement – to make way for other representatives. Fundamental here would be a sound balance between government and private sector representation, as well as strong public accountability.

DWP Personal Accounts proposals offer a framework for transition between these three stages: moving between “advisory delivery,” “executive delivery” and a working “personal accounts board.”¹¹⁸ Table 4.1 sets out responsibilities at different stages of the scheme, and is based on the Personal Accounts framework.¹¹⁹

Table 4.1: Introducing Anglo-flexicurity: three stages

Stage 1	Stage 2	Stage 3
Parliament		
UI Advisory Body	UI Executive Body	UIA Board
Scheme design, consultation & strategic direction	Establishment of, infrastructure testing, staffing & procurement	Ongoing delivery & regulation of UI

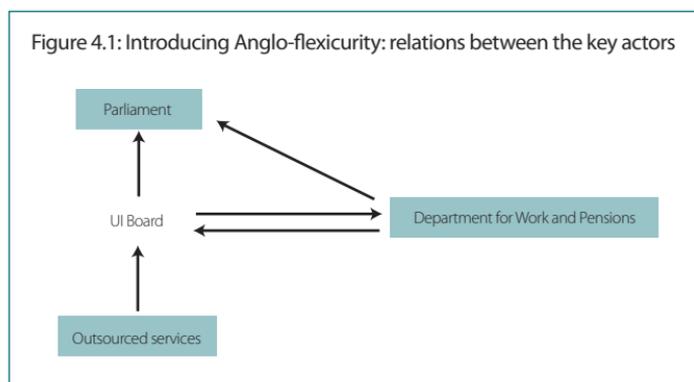
Table 4.1 and figure 4.1 show how the scheme would be subject to parliamentary scrutiny across these stages. There are also vertical lines

117 Financial Services Authority, *Insurance Sector Briefing: Risk Management in Insurers* (London: FSA, 2006), 5.

118 DWP, *Personal Accounts*, 2.

119 For the original chart, see *ibid.*, 82.

of accountability to consider within the scheme, especially given that significant elements are likely to be contracted out to private operators. Again, Personal Accounts legislation provides a replicable model, which forms the basis of the approach discussed here.¹²⁰ In this representation, the board is responsible for managing outsourced services, and is itself directly accountable to Parliament. The Department for Work and Pensions would be the Department through which Anglo-flexicurity would be delivered.



Customers will need a structure that gives them a single point of contact, supported by lines of communication that ensure clarity, trust and accessibility. This could be achieved through the establishment of two key entities: a default insurance policy and a central administrative body. We can look to Swedish pension reforms as an example of how these two might interact.

CENTRAL ADMINISTRATION OF A DEFAULT SCHEME: LESSONS FROM SWEDEN

Looking at the Swedish pension system gives us a good example of a default system at work. The Swedish system was reformed through the 1990s with two intentions: to reduce its overall cost and to establish a closer relationship between individual contributions and

120 For the original version, see *ibid.*, 85.

pension benefits. It did this through a twin-track approach – with a “guaranteed pension” offering income support for lower earners, and a “premium pension” offering individuals investment choices over and above the 16% payroll tax of the guaranteed scheme.¹²¹

The administration of the premium pension is of special relevance here. The system was built around a central administrative body called the Premium Pension Authority (PPA) and offered individuals a combination of choice – with a massive range of pensions investment funds available to them – and the option of a state-regulated default fund. The idea was that individuals could choose their own portfolios “by selecting up to five funds from an approved list.” In addition, “one fund was chosen (with some care) to be a “default” fund for anyone who, for whatever reason, did not make an active choice.”¹²²

Evidence has shown that the default choice – which offered safety, balance and, as a consequence, potentially less investment return than other funds – has been highly subscribed. This has increasingly been the case the longer the scheme has gone on. Cronqvist and Thaler note, for instance, that the proportion of first-time enrollers choosing their own portfolio dropped dramatically between 2000 and 2003 from 56.7% down to just 8.4%.¹²³ This is both an indicator of the behavioural issues at play, and the success of a default scheme in addressing them.

The success of the Swedish default fund is in part due to the role of a central administrative body in keeping costs down and maintaining a central point of entry and contact for the scheme. The PPA is able to facilitate choice and competition, maintain regulatory oversight and,

121 R. Kent Weaver, “Social Security Smorgasbord? Lessons From Sweden’s Individual Pension Accounts”, *Brookings Institution Policy Brief* 140 (2005).

122 Henrik Cronqvist and Richard H. Thaler, “Design Choices in Privatized Social-Security Systems: Learning From the Swedish Experience”, *American Economic Review* 94:2 (2004), 424.

123 Cronqvist and Thaler, “Design Choices in Privatized Social-Security Systems”, 425.

importantly, drive down management fees charged by fund providers.¹²⁴ As Weaver observes, however, the trade-off is a potentially slow set-up process and concerns over who pays for the initial capital costs involved. Allowing the cost to be borne by scheme members (as was the case in Sweden) depends on having a broad enough membership to keep this as low as possible.

So what are the lessons for Anglo-flexicurity? First, that a default choice is key. However, following Cronqvist and Thaler, we must ensure that this policy is carefully designed. It must keep administrative costs down (relative to commercial examples and other national schemes), and must be priced competitively. Combining these aims without selecting only the “best” risk employees within the UK workforce will be a significant challenge here.

Second, the Swedish example highlights the need for a new central organising body. This would provide a focal point for employers, employees and policy managers, and would be important in reducing the burden on employers and scheme members themselves.

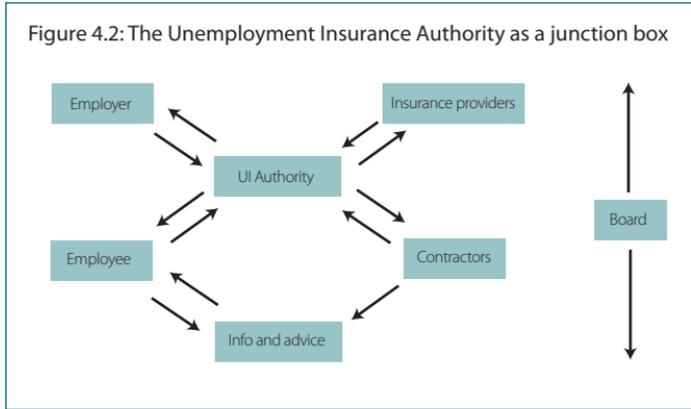
CENTRAL ADMINISTRATION OF ANGLO-FLEXICURITY

A national UI scheme should be organised through a central, state-administered body (called, for instance, the Unemployment Insurance Authority (UIA)). This would act as an administrative hub, a regulatory centre-point and a clearing house. At the front end, it would provide a point of contact for employers on triggering the scheme;¹²⁵ it would provide the point of contact for information and advice, and would be a central arbiter in potential disagreements over claims and benefits.

124 Weaver, “Social Security Smorgasbord?”, 6.

125 The need for simplified interaction between employers and funds is articulated by Jeremy Warner with reference to the Turner proposals. See Jeremy Warner, “Jeremy Warner’s Outlook: British Insurance Faces Up to the Challenge of Delivering the Right Product at the Right Price”, *Independent*, 2 September 2006: www.independent.co.uk/news/business/comment/jeremy-warner-outlook-british-insurance-faces-up-to-challenge-of-delivering-the-right-product-at-the-right-price-414306.html.

A UIA would also serve as a junction box for the insurers registered in the scheme. It should have the legal means to negotiate terms of entry for insurance providers, and to negotiate administration/membership fees at inception and at agreed points throughout the contract duration.



As figure 4.2 shows, the UIA would provide a first point of contact for employers, who are subsequently bypassed, as individuals interact within their own portable UI scheme. The UIA would enrol the employee within the default policy, and issue a “welcome pack” containing information about the default and about the individual’s right to opt-out. The employee would already have access to information and advice through the government’s public information campaign in the lead-up to scheme delivery. Employers would also be required to provide access to this information.

Figure 4.2 also shows the interaction between the UIA and the “engine room” of the scheme. Contractors and insurers would bid directly for tenders under strict guidelines, with the UIA providing a central point through which each operational area would subsequently be administered. The board would need oversight across all these areas. It would be directed to governance and operational issues by project managers within the UIA, but would also be able to hold all other aspects of the scheme to account through chosen means.

CHOOSING A DEFAULT SCHEME

We have established that Anglo-flexicurity should be a market-based solution, working within an effective framework provided by the state. A UIA would form the centre-point of the scheme, and would be accountable to its board and to the UK public through Parliament. The next stage is to establish how the private insurance element would be provided, and how this would impact upon scheme design.

Table 4.2: Overview of alternative default models

Default Option	Brief Description	Potential Benefits	Potential Drawbacks
Single Default Policy	Auto-enrollment of all members in a single default, underwritten by multiple insurers	Low risk & low administrative costs due to thick pool of members	Difficulty of ensuring competitiveness & keeping creeping costs down; denies consumer choice
Default Policy alongside fixed number of alternatives	Limited number of registered, multi-provider schemes, each subject to tight regulation	Competitive tender would drive down costs; each would draw from a broad pool of members	Limited choice for individuals; may be biased towards larger companies
Default Policy alongside multiple registered schemes	Members allowed to choose their own policy from a registered list, or are auto-enrolled into the default	Allows a high degree of choice, but within a 'safe' regulated framework	Choice limited to insurers able to satisfy conditions for registration; potentially large administrative burden; greater complexity may reduce numbers moving beyond the default
Default Policy alongside open competition	Members allowed free choice of registered schemes, or are auto-enrolled in default	Allows total choice for consumers; default would be subject to market competitiveness	Lower enrolment in default would push up costs; greater complexity may reduce numbers moving beyond the default

The Swedish experience tells us that a default would be an essential element of the scheme. The default could then be accompanied by a range of alternative policies. Table 4.2 above shows some such options.

The single default policy option would enrol all eligible employees into the same insurance policy, pooling risk across a huge number of members to create a single, national scheme. The advantages of this would be to widen the insurance pool, bringing lower premiums and administrative charges for the consumer. The policy would be underwritten by multiple insurers selected by the UIA from open competition, who would share the risk, costs and profit.

There are benefits and drawbacks to such an approach. One clear benefit is a massive pooling of risk and the concurrent effect this could have on the cost of the scheme. There is also a range of questions that would need to be addressed. How flexible would such a scheme be? Would individual variables – such as salaries, job-type, wait periods and *Efterlon*-type add-ons – be accounted for? Accounting for these variations within a single scheme would certainly pose an administrative challenge.

Another option would be to consider a fixed number of default choices, whereby the UIA would register a limited number of insurance policies, each tailored to particular membership characteristics. One policy could cater for those wanting less potential unemployment benefit and more *Efterlon*-style add-ons, for example. Another could cater for people who would rather wait six months before claiming, such as those with existing savings or other insurances. Some options could be inclusive of multiple insurances, so that people could opt for extra accident and sickness provision alongside unemployment cover.

The third and fourth options would offer a default, but encourage an open marketplace for insurance providers alongside this. One

option would be to require each policy to register after satisfying eligibility criteria, so that even if employees are choosing alternatives to the default, their choice of insurance still conforms to basic regulations.

Requiring the UIA to register (and effectively to regulate) potentially tens or hundreds of unemployment insurance policies would be an administrative challenge just because of the sheer volume. Further, a complicated array of policies may cause customers to disengage and stick with the default option regardless of whether or not it is appropriate to their needs.

WHICH MODEL IS OPTIMAL?

We have established that Anglo-flexicurity would rely on a default policy, and have sketched out four possible approaches (see table 4.2). Each has benefits and drawbacks, and the challenge now is to propose an approach that minimises the potential problems and provides the simplest, most competitive and fairest approach for employees. Any such model will need to take the following into account:

- *Broad coverage*: It is crucial that the default be made up of a wide pool of employees, reflecting a cross-section of salaries, professions and personal circumstances. This will ensure that risk is spread, and make the scheme commercially viable. A single default might be best on these grounds.
- *Low administrative costs*: The model must keep administrative costs down. Each model would carry an administrative burden, given the sheer numbers involved in the scheme. One would expect, however, that multiple-policy models would require public awareness of multiple options, and therefore cost more to advertise and promote.

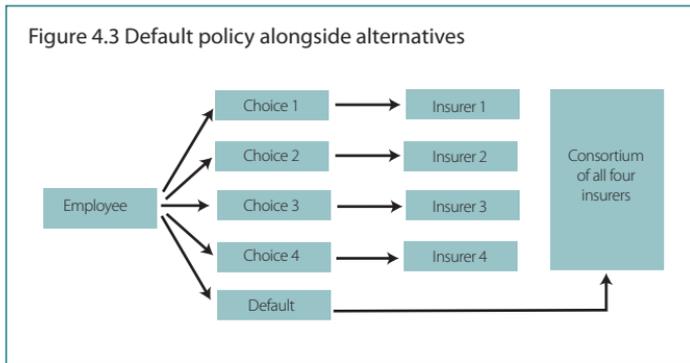
- *Ease of regulation:* Recent turbulence within the financial services underlines the need for a robust regulatory framework. In a recent FT Economists Forum posting, Michael Pomerleano noted the failure of three “pillars” of financial regulation and supervision: “disclosure to ensure market discipline, adequate capital and effective supervision.”¹²⁶ In a complicated system, these pillars are more difficult to sustain, perhaps making a simple default model more attractive.
- *Minimal burden for employers:* Minimising the administrative burden for employers is a key element of Anglo-flexicurity. Employers must be able to trigger auto-enrolment without requiring a complicated decision-making process between scheme options, and without being bombarded with advertising and marketing from competing providers. A limited-choice model would suit here, allowing employers to choose from a selected number of policies, each clearly outlining key characteristics.
- *Simple for employees:* Above all, Anglo-flexicurity must present employees with a simple and comprehensive form of personal insurance. Facilitating competition is important, but this cannot be at the expense of replicating the market complexity that undermines the current commercial marketplace. The model must negotiate this trade-off – between offering tangible choice and presenting this in a simple and accessible way. This would suggest that a flexible, limited-choice model is optimal.
- *Need to ensure competition:* Competition between providers would allow greater consumer choice. As the Competition Commission noted recently, “increased economic uncertainty makes it even more important that consumers

126 Michael Pomerleano, “The Failure of Financial Regulation”: <http://blogs.ft.com/economistsforum/2009/01/the-failure-of-financial-regulation/>.

have choices, that they have opportunity to make the right choice and they can get value for money.¹²⁷ This would favour an open-choice system at the delivery end, and competitive tender procedures to underwrite the default policy.

On balance, it appears that a single default would be the most cost-effective way of enrolling people into national UI. A single default policy would pool risk across a huge number of people, which would help push monthly premiums down to a low level. Cost is not the only consideration, however. We must consider that individuals may require different salary-replacement rates and wait periods or may want to personalise other elements of their insurance to suit their own needs. To allow for such preferences, a limited range of options could be provided.

So how would this work? The most obvious way would be to offer several different options within a single framework (the second option in table 4.2). Figure 4.3 shows this structure.



The range of options, add-ons and conditions available will ultimately depend upon scheme pricing. If the pool of members is

127 *Competition Commission*: www.competition-commission.org.uk/press_rel/2009/jan/pdf/04-09.pdf.

broad enough, there would feasibly be scope to offer qualitatively different types of policy to the relevant people. For example, a teacher might choose a policy with a low salary-replacement rate, but inclusive of other benefits such as contributions to a pension. In contrast, an investment banker might require a higher salary-replacement rate, where payments begin after six months of unemployment rather than the 31-day default. If the membership pool is broad enough, the scheme should be able to cope with these variables.

This section has sketched out some ways in which a national UI scheme could be delivered. It has argued that the scheme should be accountable to Parliament as well as private shareholders, and has borrowed from recent plans for DWP Personal Accounts to show how this could be modelled. It has used Swedish pension reforms to illustrate how a default scheme might work, and has taken on lessons learnt from Swedish government's problems in designing appropriate choice architecture¹²⁸ in this area. A wide range of options would allow competition, but might raise the risk of adverse selection. Hence we have proposed a more structured system of default choices in its place.

CONCLUSION

This chapter has looked at the potential design and governance of Anglo-flexicurity. It asked three questions at the outset. How would private and public representatives work together? How would the individual interact with the scheme? And how would UI be presented to the public? In response, a framework for the scheme has been sketched out, based on comparative examples, and drawing in large part from the DWP Personal Accounts blueprint.

128 This is a term specifically used in Thaler and Sunstein, *Nudge*.



This chapter has also shown why there is a necessary role for the state within flexicurity, stemming from the need for an auto-enrolment approach. This is combined with the establishment of a default policy, which can ensure that broad enrolment offers low premiums to employees.

CHAPTER 5: EVALUATING THE COST OF ANGLO-FLEXICURITY

This report has sought to outline a market-based solution to the problem of rising job insecurity and the inadequacy of existing state financial safety nets for many people. Previous chapters have suggested some ways such a solution could be organised, and identified ways around some key structural and logistical challenges. The task is now to work out what the cost of such a product would be, both to the individual and to the state, in order to determine whether the scheme would be sufficiently popular to function. Would a national UI scheme be financially viable? What would a monthly premium look like? Would it be unpalatably high? This chapter aims to answer these and similar questions using data that covers the entire British working population.¹²⁹ It is not intended to offer a definitive analysis, but rather a guide to the potential costs involved.

THE APPROACH

The model presented here represents a cautious analysis of costs using the data available, offering some estimates as to the costs of UI for individuals, insurers and the government. It uses claimant data from June 2007 (which is taken to represent a steady economic state) as the basis for long-term pricing, ignoring the impact of both the current downturn and likely subsequent upswing on premium levels.¹³⁰

According to Finn and Lane, “there is no ‘right’ price for a piece of insurance. There is simply the transacted market price, which is high enough to bring forth sellers, and low enough to induce buyers.” Quite simply, they argue, “it is when the perfume of the premium overcomes

129 The model uses datasets from the Office of National Statistics, via their Labour Market Portal, the Annual Survey of Hours and Earnings (ASHE), and the Nomis bespoke labour market statistics service.

130 Insurance pricing would usually be based on a steady state, assuming that upswings and downturns will even out over the long-term. In a recession unemployment rises and the risk of the scheme is “worse.” We can assume that this would be countered by significantly “better” risk during an upturn.

the pong of the peril.¹³¹ This describes a standard actuarial approach, which is based on determining a basic risk premium (BRP) “that guarantee(s) a predetermined, low probability of insolvency,”¹³² so that premiums are in proportion to the expected claim.

The BRP is derived by assessing individual liability, the likelihood of incurring this liability, and covering costs accordingly. This is often called “expected loss” pricing, which works as follows: “[A]t the systemic level, setting the price . . . equal to its expected loss ensures that the premium inflows to the fund are ultimately equal to average long-term loss, making the fund self-financing over time.”¹³³ This is not all. Insurance pricing must also take into account loaded costs that cover the additional expenditure of insurance providers – for example, advertising, marketing and solvency capital – as well as maintaining a built-in profit margin. Adding these loaded costs (in the form of a fixed percentage on each premium) to the BRP gives a good idea of what an insurance policy might cost the individual.

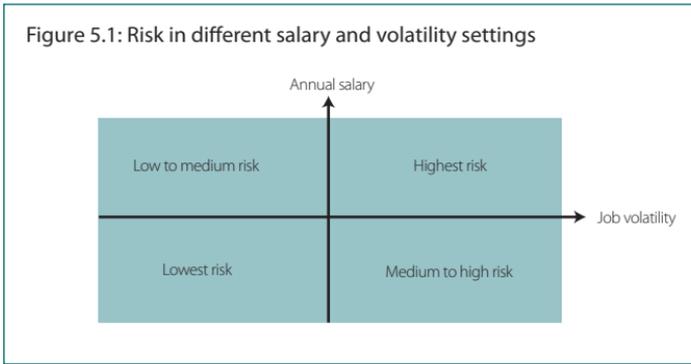
The starting point for calculating monthly premiums is to identify the frequency of claims. Second, we must think about the benefit people receive. How much money would they claim, and over what period? A combination of these two variables – frequency and benefit – will give us an idea how much UI might cost.

Insurance premiums would, in any commercial scheme, depend upon more than two variables, but the combination of frequency and benefit are the most important. Inevitably, those with high salaries are expensive to insure, as are those people working in professions known to be volatile. A combination of the two would be most risky – and therefore most expensive – of all, as figure 5.1 shows.

131 John Finn and Morton Lane, *The Perfume of the Premium . . . or Pricing Insurance Derivatives* (Georgia: Georgia State University, 1995).

132 Doron Kliger and Benny Levikson, “Pricing Insurance Contracts – An Economic Viewpoint”, *Insurance: Mathematics & Economics* 22:3 (1998), 244.

133 Andrew Kuritzkes, Til Schuermann and Scott Weiner, *Deposit Insurance and Risk Management of US Banking System: How Much? How Safe? Who Pays?*, by (Wharton, Financial Institutions Center, 2002), 33.



What this means is that a cross-section of salaries and sectors of the economy must be captured by UI. In effect, it must enrol enough low-risk employees to balance out the inevitable “bad” risks. This is especially important within periods of economic downturn, which are likely to affect different sectors of the labour force with differing levels of severity. Avoiding this adverse selection problem is a key justification for developing auto-enrolment.

The following sections will explore the methodology and assumptions of the UI pricing model, before presenting and explaining some key findings. It will begin with its key variables.

ESTIMATING UNEMPLOYMENT FREQUENCY

Unemployment figures can be expressed in several different ways. Generally, the UK government will report the unemployment rate (sometimes called unemployment stock), which measures the percentage of the economically active population currently without work.

A proxy for unemployment overall is the Jobseeker’s Allowance (JSA) claimant count. This measures the number of people claiming JSA within a given period. The count can also be expressed as a rate, illustrating the ratio of claimants to the total of workforce jobs plus the claimant count. Most recent figures showed the overall unemployment rate up to 6.7%,

and the claimant count at 1.46 million for April 2009. In addition to this, the number of job vacancies shrunk by 68,000 from the previous quarter.¹³⁴

Of relevance to estimating the cost of Anglo-flexicurity is not the overall claimant count, but claimant on-flows as a measure of newly unemployed UK workers. This gives us a better representation of how many claims providers might expect to receive.

JSA on-flows allow us to measure the number of new claimants each month, and therefore to estimate what an annual on-flow might be. Yet some manipulation of the data is needed before we can be confident that the model represents the demographic that Anglo-flexicurity is addressing. Chapter 3 noted that the scheme was concerned with providing a safety net for UK professionals – those for whom the existing regime is inadequate due to a combination of medium-to-high earnings and a low salary-replacement rate provided by state benefits. Yet this is by no means representative of the whole spectrum of JSA claimants, many of whom are in much lower occupational groups and for whom state benefits provide a relatively high replacement rate.

In a 2006 report for the DWP, Hannah Carpenter observed that “54% of all people making a claim for JSA were repeat claimants,”¹³⁵ despite government efforts to help break this pattern. And as a recent report by Work Directions notes: “[T]hose who are unemployed are far more likely to move into low-paid work, and low-paid workers are more likely to experience unemployment than better paid workers.”¹³⁶ The result is that “being low-paid, in itself, increases the probability of remaining in this cycle.”¹³⁷

134 Office for National Statistics, *Labour Market Statistics April 2009* (Newport: ONS, 2009).

135 Department for Work and Pensions, *Repeat Jobseekers Allowance Spells*, by Hannah Carpenter (London: The Stationary Office, 2006), 15.

136 Jane Mansour, *Skills and Sustainable Welfare-to-Work* (London: Work Directions, 2005), 20.

137 DWP, *Repeat Jobseekers Allowance Spells*, 8.

This cycle has implications for the UK labour market and, ultimately, for the welfare state. Of relevance to this effort to calculate an insurance premium, these findings shed light on the relationship between work background (i.e. occupational group, salary and skill level) and the propensity to claim JSA. For Carpenter: “[O]verall working background has a strong influence on the types of work that [her survey respondents] move into, with steadier work backgrounds linked to permanent work and higher occupational groups.”¹³⁸ Accordingly, her survey finds that repeat JSA claimants are most likely to have a background in elementary occupations, and a low average take-home wage.¹³⁹

These findings have fundamental implications on the way unemployment on-flows are estimated in our model. Why? First, we are initially concerned with a particular demographic – with employees within the auto-enrolment salary bracket of £27,000 to £60,000.¹⁴⁰ The evidence above suggests that unemployment trends for this group will differ from those of the lower wage bracket – they will go through periods of unemployment far less frequently. Second, the evidence tells us that repeat claimants form a significant proportion of all JSA claimant counts. The relationship between repeat claims and low wages suggests that we can assume that many in this category would not be eligible for auto-enrolment, and can therefore be discounted in the model.

So how can we estimate our unemployment “frequency” with all this in mind? First, we can take a monthly total – broken down by occupation – and multiply this by 12 to approximate an annual on-flow count. We have used figures from June 2007 in this case, representing a “steady state” in the UK economy. We can assume that upswings and downturns will eventually even out over the cycle. In June 2007 for example, 22,760 people in administrative occupations flowed on to JSA. In a stable labour market, this would amount to an annual figure of approximately 273,120.

138 *Ibid.*, 32.

139 *Ibid.*, 41–2.

140 See chapter 1 for an explanation of why this automatic-enrolment bracket is proposed.

Second, it is reasonable to assume that a proportion of the JSA on-flow – around half according to the DWP figures mentioned above – will be repeat claimants, and they should therefore be excluded from the model. This is because repeat claimants are unlikely to be in the kind of occupations that command a salary above the £27,000 auto-enrolment level suggested. This gives an annual figure of 136,560 claimant on-flows from administrative occupations.

The next stage is to estimate what proportion of these claimants would be eligible for auto-enrolment into UI. This is calculated by looking at salary distribution by occupation. As already stated, auto-enrolment applies to employees earning between £27,000 and £60,000, so we can estimate the proportion of those who would be eligible within this salary bracket using the Annual Survey of Hours and Earnings (ASHE). The claimant on-flow figure is then adjusted to reflect this.

For example, our estimate is that 10% of employees in administrative occupations have earnings within the above salary bracket; so the same percentage is applied to the on-flow total. This produces an annual on-flow figure of 13,656 for this particular occupation.

The model must also take into account that a significant proportion of people who lose their jobs will find a new one very quickly. We can estimate this figure by looking at off-flow data, which indicates that approximately 10% of claimant off-flows follow a claim duration of less than 4 weeks.¹⁴¹ These people would probably make no claim on their UI, as the default policy requires a 31-day wait before benefits can be accessed. Table 5.1 shows how these calculations work out across the main occupational groups.¹⁴² In total, this means that around 200,000 employees could claim from an Anglo-flexicurity scheme each year.

141 This figure is calculated by comparing the UK total off-flow figure for June 2007 with figures for the same month broken down by duration.

142 Certain low-skilled occupational groups are excluded from the model because of a salary distribution under the lower threshold for automatic enrolment.

Table 5.1: Unemployment figures for the main occupational groups

Occupation	Monthly On-Flow	Annual On-Flow
Corporate Managers	7255	87060
Managers and Proprietors in Agriculture and Services	2155	25860
Science and Technology Professionals	2830	33960
Health Professionals	210	2520
Teaching and Research Professionals	2435	29220
Business and Public Service Professionals	1510	18120
Science and Technology Associate Professionals	2950	35400
Health and Social Welfare Associate Professionals	1865	22380
Protective Service Occupations	295	3540
Culture, Media and Sports Occupations	4655	55860
Business and Public Service Associate Professionals	3725	44700
Administrative Occupations	22760	273120
Secretarial and Related Occupations	3085	37020
Skilled Agricultural Trades	3080	36960
Skilled Metal and Electronic Trades	7285	87420
Skilled Construction and Building Trades	10240	122880
Textiles, Printing and Other Skilled Trades	3580	42960
Leisure and Other Personal Service Occupations	3250	39000
Process, Plant and Machine Operatives	9285	111420
Transport and Mobile Machine Drivers and Operatives	13095	157140
Elementary Trades, Plant and Storage Related Occupations	49265	591180
Total number of claims per year		

Source: Calculations based on ONS, ASHE and Nomis as well as DWP research.

For some occupational groups, these calculations will overestimate the number of claims, while for others it will represent an underestimate. There would also be considerable variation within professions – some companies are more robust than others, for instance, and some employees are more vulnerable than others for a variety of reasons. Overall though, the data produces a set of ball-park figures from which we can begin to estimate the likely average annual



Minus Repeat Claimants	Within AE Salary Bracket	After 31 Days
43530	30471	27424
12930	5172	4655
16980	12735	11462
1260	945	851
14610	8766	7889
9060	5889	5300
17700	7080	6372
11190	3357	3021
1770	1328	1195
27930	11172	10055
22350	10058	9052
136560	13656	12290
18510	926	833
18480	554	499
43710	17484	15736
61440	18432	16589
21480	2148	1933
19500	585	527
55710	13928	12535
78570	15714	14143
295590	29559	26603
		188962

frequency of UI claims over the cycle – and hence, the cost of the scheme as a whole.

ESTIMATING UI BENEFITS

Having estimated how often people might trigger their UI benefits, the task is now to ask how much they would receive, and what this

would cost insurers. This is obviously contingent on a number of factors. For example, how long is the given period of unemployment? What is the relationship between benefit and salary? And how long would people wait before accessing their benefit?

Our model is based on the default criteria set out in chapter 1, which proposed the following:

- a six-month period of benefit;
- a default benefit level equal to 60% of previous gross monthly salary replacement;
- benefits accessible after a wait period of 31 days.¹⁴³

It is thus relatively easy to calculate the personal liability for a UI scheme member. If we take a claimant's previous salary of, say, £30,000, break this down to a per-month figure (£2,500) and calculate 60% of this amount, this gives a monthly benefit figure of £1,500.¹⁴⁴

It is also necessary to make some assumptions about benefit duration – that is, the length of time a person is likely to claim for before re-entering the job market. Our model assumes the maximum six months here, for two reasons: first, for reasons of caution – some people will clearly find jobs well within this six-month period,¹⁴⁵ but we must account for maximum liabilities for the insurance product to provide adequate cover; second we are advocating a product that facilitates re-entry into the job market at the right time and place. This implies a longer job-search, which should be reflected in the costing. Calculated on this basis, the relevant figures for someone earning £30,000 are shown in table 5.2.

143 This report has advocated a flexible model of UI that can be tailored to certain individual requirements; however, this model takes a set of assumptions for the sake of expediency.

144 PI insurance is generally based on the principle that premiums are paid from taxable income, and any benefit received is untaxed. Because tax relief has been explored here as a means of incentivising UI, this would imply the opposite – that benefits would be taxed. These illustrative figures do not factor this in currently, so they would need to be taken into account in setting eventual individual benefit levels.

145 According to SMF analysis, "around 60% of JSA claims last less than 3 months". See Ian Mulheirn, "Commentary on Conservative Policy Paper: Keep Britain Working": www.smf.co.uk/keep-britain-working-commentary.html.

Table 5.2: Total liability

Annual Salary	Monthly Gross Salary	Monthly Benefit from UI	Total Liability for Insurer
£30,000	£2,500	£1,500	£9,000

Clearly, higher salaries would carry greater liabilities, and lower salaries lesser. This would be reflected in the individual cost of premiums.

We have already presented *frequency* and *benefit* as the key drivers of insurance pricing, and we can reasonably assume that a high earner within a volatile profession would be an expensive person to insure. To estimate how these variables would interact across the economy, the model next looks at salary distribution within particular occupations.

This is done by estimating national median salaries, by occupation, between the upper and lower thresholds for auto-enrolment. This gives an average that excludes salaries above and below the desired bracket, and thus a better approximation of the level of benefits that might accrue to people within particular jobs. Table 5.3 shows these average salaries in four occupational groups. A significant proportion of corporate managers and health professionals will earn over £60,000, which is reflected in a high average salary. Administrative occupations will generally offer lower salaries, so the average is towards the bottom of the groups.

Table 5.3: Average banded salaries

Occupation	Average banded salary
Corporate Managers	£50,000
Health Professionals	£60,000
Administrative	£28,000
Trades	£27,000

Table 5.4: Estimated individual premiums per occupation

Occupation	Expected Unemployment Insurance claimants	Total Individual Benefit (£)
Corporate Managers	27424	15000
Managers and Proprietors in Agriculture and Services	4655	11100
Science and Technology Professionals	11462	12000
Health Professionals	851	18000
Teaching and Research Professionals	7889	11100
Business and Public Service Professionals	5300	12000
Science and Technology Associate Professionals	6372	9600
Health and Social Welfare Associate Professionals	3021	8700
Protective Service Occupations	1195	11400
Culture, Media and Sports Occupations	10055	9600
Business and Public Service Associate Professionals	9052	10800
Administrative Occupations	12290	8400
Secretarial and Related Occupations	833	8100
Skilled Agricultural Trades	499	8100
Skilled Metal and Electronic Trades	15736	9600
Skilled Construction and Building Trades	16589	9000
Textiles, Printing and Other Skilled Trades	1933	8400
Leisure and Other Personal Service Occupations	527	8400
Process, Plant and Machine Operatives	12535	9000
Transport and Mobile Machine Drivers and Operatives	14143	8700
Elementary Trades, Plant and Storage Related Occupations	26603	8100

Source: Calculations based on ONS, ASHE and Nomis.

These averages relate not to the entire number of people within this occupation, but to the proportion eligible for auto-enrolment, earning between £27,000 and £60,000 per year.

ESTIMATING INDIVIDUAL PREMIUMS

The next step is to use the unemployment on-flow estimates of table 5.1 and benefit levels in order to calculate a set of basic risk premiums

Total Annual Liability (£)	Active Engaged Employees (AEE)	Annual Basic Risk Premium (£)	Monthly Basic Risk Premium (£)
411360000	1470525	279.74	23.31
51670500	134100	385.31	32.11
137544000	410625	334.96	27.91
15318000	93938	163.07	13.59
87567900	564300	155.18	12.93
63600000	280800	226.50	18.87
61171200	134700	454.13	37.84
26282700	248175	105.90	8.83
13623000	196313	69.39	5.78
96528000	69900	1380.94	115.08
97761600	353025	276.93	23.08
103236000	152475	677.07	56.42
6747300	21038	320.72	26.73
4041900	2228	1814.14	151.18
151065600	264600	570.92	47.58
149301000	75825	1969.02	164.09
16237200	23325	696.13	58.01
4426800	7110	622.62	51.88
112815000	149438	754.93	62.91
123044100	91800	1340.35	111.70
215484300	56625	3805.46	317.12

(BRPs). This is done quite simply. First, the average personal liability is multiplied by the expected on-flows, to calculate a total annual liability by occupation. This is then shared between the total number of active and eligible employees (AEEs) for that occupation.¹⁴⁶ The result is an annual BRP, which is then divided by 12 to arrive at a monthly figure. Table 5.4 shows how this works across the main occupation groups.

¹⁴⁶ The number of AEEs is calculated by taking the total number of employees within a particular occupation, then estimating the proportion earning within the £27,000 to £60,000 salary bracket. An automatic enrolment rate of 75% is then applied to this figure.

Onto this BRP must be added an administrative or management charge, which has been assumed to be at 5%. This is approximately 3–4% lower than the commercial standard,¹⁴⁷ reflecting adjusted costs for a national scheme (such as reduced advertising and marketing costs and reduced commercial overheads due to centralised administration).

So what does this calculation about the BRP tell us? First, it shows how a combination of the two key variables – frequency and benefit – determines premium levels. If average frequency and benefit are both high for a particular occupation, the basic risk premium will be expensive, something confirmed by this model. We can now look at how pricing would vary according to individual salaries.

One way to estimate how premiums vary by income is to use weighted averages¹⁴⁸ produced by the dataset. This gives us an average on-flow across sectors of the economy, an average salary and a total number of AEEs. These figures can be used to calculate an average salary-to-premium rate, from which premium estimates across the salary range can be calculated. June 2007 JSA on-flow data gives the averages shown in table 5.5.

Table 5.5: Average monthly premium

Total AEEs	Average Unemployment On-Flow	Average Banded Salary	Average Monthly Premium
4,800,863	188962	£39,938	£35.52

According to these figures, the average monthly UI premium is 1.07% of the average monthly salary. Applying this ratio across the salary scale produces the relationship between premium and salary,

¹⁴⁷ Observation is based on personal communication with industry experts.

¹⁴⁸ I.e., the weighted arithmetic mean where relevant.

as shown in figure 5.2. This shows a linear relationship, which is due to the fixed ratio linking individual annual salary to monthly premium payable. A long-term pricing strategy should be based on this steady economic state. This would take into account periods of both recession and recovery, smoothing premium levels across potential unemployment spikes and offsetting these against periods of more intensive job creation.¹⁴⁹



Tentative conclusions based on this model are:

- a monthly premium would need to be set at approximately 1.1% of gross monthly salary;
- this means that an employee at the lower threshold for automatic enrolment would be paying just under £25 per month for UI;
- the model indicates that, on average, UI members would expect to lose their job once every 20 years (a frequency of around 5%);
- an increase in unemployment volatility would impact upon

¹⁴⁹ This model takes "steady state" (summer 2007) data as a long-term pricing strategy. This assumes that risk will be greater during an economic downturn (when unemployment increases), and better as the economy enters an upturn (when more employers are hiring). Basing the scheme on data from late 2008 would demonstrate the risks to Anglo-flexicurity during a downturn, without evening this out across the longer term.

monthly premiums, but would affect certain occupations more than others – the impact of this would be absorbed across the whole membership;

- providing comprehensive UI at these rates depends upon broad membership across the salary range, and from diverse sectors of the economy; failure to ensure a wide pool of AEEs would fundamentally undermine the scheme.

There is clearly much to think about insofar as the costing of UI is concerned. This chapter offers some approximate figures, indicating that UI may well be affordable for individuals, and thus could become a cost-effective scheme. There are inevitable caveats. Monthly premiums of 1.1% of gross monthly salary would be contingent upon a successful enrolment process, and a successful pooling of risk across the working population. The automatic enrolment system proposed in chapter 3 could make this possible.

GOVERNMENT SAVINGS ON UNEMPLOYMENT BENEFIT

This chapter has, thus far, been concerned with showing what a UI monthly premium might look like. This section looks at the potential benefit saving that the Exchequer would enjoy as a result of Anglo-flexicurity. It presents some rudimentary figures that can then be measured up against outgoings involved in providing tax relief on premiums in a cost-benefit analysis.

We can approximate a potential saving that might accrue to the Exchequer from UI using public data on unemployment durations and benefit levels. If it is assumed that each UI member is a potential adult JSA claimant (i.e. eligible for the over-25s contribution-based JSA rate), then each individual's weekly payout in the event of unemployment would be £60.50. This is, however, not the only saving to the Exchequer should people not claim their state entitlement in the event of unemployment. In addition to JSA, the state would no longer be liable

to pay housing benefits or make income support mortgage interest payments. Further, tax revenue would be higher, since UI claimants would still pay direct and indirect taxes as a result of their having significantly higher incomes than people only receiving state benefits.

Calculating counterfactual savings to the Exchequer by aggregating all these elements is very complex. So here we rely on the assumptions made in the DWP Freud Review, *Reducing Dependency, Increasing Opportunity: Options for the Future of Welfare to Work*.¹⁵⁰ This report estimated that moving a jobseeker into work would save the Exchequer £8,100 per year, including benefit savings as well as wider gains mentioned above, which, in that calculation, are partly offset by additional tax credit payments. In our previous Anglo-flexicurity publication, it was estimated that the average duration of a JSA claim is 16 weeks.¹⁵¹

Combining these two figures implies savings for the Exchequer of around £2,500 per individual claiming UI rather than state benefits. Because of the £27,000 threshold for auto-enrolment in the scheme, UI claimants are unlikely to receive tax credits when they return to work, which indicates that the benefit for the Exchequer could be substantially higher. Assuming a banded annual unemployment on-flow of around 200,000 people (see table 5.1 for that figure), this would yield a gross saving of around £500 million per year.

We can now estimate how this potential benefit saving for the Exchequer measures up against what government would lose in tax relief if applied to all insurance premium payments. As noted in table 5.5, the average banded salary in our model is £39,938, and the related premium works out at £35.52 per month. Assuming that tax relief for all AEEs was available at 20% – i.e. the marginal tax rate for the average

150 Department for Work and Pensions, *Reducing Dependency, Increasing Opportunity: Options for the Future of Welfare to Work*, by David Freud (London: HMSO, 2007), 68.

151 Evans et al., *Anglo-Flexicurity*, 69.

earner within the salary band for auto-enrolment – the annual cost of tax relief to the Exchequer would be around £400 million. Since the majority of people enrolled would earn below the higher-rate income tax threshold (HRT), offering tax relief at members' marginal tax rate (i.e. tax relief at 40% for those above the HRT) might cause the cost to the Exchequer to be only a little higher than this, at around £500–£600 million annually. This implies that the direct costs and benefits to the Exchequer would roughly offset each other.

CONCLUSION

The introduction to this chapter asked three questions. Would a national UI scheme be financially viable? What would a monthly premium look like? Would it be unpalatably high? The preceding pages have gone some way to answering these questions, showing that if Anglo-flexicurity could generate a wide enough pool of members across the UK, there is reason to think that the scheme would be very affordable for its members.

This chapter has also shown how Anglo-flexicurity would save money for the government in the long run, through effective “contracting out” of its JSA responsibility for scheme members. For the scheme to work, the state must feel the benefit in the long term, the private sector must realise an acceptable profit margin and the individual must have a reliable product at an affordable price. In the end, the future of the Anglo-flexicurity idea depends upon these and other costs matching up. It is beyond the scope of this report to predict accurately whether this is possible, but the figures above suggest that these ends can be achieved.

CHAPTER 6: EVALUATING ANGLO-FLEXICURITY

This chapter concludes the report by offering a brief evaluation of Anglo-flexicurity. Given what we have argued thus far, can we advance the scheme as a new solution to the protection gap? Just how radical would it be? Would it be workable? And, what are its wider implications? A roundtable discussion in February 2009 elucidated the complex range of issues at stake. During the event, questions were asked about the genesis of the idea, the motivation of the scheme and its viability as a policy solution. Answering some of these questions is a good place to start.

WHY A MARKET-BASED APPROACH?

Chapter 1 advanced a strong justification for this approach, based on a clear need to address two interconnected issues: the worrying emergence of a “protection gap” and lack of an adequate state-funded safety net to address it. Through the gestation of this report, the economic picture has become increasingly bleak. Individual financial vulnerability is no longer a possibility, but something tangible that is currently affecting many people’s lives.

Anglo-flexicurity offers a means of combating individual insecurity without relying on a state solution, with all the associated costs, complexities and problems that this would bring. It gives people the means to provide their own safety net at a reasonable price, and provides a safe and accessible framework within which they can do this. The analysis of this report suggests that, for those needing a high level of personal security, these ends are best achieved using market mechanisms. However, offering affordable protection for some must entail a pooling of risk.¹⁵² To this end, Anglo-flexicurity offers a default

152 One question heard throughout the research process was: “Why do we need the state? Can’t the market provide this itself?” But the market has clearly failed to do this, and state intervention is necessary to resolve key market failures and facilitate a market-based solution.

scheme that would enrol as many workers as possible across the occupational and salary spectrums.

WOULD ANGLO-FLEXICURITY LEAD TO A TWO-TIER SOCIAL SECURITY SYSTEM?

There is a danger that Anglo-flexicurity is seen as part of a “layering” of social security – of offering great benefits to some people, while excluding others. There are two responses to this. First, the scheme is designed to address the current lack of protection for mid-to-high earners. This is not provided out of general taxation – which would penalise lower earners – but rather looks to individuals to contribute towards their own security. In this sense, privately provided UI links contributions with outcomes in a potentially fairer way than similar state-funded systems.

Anglo-flexicurity thus adds something to the debate over the National Insurance contributory principle, which has highlighted the “decline” of the current system, and explored the potential benefits of moving towards a more European model. This is explained by John Hills:

Under the strongest kind of contributory principle, in private insurance, the contributions made are actuarially linked to the potential value of the benefits. Under social insurance of the Bismarckian kind in countries such as Germany and France, risks are pooled but there is still a strong link between contributions and benefits in that both are earnings-related.¹⁵³

It is also important to note that Anglo-flexicurity is not exclusively for those within the auto-enrolment bracket. Membership would be available across the salary spectrum through opt-in mechanisms,

153 John Hills, *Inclusion or Insurance? National Insurance and the Future of the Contributory Principle* (London: CASE, 2003), 3.

making this a product that could be accessed by everyone. So why the enrolment bracket? This is simply a way of safeguarding people for whom privately provided UI may not be optimal. Those earning salaries below the bracket might find existing state salary replacement levels adequate, particularly if one factors in family tax credits.

WOULDN'T ANGLO-FLEXICURITY BE TOO COMPLICATED?

Anglo-flexicurity looks to offer consumers a simple and comprehensive way of properly insuring themselves. Yet, as this report has shown, facilitating this simple option involves some complicated design elements at various stages. One recurring question throughout the research process has been: "How would UI interact with other (state and private sector) initiatives?" For example, could UI premiums integrate into Personal Accounts pensions in some way? Could families access UI on "joint" terms? To what extent would UI sweep away the need for other private insurance products?

There is no easy answer to these questions – especially those concerning integration with existing government policies. UI could become part of a comprehensive social security reform process, as it certainly shares the philosophy of "co-production" – whereby "service users and providers share responsibility for outcomes"¹⁵⁴ – at the forefront of current debates on the future of UK public services.¹⁵⁵

It is beyond the scope of this report to investigate how different benefits would integrate holistically, but UI has the potential to provide a cost-effective solution to an emerging problem that is set to grow in

154 Simon Griffiths, Beth Foley and Jessica Prendergrast, *Assertive Citizens: New Relationships in the Public Services* (London: Social Market Foundation, 2009), 25.

155 Patrick Diamond, "Public Services: A Radical Settlement for the Next Decade", in Patrick Diamond (ed.), *Public Matters: The Renewal of the Public Realm* (London: Politicos, 2007), 11.

future as wage levels continue to rise. It should therefore be taken seriously as a policy option.

DOES THE PROPOSAL EXCLUDE COMPETITION?

This report has already argued for a comprehensive package that would potentially undermine other existing insurance policies currently on the market. This may well provide a good option for consumers, but it could be argued that a competitive market is actually being squeezed by the scheme. There are two responses to this. First, it is clear that the market has failed to allow for a spontaneous solution to income insecurity. This has given rise to a patchwork of different and overlapping products aimed at insuring specific outgoings, which have been criticised for offering poor value for money and have given rise to a series of scandals involving mis-selling. UI would invigorate – not undermine – the market, as it would provide a new benchmark for quality and accessibility.

Second, we must not confuse a free market with effective competition. The Competition Commission has been unequivocal about an existing lack of competition in the PPI marketplace, so we should see UI as part of the unblocking of key failures, not an obstruction to competition in the future.

Asking how a default-based system allows competition is a legitimate question. It will be important to ensure that participating insurers are chosen from open, competitive tender, and that their participation is subject to periodic contract review and performance-related targets. Ultimately, the extent of this will depend upon the wherewithal of the UIA board, as well as the overall success of the scheme.¹⁵⁶

¹⁵⁶ I.e. a successful scheme will encourage more funds to participate. There are also associated incentives for participating insurers. They would benefit from a hugely increased membership pool, and would be in a position to offer other insurances (e.g. motor or health insurance) to existing UI members.

ANGLO-FLEXICURITY: THE WAY FORWARD

This report has proposed a new approach to unemployment insurance, based on the principles of the social market. It has been developed by addressing key failures highlighted in the SMF's March 2008 report *A Safety Net for UK Workers*, and working through some potential solutions. What these solutions represent is not a finished set of ideas, but work in progress – an amalgamation of contemporary thinking and comparative public policy solutions. While *Anglo-Flexicurity* might not provide all the answers to the potential problems it has identified, it does bring forward a joined-up approach, and proposes a set of fundamental reforms.

This report has aimed to show how a scheme based on social market principles might be designed, rolled out and paid for. Initial figures suggest that monthly premiums could be affordable for members (at just over 1% of gross monthly salary), and that tax incentives offered by the state would be offset by significant savings on JSA payouts in the future. And while any costing at this stage should be taken as both tentative and exploratory, initial figures suggest the scheme may well be viable in a financial sense – provided enough UK employees are enrolled into the scheme.

Ultimately, the solution recommended here recognises both a growing need and an existing set of market failures. Anglo-flexicurity is an attempt to think creatively about what kind of system could best address these needs. The state cannot (and should not) be the sole bearer of this responsibility, but this market-based solution nevertheless involves an important role for government to enable it to succeed.

Any contemporary solution to problems of personal indebtedness and unemployment must start with a sharing of responsibility between the state, the private sector and, increasingly, individuals. The

welfare state in the twenty-first century will increasingly be arranged around the ideas of co-production and a stronger linking of contributions and benefits. Anglo-flexicurity reflects this shift in thinking and, we hope, advances the debate in this area.



This report outlines a fresh approach to national unemployment insurance, in which people can insure themselves against loss of income due to unemployment. It builds on the conceptual framework set out in the Social Market Foundation's earlier report *Anglo-flexibility: A safety net for UK workers*. Perceived job insecurity among middle-income groups was high even before the current recession, having risen over recent decades. Steadily expanding financial commitments, such as consumer credit and mortgage debt, and declining relative generosity of state unemployment benefits have raised the consequences for those in higher income brackets who lose their jobs.

The current economic crisis and rising unemployment are turning this sense of vulnerability into a very real problem for millions of people who now find their livelihoods in jeopardy. This makes it likely that we will see increasing disaffection with current forms of unemployment benefits over the coming years and a growing desire for change.

For many reasons, the role of protecting middle and higher-income earners against unemployment should not fall directly to the state. *Anglo-flexibility II: Insuring against unemployment in the UK* makes the case for limited state involvement to unblock market failures to facilitate a market-based solution to the middle class 'protection gap'. This research provides the stepping stones by which Anglo-flexibility might be developed from a set of ideas into a concrete policy to tackle a 21st century problem.

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