# of mutual benefit personalised welfare for the many

Max Wind-Cowie

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OF MUTUAL BENEFIT

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Max Wind-Cowie
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Executive summary

Incapacity welfare is a much misunderstood, and much maligned, area of huge government spend. Successive efforts to reform the way in which incapacity benefits are assessed and paid in the UK have played on a suspicion that many who claim them are 'scroungers' and 'benefit cheats' to justify increased conditionality and more stringent testing. But the truth is that incapacity benefits in the UK are not only low but also insufficient for most people's financial needs. They may be hugely expensive overall, but they are relatively ungenerous at the individual and household level. This is particularly problematic for those who find themselves unable to work having previously earned at or above the average UK wage. This group will experience a significant financial shock, long-term hardship and steep reduction in living standards if they fall victim to a severe illness or disability that leaves them unable to work. The relentless emphasis on managing the existing benefits system to ensure that cheats do not receive benefits fails to address the inadequacy of our incapacity benefit system in dealing with the UK's 'squeezed middle'.

This report sets out to address two interlinked deficiencies in public policy: the inadequacy of welfare coverage in protecting the squeezed middle when they are unable to work, and the huge cost to the taxpayer of disability benefits. It might appear that solving the former implies worsening the latter – that better standards of living for those unable to work necessarily means a more expensive benefits system. This report demonstrates that this is not the case. By encouraging individual responsibility and engaging with the insurance industry the UK can simultaneously lift the level of financial protection available to the squeezed middle while reducing the cost on the state. The key is income protection.

In order to understand how our incapacity benefits system works, how it is perceived and how it compares with other countries we have engaged in a two-stage research process. We have spoken to the squeezed middle – those earning between £16,000 and £50,000 – through focus groups to understand what they know about welfare in the UK and how they feel about it.[1] At the same time we have developed an Index of Financial Protection, which compares the UK with peer countries in Europe, North America and Australasia – comparing the coverage from state benefits and the coverage from private insurance (including income protection, pecuniary loss and related health benefits), while controlling for factors such as different healthcare markets.

Taken together, this research tells a compelling story about UK incapacity benefits. They are neither adequate for the financial needs of the squeezed middle nor particularly generous when compared with other countries. Our overwhelming reliance on the state in the UK may, in fact, be a contributing factor to our relatively ungenerous state offer. The UK's tiny market density for income protection – just 11 per cent of the labour force are covered by an income protection policy – leaves people overwhelmingly dependent on the state if they are unable to work.[2] What is more, the squeezed middle understand and resent their vulnerabilities. They believe the benefits system is unfair because it lacks reciprocity and that it fails them because it does not take their financial commitments and needs into account. They know they would be unable to sustain their standard of living – or indeed their home if they are mortgage payers – in the event of being left unable to work by accident or sickness. While they are keen to engage with alternatives, and to be better protected, they believe that this would mean 'paying twice' and are angry that government does not recognise personal responsibility in this area.

Government should engage in 'supply side' reform of incapacity welfare structures and expectations. Only by better protecting the squeezed middle from risk can it hope to maintain their support for welfare more broadly – average earners are particularly concerned about their financial vulnerability and want government to help them better protect themselves against the risks of disability and severe illness. But reform is not simply necessary to ensure welfare's continued appeal to average earners – it is a source of huge potential savings for the Exchequer too.

Cost benefit analysis of the recommendations in this report show that by reforming the way in which statutory sick pay is managed and providing incentives to those who opt to protect themselves, government could save £2.24 billion of taxpayers' money a year. These savings emerge without any additional reform to the welfare system – they are recouped simply through the existing means testing framework. The potential savings will increase further as government normalises means testing across other benefits such as DLA.

Reform to encourage individual responsibility and income protection is genuinely of mutual benefit. Individuals, households and families would be more secure, less vulnerable to financial shocks and able to maintain their standard of living in the face of personal tragedies. The Exchequer would save billions of pounds in benefits expenditure and free up resources that could be used to target help and interventions much more effectively.

The approach laid out in this report builds on the theory and practice of 'libertarian paternalism' or 'nudge'. Nudge is not a panacea for policy makers and it cannot replace existing levers of influence at the disposal of government. However, there is a clear use for its methods in the area of personal finance and welfare. First, it has a precedent in this area – the 'opt out' reforms to pensions are a classically libertarian paternalist intervention aimed at encouraging pension take-up while allowing people independence and choice over their personal finances. The UK has taken an approach which dictates that where there are existing compulsory demands on employers – such as in statutory sick pay – it is fair and reasonable to maintain the settlement and continue to regulate, but where there are no existing provisions incentives and 'nudge' interventions would be used rather than create a burdensome new layer of bureaucracy at this difficult time for employers.

Welfare provision in the UK has been perceived as being solely the province of the state –a norm this paper explores and seeks to refute. It outlines recommendations that suggest 'nudge'-type interventions may allow policymakers to change this norm without dictating change to citizens.

Recommendations

Reform statutory sick pay

Statutory Sick Pay (SSP) is the basic living allowance paid to those who are too unwell to continue in their job but who have not yet become unemployed. It is paid by the employer and serves to ensure that those who face a new disability, sickness or health problem are not left without an income as they discover whether it is possible for them to return to their job. But SSP is dead money. It does nothing other than provide a bridge between employment and benefits. We urge the government to change the requirements placed on employers – to compel employers to insure their employees against sickness, ill heath and accidents so that an insurance company, rather than employers themselves, will be responsible for paying SSP. The reason for this is straightforward – by insuring employees, rather than paying out a flat cost whenever an employee becomes too unwell to work, employers will benefit from the extensive rehabilitation and return to work schemes that insurers offer. And insurers, driven by a financial incentive as well as broad experience in successful return-to-work programmes, will be incentivised to intervene early and effectively. This brings a net benefit to the employer – currently employee absence costs employers an average of £517 per employee per year in lost production, SSP and extra overtime costs.[3]

But it would also bring a substantial benefit to the government. Research has demonstrated that the types of intervention offered by insurers to assist people who return to work are 43 per cent more effective than non-intervention (which is the status quo).[4] Considering that 644,000 people flow onto Employment and Support Allowance (ESA) every year (of whom around 300,000 are estimated to flow from SSP) there are substantial opportunities for intervention before people ever encounter the benefits system.[5] That is where the interventions offered by insurance schemes have a place – a reduction by 43 per cent of the flow through from SSP to ESA would save the state £139 million a year.

The workplace is the right environment to promote income protection. It is the place where employees are most prepared to discuss their finances, and it provides the right space for discussions of financial protection. When employers contribute to schemes on behalf of, or in conjunction with, employees it lessens the overall cost and the cost to the individual significantly.

Reciprocate responsibility

In the qualitative work that we conducted with the squeezed middle a recurring theme was their sense that the welfare system lacks reciprocity and, therefore, fairness. Their concern for the fact that they would be unable to survive financially on incapacity benefits was not enough, alone, to motivate them to protect themselves. They thought it essential that there should be some form of incentive to encourage them to address the issue of income protection and to seek coverage. We recommend that government recognises the personal responsibility – and savings to the Exchequer – that underpins income protection. A suggested incentive of £100 per policy – paid from National Insurance to those individuals who purchased an income protection plan – could save the state as much as £2.24 billion a year in unemployment benefits.

Build the market

Income protection is not a norm in the UK. In countries where there is greater density of financial protection – and of income protection specifically – the labour force is better protected against the risk of disability, sickness or ill health, and these countries tend to have more generous state cover as well. Government should look to build the market overall so that UK workers benefit from the more robust, generous and secure levels of overall protection prevalent in countries with a greater density of financial protection coverage. We recommend it does this by offering subsidised income protection policies to public sector employees and sharing the National Insurance rebate available with employers who choose to subsidise coverage for their workforce. These measures could be introduced over time and would serve to encourage the development of market capacity and the establishment of a new norm for employers and employees alike.

Reform the £16,000 savings means test

The £16,000 savings means test forces those who become unemployed to spend any savings above £16,000 before receiving state assistance. This policy is counterproductive as it penalises responsible, future-orientated behaviour and exacerbates the financial shock of unemployment for the squeezed middle. Analysis of the government's proposed welfare reforms has shown that families will be strongly incentivised by the new structures to keep savings below £16,000. This was a cause of deep resentment and anger in our focus groups and undermines efforts to encourage more responsible financial behaviour.

We recommend that government turns this policy on its head, so that savings are left untouched by the state for the first six months of unemployment and can only be brought into the means testing framework after that time. In implementing this reform government can not only encourage saving and send a clear signal that it supports financially responsible behaviour, but also directly incentivise those who have savings to return to work. Rather than depleting their savings from the moment they become unemployed, the deadline of six months would provide a clear financial incentive for these people to return to work as swiftly as possible.

The welfare landscape

Welfare is the single biggest area of government expenditure. When we add up the cost to the taxpayer of unemployment benefits, tax credits, pension benefits and other entitlements, the huge cost that welfare places on the Exchequer is clear. The public spends £135.7 billion a year on welfare – an unsustainable amount in periods of wealth, and an unaffordable bill in an age of austerity.[6]

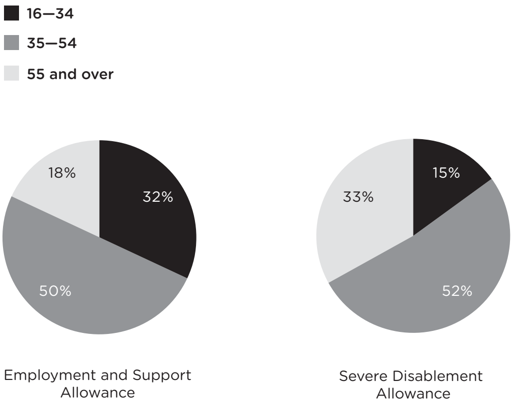
Reform to welfare is a priority for this government – as it was for the previous administration – and solving the complex and interrelated social problems associated with unemployment will take time and systemic change to the benefits system. The focus of this report is deliberately restricted to examining how people who lose their jobs as a result of accident, disability or a long-term health problem fare under our current welfare system, how that compares with international comparators and how we can both improve their financial health and reduce the cost to the state.

This area of welfare policy is, in itself, complex. People who are unable to work as a result of accident or ill health face huge challenges recovering from or managing their condition. They are unable to return to the workforce swiftly, if ever. Their financial situation is often precarious – particularly if they have limited savings or personal assets – and, currently, they are overwhelmingly dependent on the state for income. There are only 3.6 million active income protection policies in the UK; the rest of the workforce is covered for accident or serious ill health only by the state and whatever personal savings they might have.[7]

It is often imagined that those claiming benefits due to disability are mainly either suffering from congenital problems that have always prevented them from working or are older people who have become less able to work over time.[8] In fact, the largest category of new claimants for ESA – those moving from the workplace and onto benefits because they are unable to work – are those aged between 35 and 54.[9]

Figure 1 shows that 32 per cent of ESA claimants are aged 16–34 years compared with 15 per cent of Incapacity Benefit (IB) or Severe Disablement Allowance (SDA) claimants in this age group. The reverse can be seen in the older age group: 18 per

Figure 1 **Number of people claiming Employment and Support Allowance and Incapacity Benefit or Severe Disablement Allowance by age group, May 2010**



cent of ESA claimants are 55 years old and over; 33 per cent of IB/SDA claimants fall into this age group. This tells us that those transferring to ESA because they are unable, for the time being, to work because of accidents or ill health – and those who are claiming IB because they are severely disabled – are predominantly adults aged between 16 and 54. These are the individuals most likely still to be paying mortgages, and have dependent children and high fixed outgoings. This category is also further away from pensionable age, therefore facing a potentially longer period of dependency on state benefits.

ESA payments are between £51 and £65 a week – depending on whether you are over 25 and have dependants – for the first 16 weeks, followed by payments of an average of around £70 per week. You may receive assistance towards housing costs – full rent or a contribution towards your mortgage – but this assistance depends on a labyrinthine set of means-testing rules governing your savings and assets. It is little wonder that as many as 60 per cent of people with disabilities or long-term debilitating health needs live in poverty in the UK.[10] Research has also shown that 61 per cent of working adults would be unable to cope financially if they were unable to work as a result of sickness or disability.[11]

For individuals, the hardship of disability and ill health is often exacerbated by poor financial protection. For the state, taken as a whole, claimants of incapability benefits are an enormous net cost on an already struggling welfare infrastructure. There are around 2.61 million recipients of state incapability benefits with around 684,000 new claims every year.[12] The total cost to the taxpayer, of providing incomes to those unable to work, excluding housing and carer costs, is around £16.9 billion a year.[13] That figure represents an enormous cost for the taxpayer – it is, annually, a fifth of the five-year spending reduction target of this government.

The UK's income support for individuals who are unable to work suffers a double fault. It is too expensive for the taxpayer while, simultaneously, being ungenerous to the individual. This observation is borne out by both the qualitative findings of our focus groups with average earners and by our Index of Financial Protection; these are explored in the following chapters. The truth is that our welfare state does not score well compared with those of peer nations in its generosity to average earners who find themselves unable to work, and our system is also hugely expensive to the taxpayer. There are other factors that should be considered when considering whether reform is necessary to our system for looking after those who cannot work, for example, the dependency created by our welfare system and the lack of perceived fairness and reciprocity in the system. But whatever one's political or moral beliefs about welfare there is a simple and stark fact that should drive us to examine how reform might be achieved: our disability benefits system is too expensive and burdensome for the taxpayer while failing even adequately to support those who find themselves unable to work. It is neither cost-effective nor generous.

Income protection can be a tool for individuals and the state in meeting these challenges. That is not to say that there are significant challenges in using the insurance market to meet the needs of those who find themselves unable to work. The UK public has a poor understanding of what income protection actually is – they associate these products very strongly with payment protection products (which have received a great deal of negative publicity) and are nervous about involving the private sector in welfare.[14] But personal income protection – properly regulated and sold responsibly – can increase the income of those who find themselves out of work, reduce the burden on the state to pay for the needs of those who are unemployed through accident or ill health, and all in a fully-costed and self-sustaining way.

What is income protection?

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

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

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

Income protection policies – therefore – can serve to answer the concerns about the relatively ungenerous nature of incapacity and employment support benefits. What is more, these products do so without greater expenditure from the state. Why then are income protection products relatively unpopular in the UK? There are only 3.6 million income protection policies active in the UK at the moment – from a labour force of almost 32 million people.

Later in this report we will analyse more closely what can be done to encourage greater awareness and take-up of income protection products – and outline the potential savings to the state – but it is abundantly clear that beneficiaries of income protection products are themselves better off and better supported than those who do not have this coverage. That fact alone should encourage us to look at how the income protection market can be bolstered and encouraged in order to better protect more and more people from the financial consequences of disability and sickness.

Reform of pensions

We should not forget that welfare in the UK shares a governmental home with pensions. And it is from new policy initiatives in the area of pension reform that this report draws some of its lessons and insights for unemployment and accident and sickness provision. From 2012, unless employers are already operating a pension scheme that meets the required criteria (or set one up), employers will have to enrol each eligible employee into the NEST pension scheme.

The NEST scheme (formerly known as the Personal Accounts scheme) becomes compulsory for employers in 2012. It is designed to ensure that those who work, who do the right thing day-in, day-out, are provided for at an acceptable level when they come to retirement, and that employers and employees are aware of their responsibility to plan ahead.

NEST is simpler than an individual company pension scheme and it pushes employers and employees into doing the right thing. But it is not draconian. Employers and employees do not have to take the option provided by the Government and are encouraged to shop around. It is surely only possible to introduce this model of pension provision because of the steps towards inducement and incentivisation that were taken previously – encouraging personal responsibility for pensions and creating a positive norm whereby most employers offer private protection as a matter of course. We start in welfare a long way behind the position on pensions, but a start can be made. The long-term aim of this report is not necessarily a NEST equivalent for employees' income protection, but it is to reproduce the norms and expectations around pensions in how we regard accident and sickness coverage.

Reform to our welfare system to embed and reward personal responsibility would help to alleviate some of the very real, and justified, concerns about the fairness of UK welfare. By expanding and supporting the private insurance market – to encourage personal responsibility and reward personal agency – government can diminish the trap of dependency while also leveraging some of the risks and costs of accident, sickness and disability away from the state. This means encouraging awareness and take-up of income protection, as well as creating new markets to allow the insurance industry to play a role in the rehabilitation and support of those who are unable to work.

Making personal welfare work

This pamphlet explains why personalised welfare systems are important – on the practical grounds of what individuals receive, the moral grounds of personal agency and resilience, and the economic and political grounds of a reduced cost to the Exchequer. In making the case for personal welfare we look at examples from around the world – exploring what works where, what we can learn from international examples and why some solutions simply aren't applicable in the UK. We make a series of policy recommendations that are designed to encourage people to protect their incomes against accident and ill health – protecting their standard of living, alleviating the potential to fall into poverty, and reducing the cost to the taxpayer.

In seeking to develop our recommendations for personalised welfare, we have premised our work on three principles, along whose lines welfare policy should be developed in order to reduce dependency, increase trust and win public support.

First, reform must encourage future-orientated behaviour so that people understand and act on their personal responsibility for their financial futures. There is strong evidence that encouraging future-orientated behaviour in one area promotes it in others; this should be a key aspiration of welfare reform.[15]

Second and third, reform should also focus on two interlinked concepts that were overwhelmingly important to our focus group participants – fairness and reciprocity. We have uncovered a growing sense among average earners that the welfare system fails the so-called squeezed middle because it does not compensate them adequately and does not recognise their contribution. Fairness and reciprocity must be at the heart of attempts to change the way the UK 'does' welfare and they underpin our recommendations in this report.

These principles are reflected in the analysis and recommendations of this report. They are fundamentally conservative ideals with progressive underpinnings. We apply them to the current welfare settlement, finding that it is neither perceived as, nor in fact, 'fair' for low to middle earners and that many pay more into it than they would ever hope to receive, while also being actively discouraged from future-orientated, responsible financial behaviour. We apply these principles, as tests, to international case studies too – to demonstrate that it is possible to construct a more future-orientated, fair and reciprocal welfare system. Finally, we apply these tests to the recommendations we make for reform, so that people who invest against the risk of accident and ill health can be confident in the fairness and viability of the insurance products they buy.

1 Public opinion and welfare provision

There is a problem with our welfare system that will not be resolved simply through reform to encourage the long-term unemployed into work. Workers actively believe that the welfare system does not adequately protect their finances or repay their contributions. Unfortunately that perception is grounded in reality. Average earners – especially those with a mortgage – are actively disadvantaged by the low level of unemployment benefits and this exacerbates the financial shock of even very short-term worklessness.

But there are further issues with the public's perception of welfare, which undermine support for the UK's unemployed. While acknowledging their fears about the viability of a life on welfare, many earners believe the UK welfare system is in fact too generous and too accessible. This perception is informed by the tone and tenor of public debate – from tabloid fury over 'benefit scroungers' to the near endless 'crackdowns' initiated by governments of all political colours. But, again, it is also grounded in a public understanding of very real problems in the welfare system. The public knows that reciprocity does not govern welfare, that many people who claim do not need to, and that some actively seek to defraud the taxpayer.

Thus UK welfare policy has, at its heart, a dichotomy of seemingly opposed perceptions that undermine support for welfare. On the one hand, earners believe they are let down by the low level of support they know they would receive if they had to claim a welfare benefit and are resentful towards that system. On the other, they worry that the system overall is undisciplined and wasteful – that it 'throws good money after bad' and fails to recognise or reward personal responsibility.[16] This is eroding popular support for welfare and is problematic for efforts to reaffirm goodwill towards unemployment benefits and, indeed, the unemployed themselves.

If we are to maintain public goodwill towards welfare we need to make it fairer, demonstrate the rewards for personal responsibility and answer people's fears about their own security.

Prior knowledge

Working people's understanding of the UK's welfare settlement is fairly good but consistently overestimates the level of generosity that the state provides. Those in our focus groups estimated the current level of JSA for the average individual is between £65 and £80 a week – the actual level is around £65.[17] There was a strong perception – accurately – that those with children receive more money. Participants overestimated the income that people with disabilities receive, believing the amount to be between £100 and £120 a week when the real figure is an average pay-out of around £70 a week.

Housing Benefit

There was general understanding among focus group participants that the unemployed will get contributions towards the payment of rent but not towards supporting a mortgage. This was a source of mixed feelings among the focus groups – many were worried that they would almost certainly find themselves unable to continue mortgage payments if they were to lose their job:

I'm on a knife-edge as it is, with my mortgage and loans and that. Living on benefits, with no support for my mortgage or even the interest-only support, would mean losing my home – no question.[18]

They were angry that, if they became unemployed while they rented they would be able to keep their current home, whereas if this happened when they were home owners they may be disadvantaged. However, there was very little support for the idea that mortgage payments of unemployed people should be met with Housing Benefit. Several participants raised the fact that this would be a permanent, private financial benefit acquired via the taxpayer. Additionally, several participants felt that using Housing Benefit to pay mortgages could skewer the housing market and disincentivise (or at least reduce the incentive for) people to work by allowing those who are long-term unemployed to accrue significant private assets in the form of housing.

More generally on housing welfare, participants were clear that the primary driver of social housing and state benefits should be cost-effectiveness. Although some raised questions about people's and families' roots in communities there was a general and largely universal belief that Housing Benefit and social housing are too generous towards the long-term unemployed and take too little account of the cost to the taxpayer. Participants were very supportive of the government's decision to cap Housing Benefit at £400 a week and of policies to liberalise social housing tenancies. Several participants argued that residents in social housing should have their tenancies reviewed regularly to assess need; several of the participants had anecdotal stories concerning Housing Benefit fraud and social housing residents who maintained large homes despite no longer needing them. Overall, participants believed that housing welfare benefits are overly generous towards the long-term unemployed, badly managed and disproportionately ineffective at helping those who own their home.

So, while there was extensive and ingrained resentment towards the Housing Benefit system – and a belief that workers with mortgages are under-protected – there was little appetite for a broadening of the state-benefit system to compensate. Participants felt vulnerable about their mortgages and thought they were particularly at risk from financial shocks because they owned their own home. However, participants did not wish to see this resolved through the state infrastructure.

Living on benefits

We asked participants to provide some phrases and words to describe how they would feel if they needed to live on benefits.

We wanted to understand employed people's perceptions of the benefits system, how they perceive benefits and what particular impact they believe becoming unemployed might have on them. These are some of the words and phrases they used:

- 'intrusion into my life'
- 'not right: doesn't reflect well on country, also worried'
- 'insecurity'
- 'I'm self-employed, my benefits would be negligible, therefore thinks "unfair"'
- 'boredom'
- 'unfair'
- 'stingy'
- 'worried'
- 'embarrassed – because I am able to work, would rather scrub a loo than be unemployed'
- 'failure – after all previous achievement'
- 'concerned'[19]

Participants were overwhelmingly negative about the idea of 'living on benefits'. It is interesting to note that financial security was, by an extremely large margin, the highest area of concern. Participants were concerned that they would be unable to afford to sustain their standard of living on benefits, that they would lose their home, that their children would suffer and that their freedom (both economic and otherwise) would be curtailed. All of these concerns have some merit. It is true that participants who became unemployed – all of our participants were currently in employment of some form or other – would be significantly less financially secure, at risk of losing their home and so on. However, the fears described by several participants were disproportionate to the economic reality and displayed a lack of understanding about the day-to-day operation of life on benefits – for instance, one participant was fearful about 'having someone check my bank statements, telling me what I can spend money on and stuff'. Strangely, although participants overstated the generosity of benefits at the beginning of the session, they were overly fearful about the impact and effect of unemployment on their personal financial security.

The UK in the world

We were interested to understand what participants thought of the generosity of UK benefits compared with those offered in other countries. Our quantitative research demonstrated that the UK was, overall, a less secure place for average earners to lose their jobs. But it also showed that UK state benefits – when ranked against those of peer nations – are significantly less generous than many other nations.

Having asked our participants to think about the level of benefits in this country, we asked them to consider how generous some other countries would be in providing benefits to someone who became unemployed, in order to find out their views on the relative generosity of UK benefits. We also wanted to gauge whether they felt that people who became unemployed were comparatively well protected financially.

In groups, we asked participants to rank the UK against Australia, Canada, France, Netherlands, Norway, Poland, Spain, Sweden and the USA in relation to income protection in the following case:

A single individual who is 30 years old and has worked continuously since graduating from university aged 21 becomes unemployed due to their employer cutting costs. They live alone in rental accommodation, have no significant assets and remain unemployed for less than 6 months before re-entering the workforce. Rank the countries, with the most generous at the top, in order of the level of benefits you believe the state will give this person.[20]

Participants' responses were largely generalised and the groups arrived at consensus decisions within them. Overall, several trends emerged. The participants agreed that Scandinavia – both Sweden and Norway – would give very high benefits (either of those countries came top in all three groups). These countries were generally followed by continental European countries in the ranking – France, Spain, Netherlands, followed by the UK. All three groups placed Australia, Poland and the USA at the bottom of the rankings, with two of the three placing Canada at the bottom too. All three groups ranked the UK as one of the most generous top five states. All three groups ranked the USA as one of the least generous two states.[21]

The participants also raised a series of perceptions about different welfare systems that are directly relevant to our research. Several participants suggested that some countries – the Netherlands and Canada were singled out – operate systems that are based on receiving a proportion of your salary for a period of time. These systems won a great deal of support from fellow participants and several people described them as 'fairer' – highlighting two facts: those who have been earning more have been paying more tax and therefore a higher level of benefit rewards them; their living costs and outgoings are likely to be significantly higher, making the financial shock of living on a fixed state income more dramatic.

Participants were very certain that Scandinavian nations gave more generous benefits, but there was significant disagreement about the reasons for this. Some participants argued that Scandinavians were culturally and politically predisposed to higher levels of taxation, that this was more culturally ingrained and that Sweden and Norway could therefore afford significantly higher levels of benefit. However, several participants refuted that view. They suggested that these countries' high levels of natural resources coupled with small, homogenous populations meant that they could sustain very high levels of expenditure without damaging public opinion, because it did not, in fact, come from income taxes. Interestingly, there was a general consensus that although the Scandinavian model might be more generous, its structure and system simply would not work in the UK and could not be directly applied.

When presented with the actual rankings in state-benefit generosity participants expressed surprise that the benefits in the USA were more generous than those in the UK, that those in Sweden were less generous than expected and that the UK fared relatively badly.

Protection needed

The second half of the focus group meetings focused on understanding what kind of financial protection and welfare people currently in employment actually want. Rather than begin with an assumption that state benefits are the ideal means of delivering financial protection – and looking at what level we would want those benefits to be paid at – it is important to understand what kind of system working people feel best suits their needs.

We asked the participants, having engaged in conversation, thought and deliberation on the welfare system, how their attitudes towards unemployment benefit were changing. Confronted with the reality of living on benefits – the facts rather than perception – many of them expressed surprise at how little they would be expected to survive on, how little support they could expect to receive towards keeping their home (where they were property owners), and the level and impact of means testing:

To find out we are so low – does make me more scared. It would not benefit me as someone who has contributed significantly.[22]

There was a general belief that the difference between contributory and non-contributory JSA was insufficient to be either fair or reciprocal. Participants strongly believed that those who had worked – and had contributed significantly to the 'welfare pot' – should be treated more generously. Again, several participants mentioned systems that were more individualised and in which benefits corresponded more closely with what one had paid – mention of these schemes won widespread support and interest from other participants, although a couple of individuals raised political issues. One participant said:

I accept that I'd be better off if it was more like the US or Holland, we all probably would sat round this table, but that's not what I believe in because I think we're the lucky ones and we have a duty to families that aren't the lucky ones.[23]

Concerns such as this provoked interesting reactions from participants. Many agreed with the underlying assumptions but still believe that the current system fails to fairly treat those who worked and intended to work. Furthermore, many responded that the status quo was so unfair as to merit reform. However, participants did not believe reform should be used to cut the generosity of current benefits but thought instead that benefits should be more flexible and generous for those who had contributed.

Would you benefit from extra protection?

Our participants were all currently in some form of employment – we excluded current JSA and ESA claimants from this research. When asked whether they believed that they and their families would benefit from additional personal financial protection there was unanimous agreement that they would. However, in considering what they would wish to protect, and how, the participants displayed clear preferences about any additional protection they might be asked, or encouraged, to purchase.

They wanted additional protection products to answer their primary concerns with the current state-based system. They wanted it:

- to be more reciprocal and reflective of how much individuals had contributed
- to reflect their outgoings and expenditure
- to work for a variety of circumstances – the self-employed, mothers and so on.

Several participants raised concerns about 'paying twice', pointing out that they believed that National Insurance was *supposed* to function as an individualised welfare account and were very frustrated that it did not work in this way. Participants in all three groups suggested, unprompted, that some form of National Insurance rebate would be appropriate if they were to purchase alternate income protection for themselves and their families – arguing that government would be making a saving and they should not be expected to pay twice for personal financial protection.

Despite concerns, however, overall participants were very keen on the idea of reform to establish a clearer link between individuals and their financial protection. They argued that they were ill-served by either the current system or by planned reforms – they strongly believed that a more reciprocal, 'fairer', deal was needed for average earners such as themselves.

Incentives and policy

Government interventions to encourage personal financial responsibility and to grow personalised welfare solutions in the UK have been much discussed over the years, from individual credit accounts paid into by the state to total privatisation. We asked our focus group members to discuss some policy options suggested as means to encourage personal financial protection and to assess which might be more or less effective in persuading people to engage, and which they thought were workable solutions:

- The knowledge that you are protected is enough.
- You will be given a National Insurance rebate at the end of the year of between £100 and £200.
- Your employer is matching your contributions.
- Welfare is likely to be cut further – making the gap wider between what you would want and what you would need.
- You will be opted in automatically and will have to choose to opt out if you want to leave.
- You can use the fund for alternative needs if you have to – put it towards your pension if it is unused when you retire.
- You can pass it down to your children if it is unused.[24]

Participants displayed a breadth of priorities in choosing from the available policy options – all of them won some support (although at varying levels) and all of them had criticism from within the groups. However, there were some general points, ideas and responses, which won significant support.

Participants viewed the National Insurance rebate idea as a positive incentive but were sceptical about the actual financial benefit it would bring. Several participants expressed the strong opinion that there was a symbolic benefit to a National

Insurance rebate and claimed that a rebate at the level described would provoke them into considering the possibility of income protection and incentivise them into purchasing a policy. This was generally accepted by the focus groups and all three groups placed National Insurance rebates in their top two policy choices.

Participants were keen on the idea of employer contributions – feeling this would incentivise them to participate as individuals. Several participants drew comparisons with pensions and felt employers 'could do more' to contribute to the welfare of their employees. However, some raised concerns about the potential impact on small businesses and entrepreneurs and felt that any obligatory scheme risked making jobs more expensive and, therefore, restricting opportunities to enter or re-enter the workforce. All three focus groups agreed that employer contributions would be best suited to larger employers and big companies – several suggested that some form of incentive might be found to encourage employers to take part.

Participants overwhelmingly believed that some form of flexibility of use would be important to them if they were to be encouraged to participate. They were particularly keen on the idea that an account that went unused – or was used sparingly – should be transferable for use as part of a pension scheme or to put towards a pension annuity. Participants were less concerned at being able to 'pass down' their protection to their children (as is possible under the Singaporean system) and this was one of the least popular policy options.

All three focus groups agreed that an 'opt-out' system – under which employees would be automatically enrolled but would retain the right to withdraw – would be very effective at encouraging personal welfare. However, all three raised concerns that this method would be illiberal and would remove active choice from employees. Several participants were concerned that an 'opt-out' system would be less effective in encouraging a sense of responsibility:

The thing is, you want people to be more responsible and more grown up but they're not in this scheme, because they're not having to actually make the choice.[25]

State versus private, which would you prefer to hold your money?

There were low levels of trust in both state and private providers of income protection or welfare. In all three focus groups, participants raised a serious concern that the state – if entrusted to hold personal accounts – would use the funds for alternate policies and serve to undermine the reciprocity and personalisation that they felt strongly were positives. These concerns related to dissatisfaction with the state of National Insurance and resentment at the lack of individualism in that system. Furthermore, some raised concerns that a state system would undermine choice. Participants found the idea of choice appealing – being able to make decisions about how they chose to protect themselves was important to them – and a state-held scheme was seen as being a threat to choice.

The private sector was not overwhelmingly popular either. However, some of the concerns raised were perception-based and by no means insurmountable. Participants were especially concerned about the link between private welfare or income protection and insurance mis-selling in the repayment protection market. They believed that private companies had performed badly, and acted immorally, in providing such products inappropriately and refusing to pay out in the event of claims.

Some participants suggested they would like to see mixed provision of personal welfare products between the state, private sector and (potentially) not-for-profit sector such as credit unions. They felt this would protect claimants from the negative views they attached to each of those sectors acting individually.

Ideas and concerns

We presented our focus groups with an amalgam policy scenario in order to elicit their responses, ideas and concerns about reform to liberalise and personalise welfare. This was our scenario:

The government has decided that they want people to take more personal responsibility for unemployment benefits and so have developed an opt-out system. People in employment and their employers pay into a fund to protect them in the event of unemployment. Anyone who doesn't have a fund – or *whose fund 'runs out' – will remain eligible for state benefits but these will be less than the fund and will be less than is current. Your NI contributions will be partially rebated as a reward for participating but you can, if you choose, opt out of the system.*[26]

Concerns

Participants were concerned that the above policy placed too great a burden on employers. Although participants were keen, in principle, on the idea of employers contributing to personal accounts to look after their financial needs, there was a strong fear that enforcing contributions would make employing people more expensive, place undue pressure on small businesses and drive down employment opportunities.

Participants responded positively overall, though, and there was a general feeling that this scheme would provide financial security to individual participants. Several participants argued that employer contributions should be optional, but that employers should be expected to make it clear to potential employees whether they would be protected by a scheme such as this:

Then people could decide for themselves, it would be like trading off between salary and holiday. People might want the higher pay or they might want the better security that comes with a scheme like this – they could decide which was better for them.[27]

Who would be disadvantaged?

Participants recognised that those on lower incomes would acquire less protection for themselves under a more personalised welfare model. However, there was a strong feeling that people's financial needs were relative to their individual situation:

You need less. If you're used to living on [the] minimum wage, you don't spend more than you get. So you need less to keep you afloat when you lose your job, less than someone who's got a mortgage to pay and lives in a more expensive area. It's about what you need, what you're used to.[28]

Participants believed that reform along the lines of that outlined in the scenario was fair. Several suggested that not only would they be better off individually under this system but that it would be fairer across the board.

Some groups believed they would be disadvantaged by a personalised model. In particular, they were concerned about those who take time out of the workforce through no fault of their own – mothers who cease work to have children or those who suffer from a short-term disability. But participants suggested these issues could be resolved relatively easily through continued voluntary contributions while women were on maternity leave and through separate schemes to cover disability or sickness. Several participants claimed that – for these groups – a reformed system might actually be fairer and more generous. They pointed to the earlier session, where it was found that countries with private coverage were more generous in their state benefits than the UK, as an example of how there might be positive change if coverage were extended in the UK.

Conclusion

None of our participants believed that the current welfare system works well for average earners. Nearly all of them would like to see reform of the welfare system so it catered for their needs, alongside reform to make the system work better for the long-term unemployed. Average earners believed that the current system is disproportionately ungenerous towards those who have worked, that it takes too little account of what individuals have contributed and that they are especially vulnerable to the financial shock of being suddenly unable to work.

Participants want a welfare system that is more reciprocal and in which there is a clear link between what one contributes and what one is entitled to. They also believed that the existing means tests – covering savings above £16,000 – is unfair and a disincentive to savings among middle earners.

Participants would respond well to incentives but are concerned about the impact on business and employers of any form of compulsion. The strong desire for reform is tempered by scepticism about the capacity of the state or the private sector to behave in a trustworthy manner.

From our qualitative research we were able to draw up a series of principles to underpin long-term reform of the way the welfare system is structured and how it applies to average earners. These principles blend the concerns, ideas and complaints of our focus groups with the political principles of progressive conservatism and liberalism – especially the concern in these schools of political thought that people are not made dependent on the state but are given power and responsibility over their lives. These principles, alongside our new understanding of the positive relationships between private markets in welfare and overall (and state) generosity, inform the policy recommendations made in the next chapter. More broadly, they should inform any attempt by governments wishing to win broad support for welfare reform approaches – they are based on the deliberative assertions of ordinary people in the UK.

Welfare reform should promote future-orientated financial behaviour, in order to encourage norms of personal responsibility and produce more robust citizens who are equipped to withstand financial shocks. Our qualitative research showed that financial insecurity is a primary source of fear among average earners – that insecurity can only be prevented through future-orientated financial decisions in the here and now. Income protection serves that purpose admirably; it gives employees the opportunity to protect themselves against risk and to secure themselves against hardship.

Our focus groups also highlighted interconnected concerns about fairness and reciprocity – participants believed that the current welfare settlement fails to distinguish between those who have contributed through tax and those who have not. As average earners they were aware that this impacted on them – they would not receive an income they felt was sufficient, should they be unable to work, and yet they were aware that they were 'paying' for welfare provision. This lack of reciprocity concerned our participants and accentuated their underlying perception of welfare as being unfair. These key concerns emerging from the focus groups lead to the three principles of future-orientation, fairness and reciprocity that underpin the recommendations outlined in this report.

2 There is another way

One of the arguments often made in support of the UK's welfare system is that a state-centric model is 'fairer' than systems based on personalised and private welfare arrangements. The public's fear of private sector involvement in welfare – highlighted during our focus groups – has been further exacerbated by a political discourse that can make talk of reforming welfare to involve insurers and the private sector difficult. Nonetheless, an honest and open conversation about the best, fairest means of protecting individuals from the financial risks of disability and ill health is necessary.

The public's perceptions of our welfare system are mixed and subject to a certain amount of confusion. There is a growing assumption that, if anything, the UK system is *too* generous towards claimants – fuelled by a natural concern that benefits dependency has become culturally acceptable within communities across the UK. However, as our qualitative research showed, earners are very worried about their prospects should they suffer from an accident, disability or health problem that prevents them from working. We found that workers are both angry that the welfare system has become ill-disciplined and rewards irresponsible lifestyles and fearful of becoming dependent on it themselves.

There is clearly some concern that the UK's welfare system is broken – and not just for the existing long-term unemployed on whom government often focuses. The fears and concerns of the employees who participated in our qualitative research were well founded. They would be disadvantaged by losing their jobs (even for a relatively short amount of time); their higher outgoings make them more vulnerable to financial shocks; and their higher investment in welfare (through tax) is not recognised or rewarded in any meaningful way. And yet any discussion of genuine, long-term welfare reform in the UK is consistently stymied by the assumption that, despite the obvious problems, only a state-centric approach to welfare is viable.

But the UK's way of doing welfare is not the only way. Nor, in fact, is our welfare system the most generous in providing what people receive if they are unemployed, the most fair in its correlation between what one puts in and what one gets out, or the most sustainable in encouraging an affordable set of welfare expectations.[29] The squeezed middle are particularly disadvantaged. If they become unable to work, through accident or sickness, they are left with substantial financial risks such as mortgage repayments, which our welfare system leaves them unable to manage.[30]

The wholly state-centric approach that we pursue is widely, wrongly, believed to be the most generous means of providing for people in case of unemployment. Demos' research, in compiling a new Index of Financial Protection, demonstrates that the UK's model of welfare is by no means the most generous nor the most secure for people who earn an average wage, based on comparisons of available health, accident and disability insurance (with differing healthcare markets controlled for); pecuniary loss coverage; and the state welfare offer for members of the workforce.

The Index of Financial Protection

In order to understand how other welfare systems work we have to look at them in an honest, clear and ordered way. Too often, debate about means and ends in welfare policy in the UK becomes confused and overly ideological. Those who advocate greater private sector involvement are often cast as the enemies of financial security for the unemployed and of generous state help for those out of work. The Index of Financial Protection is compiled from OECD data. It lists the comparative state benefits offered to average earning individuals who lose work and the availability of private cover for a range of circumstances in which income and payment protection may be required and therefore informs the debate on welfare provision in the UK. We have analysed the comparative protection in peer nations in Europe, Australasia and North America. In doing so we have assessed both the levels of private income protection and the levels of state support available to the average citizen facing unemployment, as well as their relative reciprocity (measured through the replacement ratio of relative investment to outlay by citizens).

Overview of the index

Table 1 shows the Index of Financial Protection, which gives a broad insight into how several developed countries perform in protecting their workforce against the costs of unemployment. To do this it looks at how generous different countries' welfare states are and how much individuals protect themselves against the risk of unemployment.

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

Because we also want to see how much individuals protect themselves, regardless of state protection, against the risk of unemployment, we also measure 'private protection'. We do this by looking at two key ways people protect themselves: through taking out accident and health insurance to pay for loss of income when they are ill, and by taking out pecuniary loss insurance in case of loss of income. However, we know that health care systems vary around the world, none more so perhaps than the UK and USA. Therefore we adjust the accident and health figure to account for how large the private health system is in that country. This gives us a better indication of how much

Table 1 **The Index of Financial Protection**

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

Source: 2009 OECD data[31]

protection people want against unemployment, irrespective of the size of the private sector in the health system. Because we are interested in how much each person is protected by the state we then divide this figure by the size of the labour force. We rank countries' performance in protecting citizens from unemployment through private protection using this figure. This gives us the private protection index.

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

As the results show, unsurprisingly, Norway and Sweden perform highly in the amount of total protection they provide. However, the results interestingly show that this is in large part because, relative to the size of their private insurance sectors, they privately protect themselves fairly highly. Furthermore, the

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All monetary figures converted into US dollars PPP

Definitions

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

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

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

Labour force Number of people actively in employment or seeking employment

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

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

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

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

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

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

Total protection index An index of the average state and private protection index

USA performs a lot better on this index than most people expect, coming several places above the UK; their higher level of private protection helps explain this in part. The UK does not perform well in either state or private protection.

The USA has a higher level of financial protection than the UK

The index shows that the total level of protection that an average member of the labour force can expect is higher in the USA than in the UK. Therefore, in the event of unemployment, an individual earning the average wage can expect a more generous overall coverage in the USA than in the UK. The USA scores 60 out of a maximum 100, whereas the UK scores only 44. Thus the total protection provided in the UK is 16 points below that provided in the USA.

This finding runs contrary to the expectations of members of our focus groups, most of whom thought the USA came near the bottom of the list of countries when measuring the protection it gave the unemployed. Furthermore, it is worth noting that even when private protection is removed from the equation – leaving only state protection – the USA remains more generous towards the average labour force member than the UK. State coverage per member of the US workforce is $16,738 per year whereas the UK's state coverage per member of the labour force works out at just $14,991.36 – with both figures adjusted for purchasing power parity.

A person on an average wage in the USA can therefore expect more generous welfare whether or not they have purchased a welfare insurance product. This may be because the far larger private welfare market enables the state to be more generous where it focuses its involvement. Fewer in the labour market are wholly reliant on the state, enabling the state to allocate greater resources to each individual who does rely on it.

The UK provides relatively poor financial protection

The level of total protection available to an average member of the labour force in the UK should they become unemployed is far below that of the USA. The UK scores just 44 against the USA's score of 60, and compared with Canada and the Netherlands, the UK fares even worse. In both these countries private protection is significantly higher than in the UK.

Both state protection and private protection in the UK are below the level found in the USA. However, it is the substantial difference in the level of private protection that is the chief cause of the UK's low rating on the index.

This is significant for two reasons. First, the lack of private protection in the UK results in less overall coverage and resilience from spells out of work for the UK labour force. Therefore the UK workforce has a lower level of overall protection and is less robustly protected against unemployment, accident and ill health. Second, the findings of the index further point to the relationship between a healthy private income protection market and a more generous state welfare settlement. Countries with a higher level of private protection also tend to have higher levels of state benefit. This correlation may be explained by the reduced risk to the state when a person insures themselves to cover some – or all – of the cost of welfare should they become unwell, have an accident or become unemployed. The state is better able to predict its outgoings where it has a high level of private protection within its workforce, and that expenditure is likely to be less overall. This enables higher focused payments.

There is more variation in level of private protection than in level of state protection between countries

The standard deviation of private protection is larger than that for state protection. This is to be expected given that the coverage of insurance varies substantially between the UK and USA while eligibility for state protection and the countries' unemployment rates are broadly similar. It also implies that the most effective means to increasing coverage for individuals – and for ensuring that individuals are adequately covered to protect themselves from financial shocks – is to expand the market in personal protection.

There is broadly a positive correlation between level of state protection and level of private protection

While it is an axiom of statistics that correlation does not imply causation, it is interesting to note that there is broadly a positive correlation between the level of private protection and the level of state protection. This may be the result of a third factor, such as GDP per capita; we may expect a higher level of wealth corresponds with a greater ability for individuals to buy insurance policies and for the state to spend more on benefits.

Given the low level of private protection relative to state protection in the UK, we may expect that the level of private protection will rise to be similar to that in other nations.

There is no clear correlation between unemployment rate and the level of total protection

This is an interesting point given that it is usually assumed in economics that a higher level of protection corresponds with a higher unemployment rate. The relationship between state protection and the unemployment rate, as well as private protection and the unemployment rate, is at best very weak for the countries concerned. This suggests a more complicated picture of unemployment than is usually deployed.

The UK could be more generous to its unemployed – and save money – if we had more robust and wider insurance coverage in the UK. This is not 'privatising' welfare, it is sharing the burden and growing private sector coverage in order to enable a system that is simultaneously less expensive and harmful to individuals.

Income protection in the USA and UK

The Index of Financial Protection gives us an indicative view of the take-up of financial protection policies. That overview necessarily includes financial protection, which does not fall into the category of income protection that this report focuses on. However, looking specifically at the variance between income protection in the UK and USA bears out the findings of the Index overall.

Market density in the UK – the extent to which the workforce is covered by income protection policies – is just 11 per cent (or 3.6 million people).[32] Thus just 11 per cent of the UK labour force have protected their incomes against ill health, accidents and disability – 89 per cent of the UK labour force is dependent solely on the state and whatever savings or personal assets they may have should they be made unemployed through ill health or accident. This lack of coverage compares unfavourably with the USA, where around a quarter (27 per cent) of the labour force is covered by an income protection policy.[33] This means that the specific difference in income protection – as opposed to financial protection more broadly – between the work forces in the two countries is even starker than the Index shows us. The Index (which counts a broader range of financial protection products) shows that the US labour force is twice as well protected as the UK labour force. Looking at only income protection coverage, the US labour force is almost three times as protected as workers in the UK.

The higher level of coverage in the USA supports individuals in retaining independence should they fall victim to an accident, severe illness or disability. What's more, the higher level of coverage in the USA, coupled with workers' more generous welfare coverage in the Index, reinforces the point that higher levels of private protection do not lead to a reduction in the state's generosity. The USA has both greater density of coverage for income protection and a higher value of welfare coverage than the UK.

Savings to be made

Significant savings are available to a government that identifies means of supporting the growth in personal financial responsibility and personal welfare. The Treasury could stand to benefit significantly if the population were to move towards personal welfare; this would share the benefits of such a move between individuals – who would be better off – and the state – which would have less of a financial burden placed on it in the event of disability or severe ill health in the population.

One means of assessing the potential savings available to government – even before reform to make the benefits system more compatible with private, personal protection – is to look at the impact of accident and health insurance. This insurance covers people for loss of income and employment due to accident or ill health, and is the most basic and common form of protection.

Table 2 **Annual savings to the state if a couple earning £12,000 a year have income protection**

	Couple with non-working partner		
	Pre disability (£)	Post disability – no income protection (£)	Post disability – income protection (£)
Yearly employment income	12,000		
Income protection			4,247
State benefits			
Working Tax Credit	2,423		
Council tax		827	638
Housing	588	4,390	3,775
Disability Living Allowance		3,679	3,679
Employment Support Allowance		6,693	4,753
Total state benefit entitlement per year	3,011	15,589	12,845
Total income per year	15,011	15,589	17,092
Tax savings from income protection		£2,744	

Source: CRA calculations

As table 2 demonstrates, the state would save £2,744 a year in state benefits on a couple who had a yearly salary of £12,000 with income protection, should the person earning become unemployed.[34] These savings come without any further reform of the benefits system or any new means testing. They are what the state could save, per person, under the current system.

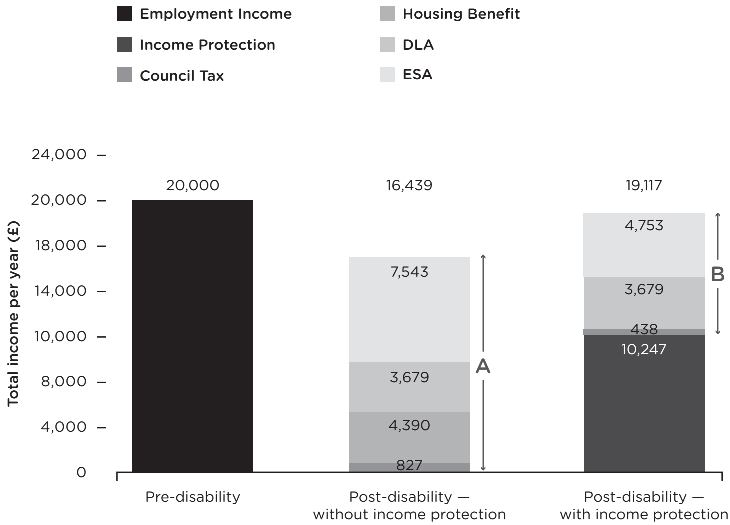
We should also recognise the routine 'costs' of employment – from paying for travel to the workplace to the cost of appropriate workplace clothing. These costs are highly variable and it would be wrong to generalise, but they are a significant additional strain on wages, which do not affect the unemployed – so the disposable income differential between low-salaried working individuals and those on ESA is even lower than it appears. In the long term the government's policy of introducing universal credits and its stated ambition that being on benefits never rewards people more than if they are in work may resolve this issue, but as things stand the routine cost of employment is a significant disincentive for individuals who want to protect their income.

It is worth remembering that the benefits of insurance for very low earners are negligible. There is little incentive for this group to invest in protecting their income as the level of state benefits they might expect to receive is relatively close to their existing incomes. Therefore, while the figures for those earning £12,000 pa (or around the minimum wage) indicate the base-line of savings for government they do not tell us the whole story. Also, the number of people leaving work because of an accident or ill health is likely to be lower in white-collar and professional groups, limiting their savings value to the state, and their premiums will be higher as the income protection required is greater.

Because certain benefits are already means tested against income – Housing Benefit, council tax and income-related ESA for example – individuals with protection will be less expensive to the state if they are unable to work.[35] They will also be personally better off. As table 2 also shows, individuals with protection will be over £1,500 better off a year than they would be without it. Thus we can see that individuals who have protection will be better off in the event of disability or severe ill health while also costing less to the taxpayer – both the state and the individual are better off.

These savings can be seen across the income spread shown in figure 2.

Figure 2 **Sources of income for a single person with and without income protection, and savings to the taxpayer**



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

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

Source: CRA[36]

As figure 2 shows, the more people earn, the more they are protected, and the more the taxpayer stands to save. Personal income protection is mutually rewarding – it serves the interests of the individual and the interests of the state.

Figure 2 demonstrates that the state would save £7,569 in means-tested benefits on a person with a pre-disability income of £20,000 a year – right in the middle of the income spread of the squeezed middle – who has income protection, should that person require state benefits. For those with a pre-disability income of £30,000–50,000 the savings are more substantial still. As a result of increased means testing across the incapacity benefits system, those who are protected will prove to be even less burdensome to the state while also having a better income. So, a person whose pre-accident income is £30,000 a year (in the middle of the range of earnings that constitute the squeezed middle) would be £7,364 a year better off with an income protection product than relying on state welfare, while providing savings for the Exchequer of £10,383 a year.[37]

The costs of disability

People who become unemployed because of long-term sickness or disability face longer in unemployment than those who lose their jobs for other reasons and find it harder to return to work. Indeed, many people who suffer an accident or sickness that prevents them working never return to the workplace. It is often third-party interventions that prove most effective in helping those who eventually find work again to realise their potential to return to the workplace and develop the adjustments that will help them to do so. It is worth noting that where personal income protection covers an individual there is a direct profit incentive for these interventions, making it more likely that they will be provided promptly and effectively.

But the long-term nature of unemployment caused by a disabling illness or accident makes the financial security of those who find themselves unemployed in this way all the more crucial. The circumstances in which individuals find themselves when they become unemployed as a result of accident or ill health will affect them for longer than would otherwise be the case.

Up to 60 per cent of disabled people in the UK live in poverty,[38] and the additional costs of living with a disability have been estimated at between £80 and £400 a week, depending on the severity of disability, or at between 11 per cent and 69 per cent of a person's income.[39] Disabled people often suffer a direct financial penalty as a result of their disability. For those reliant on state benefits this comes at the same time as they suffer the financial shock of becoming reliant on a dramatically reduced, fixed income. If they are an average or above average earner, that fixed income will be substantially below their previous earnings and, for those with sufficient income to be owner occupiers, insufficient to support their mortgage.

The allowances the state pays disabled people are set to be substantially reduced over the course of this parliament. The Disability Living Allowance is being replaced with a Personal Independence Payment, which will alter the assessment criteria and may well reduce the numbers who qualify and the amount they are eligible to receive.[40]

Personal welfare products would protect the incomes of average earners should they suffer from a disability or long-term health condition. They would help those earners to escape poverty if they lost their job and would provide the support and the interventions necessary to return them to the workplace where possible – high-quality interventions, as delivered by the insurance industry, can be as much as 43 per cent more successful in returning people to work than non-intervention.[41] It would result in more robust individuals who had more secure finances and help to end the very real problem of disability-related poverty in the UK.

Conclusion

There is a strong correlation between the extent to which the private market provides personal financial protection in a country and the overall robustness of welfare coverage and individual generosity of state benefits. There are, of course, anomalies. Norway, for example, has a relatively low level of private protection but very generous state benefits.[42] It is clear, therefore, that factors such as political culture, natural resource wealth and the size of the population have a strong bearing on the capacity of individual states to protect the finances of their citizens. However, peer nations to the UK (which have a comparable level of taxation and comparable public attitudes towards tax and spend) tend to have larger private markets in which individuals take some level of responsibility for their financial security.[43]

The UK should grow its insurance market from the impact of accident, severe ill health and sickness on income. Countries which have a higher-value market and broader coverage have more citizens who are better able to withstand the shock of being suddenly unable to work with less (or even without) significant investment from the state. Furthermore, those countries that have better levels of coverage are able to be more generous to those for whom personal financial protection is not an option.[44]

This report does not argue that privatising the welfare system would be possible or desirable. But it is right that, in this area of public policy as much as in any other, government recognises that it cannot deliver the optimum service to all comers while simultaneously focusing its resources on those most in need. Pretending that a reformed system, designed to better tackle the issues of long-term unemployment, will also be ideal for those who are workers and wish to be workers again is to ignore the fact that our benefits system already fails to cater adequately for this group.

Such a programme of incentivisation and encouragement would also serve other objectives that government is committed to pursuing – such as financial capability and financial literacy.

Increasingly, effective financial capability and literacy programmes are delivered in the workplace. It is in the interests of employers to have employees who are financially resilient and people are most likely to be willing to give time and thought to their own financial position when they are at work.

The FSA's aims of workplace financial literacy initiatives are to enable workers to:

- exercise a stronger influence in markets
- take greater responsibility for their own actions
- protect themselves through less mis-buying and being less susceptible to mis-selling.[45]

The ambitions of this approach are twofold. Financially capable consumers should:

- lessen the need for regulatory intervention and 'possibly reduce the burden on firms'[46]

- lower the social costs of what the FSA regards as irresponsible individual decision making, especially the social costs of failure to plan for retirement, and of diverting resources away from more productive uses into managing individuals' financial crises.[47]

These ambitions can be supported by and directed through welfare reform to encourage precisely the kind of future-orientated, responsible financial behaviour that those providing financial capability education desire. Personalised welfare should serve to increase not only the financial resilience of those who participate but also, through engagement, their literacy, capabilities and behaviour.

Those who face unemployment after losing an average-waged job as a result of accident or ill health are disproportionately affected by the inflexibility of benefits and their relatively ungenerous rates.[48] In addition, this category of person has greater worries – the impact of becoming unemployed on their mortgage, savings and planned future is very high and very worrying. There needs to be an effective means for people to protect themselves against accident, ill health and sickness – so they can feel confident in their ability to withstand financial shocks and so government can concentrate its efforts effectively. This can be achieved if we build a more vibrant and broader market in personal protection, incentivise those who would benefit to participate, and find ways of encouraging employers to share the costs of welfare.

To be clear, there is not a choice to be made between either a generous state benefits system or a robust private market in income protection products. These are complementary characteristics of many of the most well-protected workforces in the world. The perception that the UK provides generous welfare benefits is patently misinformed, when those benefits are compared with those provided by its peer economies. What is more, our system actively penalises and disproportionately impacts on average earners – the much-discussed squeezed middle. But the solution is not to simply ratchet up benefits. We need to grow the private market in order to better compensate average earners, retain support for welfare and free up resources to be targeted more effectively.

This end can be achieved and is worth aiming for. For conservatives and liberals alike, a more financially resilient population is a positive aspiration in and of itself. But it also delivers dividends for government and will help us to bring spending under control in the future.

However, in deliberately setting out to grow the market in this area, government must be aware of its inadequacy as a consumer and of the potential pitfalls that will come from 'picking winners'. Instead of setting out to persuade consumers into a particular model of personal financial protection – whether an insurance product, a specialised savings account or a hybrid of these two options – government should set the parameters of what it feels the public will benefit from and then allow the market to respond.

The parameters that progressive conservatives would prioritise are laid out above – they are the principles of any welfare reform that aims to produce a more resilient and less dependent population. The kind of products that should benefit from government support and incentives are ones that encourage future-orientated financial behaviour in citizens, treat people fairly and allow them to be secure and confident, and embed reciprocity in individuals' relationship to welfare.

These products deserve public support for two reasons: they are most likely to reduce dependency on the state and (therefore) to reduce long-term costs to the taxpayer; and they will develop, encourage and reward the behaviour that progressive conservatives and liberals wish to see more of in society.

3 Making it personal

The UK's welfare system is less generous than is imagined. It disproportionately disadvantages average earners – those on low to middle incomes – and those members of the labour force who have invested in savings and owning their own home. What is more, it is both less robust overall than welfare systems that have a high level of personal, private protection and less generous to individuals than those systems. It disillusions and dismays average earners who increasingly feel that the welfare system – stripped of genuine reciprocity – is too generous to some and offers insufficient protection for them. Finally, the cost of sickness and disability in the UK falls almost entirely on the Government. This state-centric approach means the UK is less covered, individuals are more at risk of financial shocks and the immediate costs of their personal misfortunes flow entirely through the Treasury.

It is important that welfare reform looks for sustainable models of protection, which are generous enough to benefit people adequately, rebuild people's sense of trust in the system and reduce the long-term risk to which the taxpayer is exposed. The Coalition Government's approach is focused on resolving some of the entrenched issues that have caused the build-up of long-term claimants. That is to be admired. But our welfare system does not work for those currently in employment either – it offers insufficient protection and insufficient assistance to help those with new disabilities or health problems to return to work in a way that works for them. We need reform to remake welfare the safety net it was designed to be for those individuals and families in the squeezed middle[49] who find themselves out of work through accident, sickness or ill health. This is dynamic welfare reform for future claimants rather than for the backlog created by the current system.

All the proposed reforms in this chapter conform to the three principles for reform that are restated throughout this report and which were developed from our qualitative work with earners: to be future-orientated, fairer and reciprocal. We advocate an approach that slowly incentivises and supports growth in the personal welfare market in order to ensure that alternatives exist for the squeezed middle, are attractive to them and recognise their responsible financial behaviour.

In this vein the proposals are aimed at developing the income protection market in the UK – this would provide savings for the state and a better quality of life for those who find themselves unable to work because of accident, sickness or ill health.

Recommendations

Reform statutory sick pay

Welfare reform often focuses on those who are in most need of additional investment, effort and zeal to get them back to work. The Coalition Government – in tune with the last – has placed a great deal of emphasis on targeting and helping the long-term unemployed to rediscover the workplace. In practical terms this has necessarily meant reforming the model of the Incapacity Benefit (IB).

Government's approach to disability and worklessness has therefore focused on the benefits system itself. The new Employment Support Allowance (ESA) structure – which replaces IB – better assesses the capabilities of claimants and uses third parties to help those who may previously have been left on the scrap-heap of unemployment return to work.

This approach is necessary but insufficient. Government should look not simply at the *demand* side of welfare but also at the *supply* side. Interventions earlier on – before a person has permanently dropped out of work – could radically reduce the numbers and cost of ESA and ensure that unwell or disabled individuals get the help they need to go on working.

If we wish to see fewer people spending significant amounts of time invalided out of the workforce, the evidence strongly points to an early-intervention approach. Working with people early on, to understand their need, make reasonable adjustments and manage them back into the workplace means reducing the flow of people onto long-term welfare and improving the standard of living for those helped. It is, therefore, important that government find means of incentivising that early intervention – both to reduce the cost to themselves and to improve the life chances of individuals.

About 300,000 people a year flow from receiving Statutory Sick Pay (SSP) to receiving ESA and thus onto the payroll of the state. These 300,000 people are assessed for 13 weeks and, if they don't drop out, they pass onto either JSA if they are deemed able to work, work-related activities ESA if able to work in some capacity, or a support group, if they are unable to work. The proportion going to each category is:

- fit for work – 39 per cent
- work-related activity group – 14 per cent
- support group – 6 per cent
- claim closed before assessment complete – 37 per cent
- assessment still in progress – 4 per cent.

Early intervention can help prevent this flow from claimants moving from one benefit to another. Insurance policies that include intervention measures have been shown to be particularly successful in increasing rates of return to work. Ensuring physical activity, education (possibly in the form of Cognitive Behavioural Therapy) and workplace intervention, as income protection packages do, improves the probability of claimants returning to work by 43 per cent. Only 64.8 per cent of people on long-term sick leave return to work within the first six months (the period of SSP payment) of becoming unemployed, so a package like this can be expected to increase the return to work rate to 92.7 per cent.

At the moment there is little, if any, incentive for employers to invest in return to work interventions – instead SSP is essentially 'dead money' used as a bridge between employment and benefits.[50]

We propose that employers should be obliged to insure their employees against the income risk of accidents, ill health and disability, essentially insuring against the cost of SSP for their employees. Taking out insurance for their employees with insurance providers who – having both a financial incentive and the necessary experience – offer interventions themselves would build in an effective incentive to encourage effective return to work interventions as early as possible.

This could cut expenditure on flow-through to ESA with relatively low financial impact on employers while also ensuring that unwell employees get the help they need to prevent long-term complications (such as mental health issues) of unemployment.

In the knowledge that intervention improves return to work rates by 43 per cent, and looking at where people end up after their assessment and the average ESA payment (£69.57 per week), we can calculate expected savings to the state of requiring firms to take out such policies. As it is, the raw cost of ESA for these 300,000 people (excluding those who pass onto JSA), excluding indirect costs like administration, is around £385 million per year (see appendix 2).

It is unlikely that those in the support group would be able to return to work. However, if we assume that the remaining people flowing onto ESA from SSP benefit from intervention schemes we achieve significant cost savings. The lower ESA bill for this group is £246 million. This is a saving of almost £139 million a year. This is because fewer people would be assessed in the first place, and fewer people would go on to work-related activities.

This change would also have the positive effect of ensuring that needs are assessed earlier and more robustly than is possible under the current system. The Government has made clear its intention to remove people from ESA through rigorous retesting – and the provisional results show that many claimants could find employment. This is a necessary development with some early reports showing that as many as 75 per cent of claimants are, in fact, able to seek work.[51] This policy would cut long-term disability rates, too; the probability of being on long-term sickness absence and returning to work within six months is 64.8 per cent.[52] However, those who have been off work sick for six months or longer have an 80 per cent chance of being off work for five years.[53]

Under an insurance regime, where there is an incentive to return employees to work as soon as possible, there is likely to be earlier and more rigorous medical testing to ensure there are genuine medical reasons why a person is unable to attend work. This would filter many more people out of the system before they even flow through to ESA and would save the government the cost of providing welfare and retesting.

There must also be action to streamline the existing benefits, means-testing framework to ensure that those who do not return to work – or are made unemployed – are rewarded for positive behaviour rather than being penalised.

Adoption of this policy – if it provided for high-quality third-party interventions – could lead to a 43 per cent reduction in the numbers of flow-through and cost to the state of support for recipients, generating a net saving for government of £139 million a year.[54]

Reform the £16,000 means test

Our qualitative work with average earners highlighted an alarming amount of resentment and dissatisfaction towards the UK welfare system. Not all the problems raised are fixable, and some of them will take time to change, but on the issue of perceived hypocrisy about savings government can and should act straight away.

Our focus group participants believed, overwhelmingly, that the £16,000 means test rules – whereby savings over £16,000 must be used by claimants before full benefits can be accessed – was unfair and counterproductive. Many thought that the UK's savings culture had retreated and this caused problems for individuals, families and society. Participants believed that the current policy sent the wrong message to hard-working families, unfairly penalised them for 'doing the right thing' and undermined government's efforts to encourage healthy levels of saving. The implications of the Government's existing reform agenda are poor for this group – they will receive even less and be more harshly penalised for their future-orientated behaviour.

Mike Brewer, Programme Director at the Institute for Fiscal Studies, has claimed that the adjustment to the already punitive rules 'gives families an extremely strong incentive to keep financial assets below this level' – this policy is a clear disincentive to save.[55] The rules are much the same for direct out-of-work benefits but also impose a means test for tax credits, leaving families with savings – on average – worse off again.[56]

Obviously, the means test enables the state to save money by focusing resources where they are most needed – but it also acts as a disincentive to saving and causes deep resentment among earners who put money aside.[57] Furthermore, the £16,000 rule exacerbates the financial shock of unemployment to average earners and makes it harder for them to recover even once they return to work.

Levels of debt in the UK, linked to high house prices and cheap, affordable credit, have had a profound impact on individuals' and families' ability to recover from economic shock. What is more, savings levels are worryingly low and falling. At the same time there is increased awareness – in government and the financial services industry – that levels of financial and economic literacy are poor in the UK. Demos' work on financial capability, asset-based welfare and economic literacy over the past 12 months has highlighted the very real need for a concerted approach to improving the financial security, and awareness, of individuals and families in the UK. This lack of knowledge and forward-orientated behaviour is nowhere more visible than in attitudes and actions on saving in the UK

On average, the UK public is now setting aside 6.25 per cent of their monthly take-home income. This figure has fallen since this time last year (when it was 6.48 per cent), and is at its lowest level since summer 2007 (6.22 per cent) but is actually higher than it has been for most of the last two decades.[58] All the same, it represents a worrying lack of long-term, future-orientated financial behaviour in the UK.

Figure 3 **The UK household savings ratio**

Average monthly savings in the UK have fallen from £90.12 in winter 2008/09 to £81.94 in winter 2010/11. In addition, the average monthly income has fallen to £1,310, from £1,384 last quarter and is at its lowest level since spring 2008 (when it was £1,306).[59] This collapse in individual savings is an extension of a pre-existing downwards trend in personal saving. In 2008 (before the collapse of the banking sector in the UK) savings fell to –0.8 per cent, making UK families net borrowers for the first time in nearly 60 years (figure 3).[60]

The lack of future-orientated saving behaviour in the UK is a major policy issue for government. And it is perverse to enforce rules that actively disincentivise savings among those on average earnings who may be at risk from unemployment and then decimate what savings those people have if they become unemployed.

Therefore, we urge reform of the means test to enable the recently unemployed to protect their savings for an initial six months of their time on welfare. Claimants who can demonstrate that their assets are being kept in long-term savings vehicles – and are not able, therefore, to use them as income – should not face any means testing of their existing assets for the first six months of unemployment.

As we have already seen, that six-month period is indicative of what the likely overall period of unemployment is for an individual – those who fail to re-enter the workforce in that period are likely to require extensive intervention over a longer period to enable them to do so. This change to the current rules would allow individuals and families who suffer the financial shock of unemployment time to re-enter the workforce without suffering an additional and excessive financial shock from having their savings used to restrict their benefits. Furthermore, if an individual goes on to struggle to find work and requires further state investment, government would still be able to use their personal wealth over the longer term.

Reform would allow inbuilt disadvantages to those who have behaved responsibly to be fixed – incentivising positive financial behaviour. But, in the longer term, action is needed to grow and develop the private market in personal protection in the UK, the better to emulate those countries that have more robust personal protection and greater state benefits levels.

Build market capacity

The UK should incubate its insurance market for sickness cover. Countries that have a higher-value market, and broader coverage, have more robust citizens who are better able to withstand the shock of worklessness with less (or even without) significant investment from the state. Furthermore, those countries that have better levels of coverage are able to be more generous to those for whom personal financial protection is not an option.[61]

It is worth restating a fact about the findings, argument and recommendations of this report. We do not believe that privatising the welfare system would be possible or desirable. But it is right that, in this area of public policy as much as in any other, government recognises that it cannot deliver the optimum service to all comers while simultaneously focusing its energy, effort and resources on those most in need and least able to protect themselves.

Those who become unable to work after losing an average-waged job are disproportionately affected by the inflexibility of unemployment benefits and their relatively ungenerous rates. In addition, this category of person has greater worries – the impact of becoming unemployed on their mortgage, savings and planned future is very high and very worrying. There needs to be an effective means for these people to protect themselves against the financial shock of disability or severe health problems, so they can feel confident in their ability to withstand financial shocks and government can concentrate its efforts effectively. This can be achieved if we build a more vibrant and broader market in personal protection, incentivise those who would benefit to participate and find ways of encouraging employers to share the burden of the costs of welfare.

This end can be achieved and is worth aiming for. For conservatives and liberals alike, a more financially resilient population is a positive aspiration in and of itself. But it also delivers dividends for government and will help us to bring spending under control in the future.

The kind of products that should benefit from governmental support and incentive are ones that encourage future-orientated financial behaviour in citizens, treat people fairly and allow them to be secure and confident, and embed reciprocity in individuals' relationship to welfare. These products deserve public support for two reasons: they are most likely to reduce dependency on the state and (therefore) to reduce long-term costs to the taxpayer; and they will develop, encourage and reward the behaviours that progressive conservatives and liberals wish to see more of in society.

Growing a healthy marketplace, in which there is competition and innovation in meeting the needs of the UK's squeezed middle, will take time and effort on the part of government. Citizens in the UK are currently considerably less likely to protect their incomes against accident or ill health than workers in other developed economies.

These recommendations are designed to grow the market over time, with as little state expenditure as possible. Wherever government spends money on developing personal financial responsibility it should be done with the dual purposes of building independence and reducing the role (and cost) of the state. Therefore, it is vital that the state be able to demonstrate, and realise, savings as quickly as possible. Initial investment should be kept to a minimum.

The following policies would serve multiple purposes in growing the market in the UK while also achieving other government goals such as increased future-orientated behaviour, better financial literacy and a more stable public-sector settlement.

Privilege the public sector

The unwritten rewards for public and private sector employees have been steadily changing over the last 30 years. Whereas once a public servant could expect to be paid less than their private sector peers but be rewarded with greater job security, a more generous pension and better overall benefits, now they can simply expect to be paid relatively less than they would be in the private sector. This situation has been compounded by the economic crisis and efforts to reduce government expenditure. Public sector employees earning more than £21,000 a year are currently subject to a pay freeze and will be expected to contribute more from their salaries to their pension funds than before – while future public servants will receive normalised pension funds that resemble those of their private sector equivalents more closely.[62] Efforts to make the wage and pensions bills of our public sector more manageable are much needed, but there must also be benefits to those entering the public sector which balance out relative pay restraint and less generous benefits.

The government should combine the objectives of making the public sector a cost-effective but attractive place to work with a desire to grow financial resilience and personal protection. In order to grow the market in personal income protection government must help to create consumers – it should start with its own employees.

It should do this by offering public sector employees personal financial protection, with contributions from their employer to balance out the individual cost. This would involve expenditure from the state – for each public servant who took up the opportunity there would be payroll costs. But it would also save the state money overall and grow the market for these products in the UK – public sector employees are absent from work through ill health and sickness more often than private sector employees are.[63] What is more, this policy would re-benefit public sector employment and provide for a slight rebalancing of the public sector offer.

It would be foolhardy to expect the market to grow entirely on the basis of public sector opt-ins. We must also incentivise those in the private sector to participate, and recognise their positive behavioural choices when they do.

Reciprocate responsibility

People are unwilling to hand more money over to the state in return for higher welfare.[64] They are fearful that their contributions are misused and resentful of the lack of reciprocity and perceived unfairness in the welfare system. Our focus groups uncovered a very real appetite for personal protection and personalised welfare but, crucially, participants expressed deep resentment at the prospect of 'paying twice'. If government is to create the conditions for this market to grow, it must recognise and address this concern among average earners.

The reality is that when a person opts to protect themselves through an income protection policy they are saving the state money. Even without further reform to eligibility criteria, the state currently saves money on anyone who becomes unemployed but has a protected income – existing income-related means testing ensures that. For example, an average single person who covers their finances against accident or ill health, and finds themselves out of work, saves the state almost £8,000 a year simply by virtue of excluding themselves from certain means-tested benefits.[65]

Those savings are an incentive for government to encourage greater take-up, but they should also be used to help incentivise take-up. By opting out of certain means-tested benefits, and taking personal responsibility, individuals are doing the right thing – we should reward them for that.

Government should look to offer rebates – which should explicitly come from National Insurance contributions – to those who choose to take responsibility for their welfare. Of course, such rebates would not be substantial enough to fully cover the cost of personal protection. But they would provide a direct financial incentive for taking responsibility and would also serve to give recognition to the significant resentment that average earners feel about their relative disadvantage in our welfare system.

We suggest offering an initial rebate of around £100 as a flat sum so people on lower incomes benefit more from the support than those on higher incomes. This money should be paid yearly to those who are enrolled in an income protection scheme, to incentivise and reward their responsible behaviour, and in recognition of the fact that by protecting themselves they lessen the risk to the state of having to pay them welfare benefits if they become unemployed: £100 is a very substantial rebate towards the cost of an income protection policy.

If such an incentive scheme succeeded in lifting the level of financial protection in the UK from its current level – of around 11 per cent[66] – to a similar penetration to the USA (around 27 per cent[67]), it would present a cost in lost National Insurance revenues of around £0.86 billion a year,[68] but the year-on-year projected savings would exceed this amount. Because of existing means tests built into the benefits criteria for those who are unable to work, the government would automatically recoup more than the cost of the incentive.

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

The most conservative estimate of the potential savings for the taxpayer – £1.9 billion annually – from the US level take-up of income protection policies would represent a 'profit' for the Exchequer of around £1.1 billion a year. At the top of the range, where there is a 5 per cent rate of sickness and disability, there is a £3.1 billion gross saving, representing profit of £2.24 billion annually. Thus once the incentive costs of providing the rebate are factored in, the government could expect an annual net saving of between £1.1 billion and £2.24 billion each year.[69] This is up from the range of £0.6 billion to £1.2 billion saving that currently benefits the public purse from income protection products. This increase reflects a more substantial take-up in the population, with the result that not only are more people covered – delivering more savings to the Exchequer and higher incomes to more people with disabilities – but the range of people covered will be more diverse and representative of the UK population as a whole.

There is also considerable scope for increasing the incentive available by offering a more generous rebate. We have chosen the figure of £100 because it sits in the reasonable range that was debated and discussed – and approved of – by our focus group participants. It also represents a substantial contribution to the average cost of income protection. However, it is reasonable to assume that a more generous incentive would prove even more effective in driving up coverage and the level of savings available to the state year-on-year point to the potential for more significant support for these products from government. We also strongly recommend that any incentive is offered in conjunction with a campaign to inform people of the risks of disability, the financial implications of being unable to work, and the benefits of income protection.

It is unwise to attempt to project savings such as these further into the future – the variables become too changeable and the projections too risky – but it is important to understand that annual savings as described above are not limited to a single year.

Our qualitative research showed strong feeling that – in order for earners to be encouraged to participate in personal protection – there would need to be some action to offset the perception that they were 'paying twice'. Average earners are keen on the idea of personal, reciprocal protection (recognising that they would suffer a considerable financial shock were they to become unemployed) but are angry that their National Insurance contributions are not enough to ensure they would be 'looked after' should they become unemployed.[70] Offering a rebate would be a powerful tool in incentivising these schemes and dealing with considerable anger about the extent to which workers already contribute towards a welfare system that does not suit their needs. What is more, a rebate would not undermine the potential savings for the state.

Calculations based on the most conservative estimate of the rate of disability – 3 per cent, or 2.4 per cent less than is presently the case within the UK labour force – show that the state could save £1.1 billion a year. A more realistic expectation – based on our current disability rate of 5 per cent in the covered workforce – would yield a net saving of £2.24 billion a year. Should the government prove able to promote income protection further – and achieve a take-up rate greater than that in the USA – the savings would continue to increase in line with greater density of coverage. Income protection genuinely provides a 'mutual benefit' – it protects the standard of living of its beneficiaries while reducing costs and generating savings for the Exchequer.

It is important that government encourage personal responsibility and the take-up of income protection. However, as it incentivises and encourages income protection, trust must be built in the market too. Government must balance its efforts to encourage greater take-up with tougher regulation of financial protection in general in order to ensure that people are sold to responsibly and have their interests protected. The ongoing scandal of mis-sold payment protection has severely damaged the public's trust in financial protection products – this trust will only be rebuilt if regulation is seen to be effective and robust.

The moral burden of welfare should – and can – be more fairly shared so the claims of the unemployed do not fall solely on the state. But this is not simply a question of employee participation; employers should take responsibility too.

Employers gain too

Let us be clear. Employers have a role to play in this too. The pension reforms that will lead to the creation of NEST will place a higher payroll burden on many employers, compelling them to provide a basic level of pension protection for their employees. Now is not the time to compel similar arrangements for personal welfare. It is important that government recognises the key role for employers in educating their workforce about the benefits of future-orientated financial behaviour and rewards those employers who go a step further and contribute on their employees' behalf.

We have already outlined how employers might begin to do this – by insuring their employees to cover any statutory sick pay that they might become entitled to. The benefits to that policy are clear – the individual, their employer and the state all benefit when such an approach is taken. The same can be said to be true for more general personal financial coverage – although the employer's benefits are less tangible.

The moral and financial burden of the welfare of employees must be shared more fairly between those who are interested parties – the state, the individual and the employee. This means that employers have a role to play in encouraging, and potentially financing, personal welfare too. Government should reward employers who contribute to income protection insurance for their employees by offering them parallel rebates on their institutional National Insurance contributions – making insurance an attractive option for employers as well as employees. What is more there is strong evidence that offering income protection to employees increases loyalty, morale and productivity for the employer.[71]

The role of employers as educators, and facilitators of financial literacy and planning, is not to be underestimated either. The workplace is a vital venue for teaching people about their finances and encouraging positive behaviour. Employers should be encouraged by government to take up their responsibility as advocates of personal responsibility. Government should provide information to employers – for them to pass on to employees – explaining the benefits of products which offer protection.

Personalised welfare for the many

Individuals taking greater responsibility for financial risks – especially the risk of sickness, disability and ill health – would be advantageous to the UK.

There are the concrete benefits. It would make overall UK benefit cover more robust and more generous. It would relieve some of the burden on the state. It would free up resources so they could be more efficiently and effectively targeted, and it would better protect the squeezed middle from financial shocks.

But there are also benefits in how society, and individuals within it, relate to issues of personal responsibility, financial security and future planning. People who take responsibility for their financial future are better secured and less likely to suffer disproportionate financial shocks resulting from enforced worklessness – such as the loss of their house. They are less dependent on the state for help in their time of need and are more resilient. For conservatives and liberals alike, this outcome, in and of itself, is politically appealing.

Personalising welfare is not the same as privatising it or removing the safety net that provides for those in need. It is about promoting alternatives and mixing the economy of personal protection. Doing so, and bringing the private sector in to this area of welfare, should benefit individuals who opt in directly. But it will also benefit those who cannot invest in their personal, financial security as it will liberate resources to ensure they can be helped effectively, quickly and generously. This agenda is about recognising that – as in so many of our public services – a one-size-fits-all solution to welfare has ended up failing to deliver for everyone. Instead of the state-centric, universal approach that we have made do with for the last 60 years, reform is needed to ensure that consumers are able to choose what welfare best suits their particular needs, and that those who take responsibility and leverage risk away from the state are adequately rewarded and recognised for their positive choices. Done properly, a concerted effort to grow the private market in this sphere and to grow new norms of personal welfare will bring dividends for government.

A dogmatic universalist will respond to this report – and to its recommendations – by saying that a more diverse welfare market would lead to an ebbing away of support for state benefits. The truth, difficult as it may be to accept, is that support for state benefits is already at an all-time low and, without action, looks set to continue to fall.[72] Our qualitative research with earners showed they lacked support for the welfare system in general and benefits in particular. In fact, many people resent benefits while recognising that they are less than generous. The reason for this is that earners – with mortgages to pay and lifestyles to support – understand they would be disproportionately worse off if forced to live on the available unemployment entitlement. They also see, and resent, the possibility of their being punished for having 'done the right thing' and saved, all the while aware that their taxes have financed the system in the first place.

The reforms the Coalition Government is pursuing – to make work pay – necessarily mean there will be lower benefit rates. Under the new regime claimants are far more (almost twice as) likely to fail the incapacity test and be moved to JSA than before, so they will have a far lower income and additional conditionality.[73] Claimants lose their benefits for three months if they refuse a job offer on JSA, for example.

Even those who do get put on the ESA work-related activity group can only stay there for a year before being transferred to JSA. As the average claim time is eight years for those on IB for a year, the vast majority will eventually end up on JSA.

There has to be a better way of protecting this group of people against the risk to their financial wellbeing of disability, accident or severe ill health. The state system is not capable of greater generosity – it struggles with its bills as it is – but, by opting out and investing in protection, the UK's squeezed middle could be able to build personalised welfare that works well for them and provide for their needs. A new norm of self-managed income protection would ease some of the criticisms and concerns that average earners have about welfare and would enable government to target the safety net more effectively at those who really do need it.

Any reform in pursuit of this agenda should abide by three core principles:

- *Be future-orientated* The savings gap is a much discussed source of economic problems for the UK as a whole and of personal financial difficulty for individuals and families. It is the policy of the Coalition Government – and of the previous administration – to encourage a savings culture and to educate citizens on their need to provide for their futures. Evidence shows that future-orientated financial behaviour in one area makes an individual more likely to behave in a future-orientated way in other areas of their life. The proposals in this paper urge an emphasis on future-orientated behaviour in welfare both to achieve the objectives of fairer and more reciprocal welfare provision and to expose greater numbers of people to experience of future-orientated behaviour.
- *Be fairer* Any reform to the welfare system has to be 'fairer' than the current settlement. In our qualitative work we uncovered a growing sense among low to middle earners that the welfare system and welfare reform simply don't work for them. Long-term reform, to mirror that being undertaken for people in entrenched unemployment, is needed to make the welfare system work for these people in a fair manner.
- *Be reciprocal* Personalised welfare relies, to some extent, on the individual contributing more in order to secure their own financial future. Our research shows an appetite for this, but that is tempered by a feeling that if government wishes to promote such behaviour then it ought to be prepared to invest in it.

And it should aim to achieve positive outcomes for individuals, families and the state simultaneously. The best way for government to achieve this is for it to actively pursue growth in the marketplace while refraining from picking winners. Individuals and employers will make the right decisions about what kind of products are best for them – the state must simply provide the parameters. Therefore, using its own employees as consumers first – followed by incentivisation and by an eventual opt-out system – the state should actively direct investment into the personal protection market without dictating the specifics of policies and vehicles. By implementing the recommendations laid out in this report, government could recoup savings from the incapacity benefits system of over £2 billion a year. The fact that it can generate these levels of savings while simultaneously improving the financial security of the squeezed middle and lifting the UK's international rankings of labour force coverage only adds to the case for urgent reform. These measures really do provide mutual benefit – to the individual, the household, the taxpayer and society.

Personalised welfare means a more robust welfare system, better tailored to the needs of each of us and less expensive to the state. It is about putting people in control of their financial destinies. This is a natural political, economic and fiscal aim for government to pursue and the policies in this pamphlet represent a route to achieving it and bringing about a fairer, cheaper welfare for all.

Appendices

Appendix 1 The Index of Financial Protection

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

Types of protection

1 State protection

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

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

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

2 Private protection

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

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

Methodology

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

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

Appendix 2 Savings from reforming statutory sick pay

In order to calculate the fiscal savings of having a work intervention, education and physical activity scheme for those on SSP we create a hypothetical cohort based on the 300,000 who flow onto ESA each year. We first calculate the current costs of ESA for this group before looking at the projected costs if the intervention scheme were implemented.

To do this we put the 300,000 people into the assessment phase. We then used information from the Department for Work and Pensions (DWP) showing that the average ESA payment is £69.57 per week and data on where people flowed during and after the assessment; we then calculated expected costs. Therefore, in the knowledge that 37 per cent of ESA applicants leave before assessment, we reduced the 300,000 people by 37 per cent by week 7 (halfway through the assessment period). We then passed on the remaining people to the areas DWP data shows they flow to:

- support group – 6 per cent
- work-related activity group – 14 per cent
- fit for work – 39 per cent
- claim closed before assessment complete – 37 per cent
- assessment still in progress – 4 per cent

We excluded those whose 'assessment is still in progress' and assumed that where people flow to after their assessment is the group they stay in for the rest of the year. As those in the 'fit for work group' passed onto JSA we did not include these costs. See table 3.

Table 3 **Hypothetical cohort analysis of ESA costs for those flowing-in from SSP before intervention**

	Phase	Duration	No of people	Cost of this phase of ESA (£ 000s)
Weeks 0–13	Assessment phase (assuming 37% drop out at week 7)	0–13 weeks	300,000	222,485
From this stage, 39 per cent are put onto JSA, 14 per cent onto work-related activities, and 6 per cent onto a support group				
Weeks 14+	Fit for work	14 weeks+	117,000	–
Weeks 14+	Work-related activities or	14 weeks+	42,000	113,955.7
Weeks 14+	Support group	14 weeks+	18,000	48,838.1
			Total	385,279
			Total (excl. support group)	336,441

The 4 per cent in the assessment period are excluded

We then look at the effect of requiring firms to have SSP that had the necessary elements of workplace intervention, education and physical activity, and thus achieve a 43 per cent improvement in return to work rates.

It is unlikely that those in the support group would have been able to return to work. However, if we assume that the remaining people flowing onto ESA from SSP benefit from intervention schemes we achieve significant cost savings. We therefore reduce these other groups, excluding the support group, by 43 per cent (table 4).

Table 4 **Hypothetical cohort analysis of ESA costs for those flowing-in from SSP**

	Phase	Duration	No of people	Cost of this phase of ESA (£ 000s)
Weeks 0–13	Assessment phase (assuming 37% drop out at week 7)	0–13 weeks	178.74	132,556
From this stage, 39 per cent are put onto JSA, 14 per cent onto work-related activities, and 6 per cent onto a support group				
Weeks 14+	Fit for work	14 weeks+	66.69	–
Weeks 14+	Work-related activities or	14 weeks+	23.94	64,954.73
Weeks 14+	Support group	14 weeks+	18.00	48,838.14
			Total	246,349
			Total (excl. support group)	197,511

The total cost of ESA for this group has therefore been reduced from £385 million to £246 million, a saving of almost £139 million.

Appendix 3 Savings from incentivised income protection

In May 2010, 527,000 people claimed ESA. The cost to the taxpayer of this was approximately £36.6 million per week, without accounting for the cost of administration. Furthermore, 1.89 million people were on Incapacity Benefit in May 2010, which cost the taxpayer approximately £111.3 million per week. This equates to a bill of approximately £7.7 billion a year.

Given that the labour force size is approximately 31.59 million[74] this suggests a disability rate of 5.4%.

Take-up of private income protection will reduce the cost to the Exchequer of disability-related benefits and increase the post-injury income of individual policyholders (figure 2).

Figure 2 illustrates the savings to taxpayer and individual of a person on a £20,000 income holding an income protection policy. It shows that the state would save £7,569 in means-tested benefits on a person with a pre-disability income of £20,000 a year – right in the middle of the income spread of the squeezed middle – who has income protection, should that person require state benefits. The expected public savings are larger for higher income groups.

With this saving it seems sensible to incentivise the take-up of income protection. A National Insurance rebate of £100 could help to do this.

Currently income protection is taken up by approximately 3.6 million people in the UK, equivalent to an insurance penetration rate (the proportion of the labour force with a policy) of around 11 per cent.[75] The estimated saving for the taxpayer from the people who have income protection policies is between £0.6 billion[76] (assuming they have a lower rate of injury of 1 per cent) and £1.2 billion (assuming an injury rate of 2 per cent). The injury rates for the existing policy holders are lower because of the nature of existing income protection holders. The explicit aim of these policy recommendations is to expand and diversify the customer base for these products so that it more closely resembles the UK workforce as a whole.

If we were to create a National Insurance rebate of £100 per income protection policyholder then this group would receive

£360 million from the taxpayer. Therefore, the net savings to the public purse decrease to around £240–840 million.

However, given that the purpose of this rebate is to incentivise a higher level of premium take-up we can expect income protection to become more popular in the UK. Without vast market data it is not possible to know the response to this rebate, but we can look at comparative levels of market penetration in other countries and calculate the cost and benefits to the taxpayer. If we assume that the level of take-up, or penetration, in the UK increases to the US level, which for the equivalent product is 27 per cent,[77] then the number of policyholders would increase to 8.6 million people and the rebate bill would rise to around £0.86 billion. However, this would lead to greater savings to the Exchequer by having a lower welfare bill.

If income protection insurance penetration is at the level found in the USA then it could lead to savings to the welfare bill of around £1.9 billion[78] (assuming the rate of injury is 3 per cent) and £3.1 billion (assuming the rate of injury is 5 per cent) – before a tax rebate. Therefore, if the rebate increases income protection penetration up to US levels we could save the Exchequer £1.04 billion if there is a 3 per cent injury rate, and if it is 5 per cent save it £2.24 billion.

Notes

1 For the purposes of this report we are using the definition of the 'squeezed middle' provided by Liam Byrne (the shadow cabinet member responsible for reviewing Labour's policy offer). He has said that the squeezed middle are individuals and families earning between £16,000 and £50,000. These earners are not living in poverty but their incomes are tight, their outgoings significant and their spending power declining in the face of inflation and the VAT increase.

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The British benefits system is in chaos. Incapacity benefits are a case in point: they are too expensive for the taxpayer while being too ungenerous for the individual. The Coalition Government has set its sights on welfare reform, but it will be no easy task.

This pamphlet informs that challenge. A new Index of Financial Protection, published for the first time here, shows that British workers are some of the worst protected in the OECD. *Of Mutual Benefit* sets out another way: reforming Statutory Sick Pay so that people get back into work before they become long-term unemployed, no longer punishing the savers of the 'squeezed middle' and encouraging more personal responsibility. These measures would save the state billions and be of mutual benefit to the individual, the household, the taxpayer and society.

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