

Insurance for Unemployment Deenstock and Brasse

INSURANCE FOR UNEMPLOYMENT

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INSURANCE FOR UNEMPLOYMENT

There is undoubtedly a case for genuine insurance against unemployment wherever practical, insurance in which the different risks of the various trades are reflected in the premiums paid.
(F. A. Hayek, *The Constitution of Liberty*, 1960, p. 301)

Preface

This volume forms part of a research programme into the Economics of the Welfare State that I have been directing at City University Business School. In a related volume, *Work, Welfare and Taxation* (also published by Allen & Unwin), other aspects of the research are reported, while other papers in the series have focused upon pensions.

On behalf of my co-author I wish to thank Sian Billington for her assistance with data collection in relation to Chapter 4. I also wish to thank the Institute for Economic Affairs which has generously financed the research programme since 1981.

Michael Beenstock
September 1985

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CHAPTER 1

The Political Economy of Unemployment Insurance

The Basic Proposal

In the United Kingdom there is currently no economic relationship between the benefits that the unemployed receive and the premia that individuals have paid in the past in the form of National Insurance contributions. As a form of insurance, unemployment insurance is inadequate because there is no relationship between premia paid and the underlying unemployment risks that are being insured. In all other insurance markets (property, health, life, etc.), premia vary directly with the risks that are underwritten. In the case of unemployment insurance, however, those who face high unemployment risks contribute at the same rate as those who might face no such risks at all. Similarly, the benefits that the unemployed receive are flat rated: those who have contributed more receive the same benefit as those who have contributed less.

In this monograph we set out proposals for the rational pricing of unemployment insurance. In these proposals we regard unemployment insurance as a form of insurance proper in which premia are related to the unemployment risks that are being underwritten. Those who face higher unemployment risks would pay higher premiums. From this point of view unemployment insurance would be no different from other forms of insurance.

Goals and Means in Social Policy

There is no doubt that if our proposals were implemented the political economy of social security would be radically trans-

formed. The fundamental objection of those supporting the status quo will most probably be that those facing high risks will be unable to afford the correspondingly high premia and that our present arrangements are justifiable on distributive grounds. In other words, just as the National Health Service may be regarded as an institution for redistributing resources from the well off to the less well off, the social security system may be similarly regarded. Indeed, this is the very essence of Beveridge and the welfare state.

The counter-objection runs as follows. Economists are essentially concerned with the most efficient way of achieving a given set of objectives. In the present context there are two objectives. First to supply unemployment insurance that gives value for money to the insured. As we shall see, this involves charging the customer the true competitive cost of the cover he buys. In this sense unemployment insurance is no different from the provision of other goods and services. The second objective is to redistribute resources to those who are most in need. As Beenstock has argued elsewhere (Beenstock, 1983), present arrangements in social policy confuse policy means and objectives. If, as we believe, the basic objective of social policy is to redistribute resources to those in need, the efficient means for achieving this are incompatible with present arrangements. It makes no sense to make something such as health free for 100 per cent of the population when the target group in terms of resource transfer is perhaps 15 per cent of the population. Similarly, it makes no sense to charge everybody the same price for unemployment insurance when the purpose is to help a target group. Saturation bombing is inefficient when the target is relatively small.

We therefore argue that the price mechanism is an inefficient means of redistribution. It is, however, efficient in allocating resources. This implies that the price mechanism should be used for allocating unemployment insurance services while the fiscal system should transfer resources to those who are in need.

If our proposals were implemented there would be substantial redistributive effects. Thus, the argument that present

arrangements are redistributive is not an effective objection to our basic proposal. In any case, it is not a foregone conclusion that the unemployment benefit system redistributes resources in a way that is intended. It may be that some of the better off face relatively high unemployment risks, in which case the redistribution of resources would be the opposite of what was intended: the better off would be benefiting at the expense of the rest of society. This serves to remind us that resource creation and allocation should always be kept separate from resource redistribution.

In fact, the calculations we report in Chapter 6 suggest that, on the whole, present arrangements are not redistributive. Therefore, implementation of our proposals would not in general adversely affect those who are in relatively low-paid jobs. It is also worth pointing out that Beveridge never suggested that unemployment benefit should be open-ended. Indeed, in his *Full Employment in a Free Society* (1944) he argued that benefits should decline over time in order to increase the incentive for the unemployed to find jobs. However, he explicitly ruled out the case we make for individual risk assessment and his view has become enshrined in postwar practice. It is worth quoting him at length:

When State insurance began in Britain, it was felt that compulsory insurance should be like voluntary insurance in adjusting premiums to risks. This was secured in health insurance by the system of Approved Societies. It was intended to be secured in unemployment insurance by variation of contribution rates between industries as soon as accurate valuation became possible, by encouragement of special schemes of insurance by industry, and by return of contributions to individuals who made no claims. In the still earlier institution of workmen's compensation, adjustment of premiums to industrial risks was a necessary consequence of the form in which provision for industrial accidents was made, by placing liability on employers individually and leaving them to insure voluntarily against their liability. In

the thirty years since 1912, there has been an unmistakable movement of public opinion away from these original ideas, that is to say, away from the principle of adjusting premiums to risks in compulsory insurance and in favour of pooling risks. This change has been most marked and most complete in regard to unemployment, where, in the general scheme, insurance by industry, in place of covering a large part of the field, has been reduced to historical exceptions; today the common argument is that the volume of unemployment in an industry is not to any effective extent within its control; that all industries depend upon one another, and that those which are fortunate in being regular should share the cost of unemployment in those which are less regular. The same tendency of opinion in favour of pooling of social risks has shown itself in the views expressed by the great majority of witnesses to the present Committee in regard to health insurance. In regard to workmen's compensation, the same argument has been put by the Mineworkers' Federation to the Royal Commission on Workmen's Compensation: as other industries cannot exist without coalmining, they have proposed that employers in all industries should bear equally the cost of industrial accidents and disease, in coalmining as elsewhere.

There is here an issue of principle and practice on which strong arguments can be advanced on each side by reasonable men. But the general tendency of public opinion seems clear. After trial of a different principle, it has been found to accord best with the sentiments of the British people that in insurance organised by the community by use of compulsory powers each individual should stand in on the same terms; none should claim to pay less because he is healthier or has more regular employment. In accord with that view, the proposals of the Report mark another step forward to the development of State insurance as a new type of human institution, differing both from the former methods of preventing or alleviating distress and from voluntary insurance. The term 'social insurance' to describe this institution implies

both that it is compulsory and that men stand together with their fellows. The term implies a pooling of risks except so far as separation of risks serves a social purpose. There may be reasons of social policy for adjusting premiums to risks, in order to give a stimulus for avoidance of danger, as in the case of industrial accident and disease. There is no longer an admitted claim of the individual citizen to share in national insurance and yet to stand outside it, keeping the advantage of his individual lower risk whether of unemployment or of disease or accident. [Beveridge, 1942a, p. 13]

Beveridge's case for social insurance has recently been reaffirmed by Mrs Thatcher and her government. The Green Paper, *The Reform of Social Security*, published in June 1985, tends, indeed, to go beyond Beveridge in certain respects. Beveridge's social insurance fund was to be actuarially sound, whereas the Green Paper argues that '... the contributory principle can be seen not so much as social insurance but as a social compact – between those in work and those not, or between one generation and the next' (p. 40). At the same time it is admitted (p. 19) that 'the contributory system is not based on strict insurance principles, and never has been, but it provides a valuable means for determining entitlement'.

At the Institute for Fiscal Studies, Dilnot *et al.* (1984) have recommended that the contributory principle should be abolished entirely and that social insurance should be financed out of general taxation. This treats public expenditure on unemployment benefit on the same basis as public expenditure on defence. Since National Insurance contributions are tantamount to taxes and do not in practice confer property rights with respect to benefits, one might as well rip away the veil of the contributory principle. We have a lot of sympathy for the IFS position, but we prefer to pursue the logic to its diametrically opposite conclusion, in which contributions are actuarially fair and buy well-defined property rights over unemployment-contingent benefits.

Habitual Modes of Thought

In his preface to the *General Theory* Keynes spoke of the difficulties of escaping from habitual modes of thought. The institutions that we build reflect both our habitual modes of thought and emotion. It is upon them that intellectual prejudice feeds. We have persuaded ourselves that unemployment insurance is different from other types of insurance, when this is not so. We have simply become habituated to present arrangements and have grown to take them for granted.

In this monograph we have tried to escape from both habitual modes of thought and emotion. This is important because kicking the habit is likely to confer important benefits both social and private.

First, the cost of providing unemployment insurance will be minimized through competition. The present system is run by a state monopoly, which is likely to harbour various forms of inefficiency.

Secondly, under our proposals people will be able to buy the amount of unemployment insurance they desire. No doubt there are many unemployed people today who might have sought to buy more cover than is provided by the state. At the same time there must be many people who are forced by present arrangements to over-insure themselves. Thus, our proposals put unemployment insurance on the same footing as other types of insurance and goods and services in general. The consumer should be sovereign.

Thirdly, we cannot take it for granted that present arrangements are in fact distributing resources to those in need. Implementing our proposals would expose this issue, and pave the way for redistribution policies that are more effective in transferring resources to those in need.

Fourthly, by pricing unemployment risks on the basis of economic costs, individuals will be less exposed to moral hazard than they are at present. We drive our cars carefully, partly because accidents will raise the cost of car insurance. The same checks and balances should apply to unemployment insurance.

We are likely to take more care about our jobs because this would help to minimize the premia we have to pay.

The Chapters Ahead

We begin in the next chapter by asking how the unemployed coped before Lloyd George established the prototype of the present UK system in 1911. We do so for two reasons: first, out of historical interest, but secondly and more importantly because it might yield some insights into how our proposals might operate. During the second half of the nineteenth century trade unions operated private unemployment insurance schemes. We document this practice by reviewing previous studies of the matter as well as by appealing to various official reports that thus far have not been analysed in the present context. One of the factors that led to the spread of trade unionization in the last century was that friendly societies did *not cover unemployment risks, while the trade unions did*. The trade unions thus filled an important gap in the market. Indeed, many trade unions objected to the Lloyd George reforms because they rightly saw that they would forfeit some of their power.

It turns out that nineteenth-century trade union practice does not provide a practical model for our proposals. On the contrary, the lessons to be learnt are more negative than positive because on the whole the various schemes were not run according to appropriate actuarial principles.

Although trade unions entered the market for unemployment insurance, in a sense the state system has always been with us. Since the Elizabethan Poor Law Act of 1601 there has been some form of support for the destitute in Britain. We investigate the degree to which the Poor Laws might be thought of as providing unemployment benefit. In our view, the Poor Laws were never intended for such purposes but in practice the administrators of the Poor Laws provided what today would be regarded as Unemployment Benefit, Supplementary Benefit

and even Family Income Supplement. This was not, of course, as systematic as it is today, but over the years human concern and compassion brought this situation about until the Minority Report of the 1909 Royal Commission on the Poor Laws laid the foundation for the social security system of the twentieth century. Thus, for the non-insured unemployed, some relief was obtainable through the Poor Law system, although this varied both regionally and over time according to the breadth of interpretation of the acts by the Poor Law administrators.

In Chapter 3 we describe our methodology for calculating the competitive premia for unemployment insurance. This methodology builds upon fairly standard actuarial techniques and assumes that workers face different unemployment risks. The central insight of our approach is that the premia that individuals pay to buy unemployment insurance should reflect the true actuarial cost of the policy. These premia generate normal profits for the insurance industry and it is in this sense that we may consider them as being competitive. It turns out that the major determinants of the premia are the rates at which workers are likely to join the unemployed and the rates at which they are likely to find other employment. Risk classes are determined according to these two rates.

We also discuss the effects of moral hazard on the determination of premia and we consider the nature of the demand for unemployment insurance by people exposed to unemployment risks. This chapter is theoretical and will be beyond the reach of the lay reader. However, at the beginning of Chapter 4 we describe the main insights of Chapter 3 in intuitive terms. Thus, the lay reader should not be put off and is advised to skip Chapter 3 altogether. Chapter 3 is none the less important because it justifies our basic methodology.

This methodology is illustrated in Chapter 4 where we perform numerous calculations of what the unemployment insurance premia might be for different types of workers. We use available data sources for determining the risk classes of workers and we find that premia are wide ranging. This reflects the wide range of unemployment risks that are being under-

written. In contrast, therefore, to the present state system where all contribute at the same rate, our analysis suggests that the appropriate premia are varied. Indeed, these premium rates are as wide ranging as in other branches of insurance.

These calculations are no more than illustrative because what few data are available are most probably too crude for our present purposes. Indeed, if our approach is to be implemented, appropriate data bases will have to be constructed either by the Central Statistical Office or by the insurance industry itself. Nevertheless, we believe that our calculations provide an important starting point for moving away from flat-rated contributions.

It turns out that even at the present time there are various forms of unemployment insurance in the UK that are outside the state system. First of all, there are various insurance policies regarding mortgage repayments which are unemployment contingent. This is not a direct form of unemployment insurance because the cover refers to specific payments. Secondly, a number of trade unions provide unemployment benefit for their members. To some extent this practice is a vestige of the last century when trade unions operated unemployment insurance schemes as described in Chapter 2. The practice is by no means widespread today, but it is of some interest in the present context that the practice has survived. These contemporary practices are described and reviewed in Chapter 5.

Finally, in Chapter 6, we discuss the policy implications of our study. We believe these to be major. There are two main issues. First, the present practice of flat rating contributions should be abandoned in favour of the economic pricing of unemployment insurance. This means that those who face higher risks of unemployment should pay higher premia than those who face lower unemployment risks. The base line should be that people should be charged according to the competitively determined costs of their policies. This would put unemployment insurance on the same footing as other types of insurance by relating premia to individual or group experience.

Before such a policy could be implemented, however,