findings

Social Policy Research 111
February 1997

Private welfare insurance and social security

Where the boundaries are drawn between collectively financed social security and individually financed private provision affects the lives of everyone and the allocation of a large fraction of the national income. Tania Burchardt and John Hills used three case studies - insurance against care costs in old age, income replacement during long-term sickness or disability, and cover for mortgage payments if earnings are interrupted - to examine the potential effects of shifts from public to private provision. They found:

- **The cost of insurance, just for these three areas of welfare, is significant. A 45-year-old married man might pay £900 per year to purchase mortgage payment protection against unemployment, permanent health insurance for long-term incapacity, and long-term care insurance. This is six times larger than a one pence in the pound rise in the lower and basic rates of his income tax, if he has average earnings.**
- **Switching from social security to private insurance generally increases costs for those on low incomes; premium levels for products examined mean that those with average incomes and average risk also lose. For some products women, older people and those in poorer health lose most.**
- **Unemployment-only mortgage payment protection policies offer poorer value for money than some other insurance products: mortgagors of average risk could expect to recoup only between 43 and 60 per cent of their premiums in claims.**
- **For many with higher incomes, the role of permanent health insurance is already filled by long-term occupational sick pay while for those with lower incomes, affording enough cover to get clear of means-tested benefit entitlement is difficult.**
- **Uncertainty over future long-term care needs and costs makes policies virtually impossible to assess, for both consumers and providers, making reliance on private insurance a dubious proposition.**
- **The nature of the risks leads to policies which limit coverage and exclude some groups, including those without good employment records and some people with disabilities.**

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Background

In discussing the future of the welfare state, the question of whether the private sector should take on some of the insurance functions hitherto provided by social security has inevitably arisen. Much of this debate is ideological; this research sought to shed *empirical* light on the appropriate boundary between public and private welfare sectors. The three case studies chosen were areas where private insurance is already supplementing state provision:

- Mortgage payment protection (MPP) - cover for mortgage payments if earnings are interrupted
- Permanent health insurance (PHI) - income replacement during long-term sickness or disability
- Long-term care insurance (LTC) - insurance against care costs in old age

The central questions posed were:

- Do the policies currently available represent good value for money?
- What are the distributional differences between tax funding and premium funding? Who would be the gainers and losers from a shift to private provision?
- Do problems predicted by the economic theory of insurance occur in practice? If so, how do insurers cope, and does this create gaps in cover?
- From these case studies, what can be said about the potential for the private sector to take on other areas of provision which have traditionally been seen as the realm of social security?

Value for money

A 45-year-old man might pay a total of £900 per year for mortgage payment protection covering £250 per month in the event of unemployment, permanent health insurance providing £200 a week should he suffer long-term incapacity, and long-term care insurance for severe disability in old age. He would pay more if he was older, in poor health, or worked in a hazardous occupation.

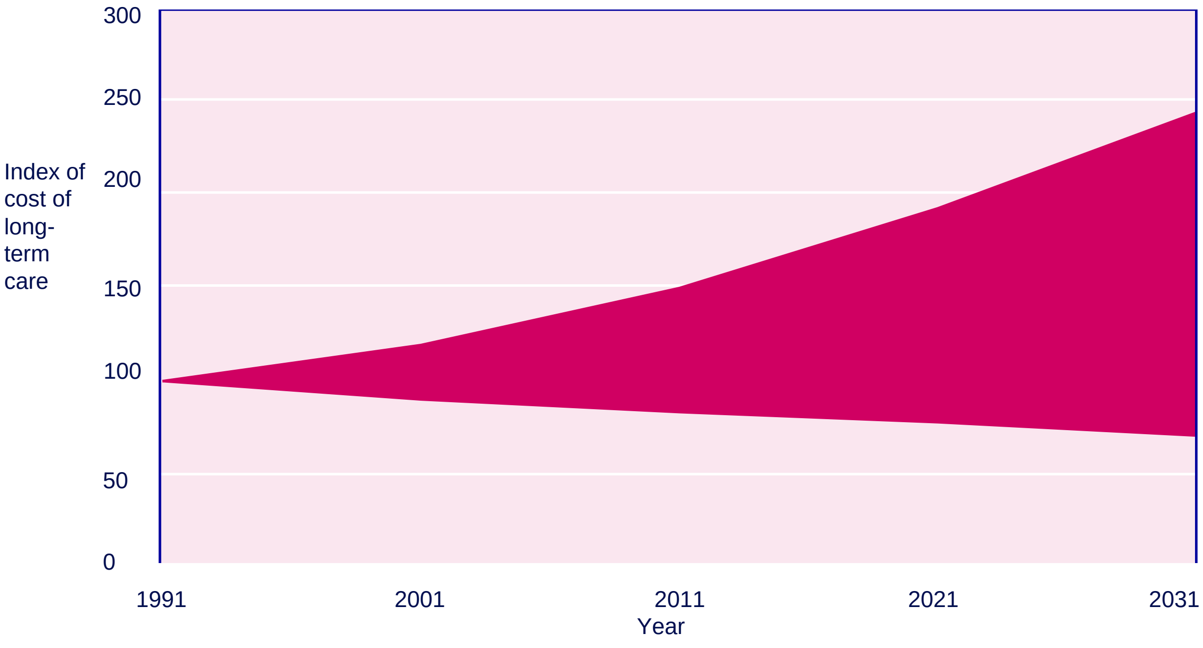
These figures indicate that the cost of private welfare insurance could be significant even for limited items, but they do not show whether the policies on offer provide good value for money. The research used survey data to examine what pay-outs would have been in 1991/2 to 1993/4 for mortgagors as a whole under an unemployment-only mortgage payment protection policy with typical policy conditions. The results suggest that pay-outs would have been £2.42 per £100 of cover, or £1.71 if exclusions from cover are allowed for, just 43 to 60 per cent of actual premiums in 1996. MPP appears to offer poorer value for money than other products such as motor insurance (72 per cent pay-out to premiums ratio).

For many with higher incomes, the role of permanent health insurance is already filled by long-term occupational sick pay, while for those with lower incomes, affording enough cover to get clear of means-tested benefit entitlement is difficult. For others PHI has potential value in certain niche markets. However, for typical younger employees, at least, evidence from Invalidity Benefit claims suggests that commercial policies are expensive for the cover provided.

The value for money of long-term care policies seems virtually impossible to evaluate, given available data on disability and the huge uncertainty over future care costs and needs (Figure 1). Benefits are paid according to strict disability-based criteria, which some people admitted to residential care would not meet. However, if benefits were paid on the basis of admissions to residential or nursing care, and rates and durations of stay remained as they were in the early 1990s, the lump-sum premium (excluding costs) for men aged 70 would be in the region of £3,500 (or £500 for nursing care only). This compares to an average commercial premium of £7,800. For women aged 70, the figures would be £7,800 for residential

Figure 1: **The funnel of doubt**

Range of Nuttall et al projections of future costs of long-termcare in GB 1991 - 100



Source: Based on Nuttall et al (1995) “Financing Long Term Care in Great Britain” Jnl Inst Actuaries 121.1 I 68 and nursing care. and £1,100 for nursing care only. The average commercial premium is £12,600.

Distributional impact

Overall, switching from tax-funded protection to premium-funding for MPP would benefit those on higher incomes whilst poorer people would lose out (a 'regressive' effect), even though non-mortgagors (who generally have lower incomes) would gain. Mortgagors with poor employment records are excluded from cover and the regressive effect is even stronger when this is taken into account (Figure 2).

At present premiums are generally flat-rate, but the future differentiation of premiums, for example by occupation, is likely and would mean higher costs for lower-income mortgagors.

Commercial PHI policies would cost considerably more than equivalent tax-financed cover for low income groups, for those in poor health at the outset, for women, and for those in high-risk occupations (for example, manual work). This highlights the difference between systems where payments are made in relation to people's risk status as opposed to ability to pay. A crucial question is whether individuals with a higher risk of incapacity should bear its financial as well as physical costs, or whether society as a whole should do so.

Preliminary calculations suggest that the choice between tax- and premium-finance of long-term care has very large distributional implications. Moving to private insurance would be equivalent to shifting tens of thousands of pounds over their lifetimes from those at the bottom of the income distribution to those at the top, and from women to men.

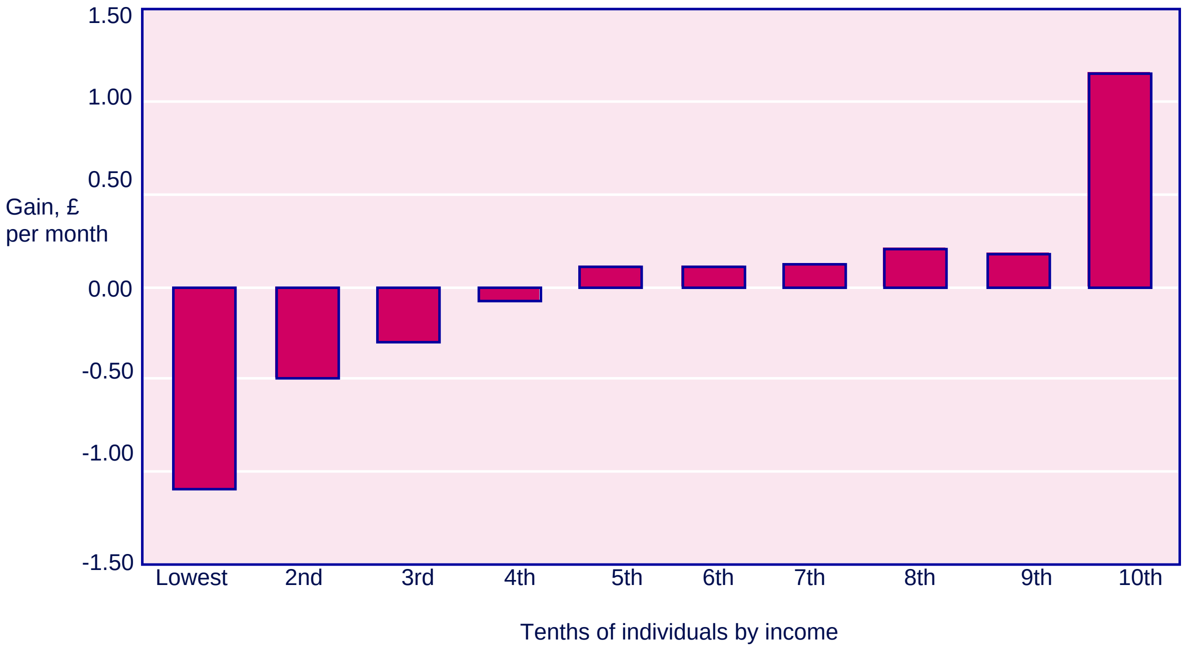
Buying and claiming

Private insurance products offer greater choice and flexibility to consumers than their public sector counterparts. But the variety of policy conditions comes at a price in terms of complexity which may make purchasing decisions difficult. Choosing whether to buy permanent health insurance, for example, involves assessing the likelihood of falling ill or becoming disabled and remaining incapacitated for longer than the 'deferral period' on the policy. Entitlement to employer or state benefits, future earnings, age at purchase, and age when the policy expires will also affect the value of the cover. Only then can premiums charged by different companies be compared. This complexity creates a risk of mis-selling or mistaken purchase. For long-term contracts like PHI and long-term care insurance, such mistakes are expensive or impossible to correct

When it comes to renewing a policy, there will be problems for those whose risk status has changed during the period. For example, someone who has become threatened by unemployment may be unable to renew her mortgage payment protection. By contrast, long-term contracts often lapse, meaning that policyholders lose much of the value of previous payments.

Claiming may also not be straightforward. To protect against bogus or exaggerated claims, insurers define claiming conditions tightly, but if consumers are not aware of the precise policy wording there will be a gap between the protection they believe they have, and their actual legal position. For example, long-term care insurance pays out only when the policyholder fails three 'Activities of Daily Living', which means that he or she needs the assistance of another person on every occasion throughout the duration of the activities and even if using special equipment, but many people with less severe disabilities would want or need to go into residential care.

Figure 2: **Moving from tax to premium-funding for hypothetical MPP cover, with premiums differentiated by employment history**
Average gain, by income group



Source: Based on BHPS Waves 3 and 4

Conclusions

The three areas involve progressively greater changes from the existing system of social security. Mortgage payment protection is becoming well-established. However, the costs of existing policies seem high and future differentiation of premiums may lead to further gaps in coverage or more regressive effects. Permanent health insurance, as an alternative to social security arrangements, looks much more regressive and would redistribute from women to men, as well as leaving those initially in poor health without cover. Long-term care appears to be a most unsuitable risk to be covered privately except for a small, relatively wealthy, healthy group (mostly men). Even as a way of reducing public spending, reliance on private insurance in this area looks a dubious proposition, as so much of the 'downside risk' would remain with the state, while the considerable costs of private cover would tighten the general tax constraint on government.

Since provision in these areas has already partially shifted into the private sector, they may be amongst the easiest to move. By implication, other areas of social security would raise equally if not more serious problems, albeit different ones. That private insurance may not always be an appropriate solution is a reflection of the nature of the market. Insurers can avoid some of the problems predicted by economic theory by exclusions, co-insurance, and reviewable premiums, but only at a cost to consumers in terms of comprehensiveness and affordability of cover. Moreover, a switch from tax to premium funding will in general be regressive.

The researchers conclude that if their case studies are typical of the kinds of risks which would have to be taken on by private insurance as the boundaries between state and private sectors move, collectively financed social security may offer a better deal than is commonly supposed, not just for those with low incomes and at high risk, but also for those with average incomes and at more typical risk.

About the study

Information on insurance products was collected from consumer and industry surveys and directly from the main providers. The main data source used, supplied by the ESRC Data Archive, was the British Household Panel Survey (BHPS), which follows a sample of 10,000 individuals, and is run by the ESRC Centre on Micro-Social Change at the University of Essex. Invalidity Benefit data were provided by the Department of Social Security from their 1 per cent sample of claims for Sickness/Invalidity Benefit in Great Britain for 1993/4.

Further information

A more detailed report, Private Welfare Insurance and Social Security: Pushing the Boundaries by Tania Burchardt and John Hills, is available from York Publishing Services Ltd (price £11.95 plus £1.50 post and packing, ISBN 1 899987 32 0).

A background discussion paper, What Price Security? by Tania Burchardt is available from Welfare State Programme, STICERD, London School of Economics, Houghton St, London WC2A 2AE, 0171 955 6679, where the authors can be contacted.

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Social Care

84 Meeting the cost of continuing care: public views and perceptions (Apr 96)

The conclusions of the JRF Inquiry into paying for long-term care are summarised in *Meeting the costs of continuing care* (*Foundations:* January 1997)

Full details of all JRF *Findings* and other publications can be found on our website: http://www.jrf.org.uk. If you do not have access to the Internet or have any further queries on publications, contact Sally Corrie on 01904 615905 (direct line/answerphone for publications queries only).

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Policy options

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Private welfare insurance and social security

Tax constraints on government are colliding with slowly rising demands on the welfare state. Substituting private insurance for tax-financed welfare provision could offer a way out. Drawing on three case studies of areas where private welfare insurance has been taking a greater role, Tania Burchardt and John Hills suggest that such solutions require careful appraisal.

Private welfare insurance does not offer a painless way out of the tax constraints on government.

Depending on the particular problems in an area of welfare provision, policy-makers have a spectrum of options. These include: improving information to consumers; regulation of premiums and policy conditions; compulsory insurance; and unified national schemes, either within the public sector or run at arm's-length.

In considering the suitability of private insurance to cover a particular risk, a series of questions need to be answered about the efficiency of private provision and whether it effects both better and less well-off people equally. Solutions need to be tailored on a case-by-case basis.

In the case of mortgage payment protection, regulation could be used to prevent greater differentiation of premiums and to limit exclusions from cover. Alternatively, existing insurance could be replaced by a unified national scheme, but with the costs borne by mortgagors rather than by taxpayers in general. A reduction in mortgage interest tax relief could pay for this.

In the case of long-term care insurance, regulation of premiums and contract conditions could lessen, but not solve, some of the problems associated with private insurance. Given the uncertainties associated with future care needs and costs, a unified national care insurance scheme may offer a better solution.

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Introduction

Public policy towards the welfare state faces a collision between slowly but steadily rising demands for services and what is seen as an increasingly rigid tax constraint, limiting the scope for tax-financed provision to meet these demands. Inevitably this raises the question of whether private provision could take a greater role.

This investigation looked at three case study areas where private insurance is already meeting part of what was once covered by social security - or might do so more in the future: mortgage payment protection; permanent health insurance; and long-term care insurance. The accompanying *Findings* (Social Policy Research Findings No. 111) summarises the research results. This paper outlines the policy options which might be considered. The case studies suggest a number of problems with private insurance, summarised below. The importance of each varies from area to area - the challenge for policy-makers is to establish the appropriate response in each case.

Potential problems

Distribution In general, switching from tax-financed social security to private insurance, where premiums are related to each individual's risk status, will be 'regressive', i.e. will benefit the better-off at the expense of the less well-off.

Gaps in coverage Certain *people* will not be offered cover because their level of risk is too high to make it economic. This usually adds to regressive effects. Certain *risks* will be excluded from cover as a result of the nature of the insurance market. This means that the cover available may be incomplete.

Average costs The nature of the business may mean that even for consumers with average risk, premiums are well above the tax they would pay for alternative social security arrangements. If so, this is also likely to reduce people's ability or willingness to pay taxes and hence be a problem for government.

Costs to consumers If insurance products and the nature of the risk are complex, making informed choices between competing products may be very hard and the chances of mistaken purchase, or even mis-selling, correspondingly high. With long-term contracts such mistakes are hard to reverse.

Means-testing Where some form of state means-tested safety net remains for consumers unable to afford private cover, decisions become harder for those potentially at the margin of state cover.

Future uncertainties Where the risks covered are hard to assess - for instance, where they may occur decades in the future or where inflation forecasts are required - setting premiums is hard. If the state still provides some kind of safety net, it may end up with all of the 'downside risk' but none of the 'upside gain': if things turn out badly and insurers are unable to meet their commitments, the state has to fill the gap, but if things turn out well, it is the insurers who keep the surplus.

Opt-outs Where the state allows or encourages 'opt-outs' from a more general state system, those at low risk may opt out, leaving the state with most of the costs, but less revenue.

Potential solutions

Against this range of potential problems there is a spectrum of ways and degrees in which it may be appropriate for the state to intervene, each with its own strengths and weaknesses.

No intervention Even if some problems listed above are present in some degree, this may not make the case for intervention. State regulation and provision also have drawbacks and costs which the advantages of competition and avoidance of tax costs may outweigh.

Safety net provision Faced with excluded groups and others unable to afford private cover, equity may dictate state provision for them, or subsidies to allow purchase of private cover.

Information Where decision-making is difficult for consumers, insurers could be required to provide standardised information, as in the 'APR' system for borrowing costs, and industry-wide codes of practice could be encouraged or required to minimise dangers of mis-selling. Networks of brokers, not tied to a particular insurer, might help to make information available about a wider range of products.

Regulation Some problems could be tackled by regulation of insurers, including: requirements to take all applicants (to avoid gaps); to charge premiums according to certain rules (to reduce costs for low income or high risk groups); or to limit contracts in certain ways (for instance, returning minimum amounts to those whose policies lapse). More extensively, regulation could control premiums in relation to the actuarial value of the risks being taken on. In a competitive market, it may, however, be hard to avoid niche marketing or other ways of partially circumventing such regulation.

Compulsion Some problems arise where insurance is voluntary and only certain consumers seek cover. As with third party car insurance, compelling consumers to buy some form of cover may be a solution. In combination with regulation of premiums, compulsion may create some of the universal coverage advantages of social security, while maintaining a variety of products and competition between providers.

Arm's-length provision Economies of scale from having a single provider may outweigh the advantages of competition, particularly where the nature of the risks leads insurers to set policy conditions which exclude some people and restrict cover. A single provider does not, however, have to be part of the public sector and there may be advantages of clarity of purpose (and of destination of payments) if it is at arm's length. Non-profit, ‘mutual’ organisations may have advantages in terms of better control of abuse through unjustified claims than either profit-making or public providers.

Earmarked taxes Where state provision is the most equitable or efficient solution, there may be advantages in earmarking (or ‘hypothecating’) contributions or taxes which pay for it, both in terms of the constraints on general taxes, and in making clear the cost of the service to consumers.

Tax-financed provision. Where none of these alternatives overcomes the problems, tax-financed provision may offer not only the most equitable but also the most efficient solution, minimising costs to average-risk as well as high-risk and low-income consumers and preserving the advantages of unified public finances.

Specific solutions

Two of the case study areas illustrate the kinds of solution available and their strengths and weaknesses.

Mortgage payment protection

Available approaches include:

The status quo Mortgage protection presents fewer problems for private insurance than the other case studies. Premium finance is more regressive than tax finance, but this is tempered by the gains to non-mortgagors if the state no longer bears the costs. For typical mortgagors, premiums appear high in relation to the risks covered, but competition may eventually bring a better balance. This process may, however, be slow and during it premiums would be likely to become differentiated between high- and low-risk customers, with further regressive effects, potentially excluding some groups from owner-occupation altogether.

Regulation Regulation could require equal premium rates for all mortgagors, in effect preserving a cross-subsidy between mortgagors to reduce regressive effects. This could, however, result in higher-risk cases being excluded altogether. Further regulation could require open access to all mortgagors, but the danger would be mortgages being offered to those who could not really afford to buy on the understanding that their insurance would pay. Some kind of test of resources would have to be required.

Compulsion Making payment protection compulsory for mortgagors might both protect insurers from only being used by ‘bad risks’ (although the study’s survey does not suggest this is currently a major problem) and protect the state from effectively bearing the downside risk via housing benefit or homelessness legislation after mortgage default.

A national scheme If tight regulation of insurers and compulsory membership were in place, the residual advantages of competition might be outweighed by the economies of a single national scheme. This could be run at arm’s-length from government, with premiums regulated in relation to annual costs. Alternatively, it could be run within the public finances (replacing current Income Support arrangements which give partial protection). This could either be at cost to the taxpayer in general, or - if the principle of mortgagors meeting their own costs was to be preserved - could be financed by an equivalent reduction in the rate of mortgage interest tax relief. For typical mortgagors, a national scheme could well imply savings compared to current arrangements.

Long-term care

Private long-term care insurance presented the greatest difficulties of the three case studies, particularly resulting from uncertainties around future care needs and costs. Again, a range of solutions can be considered.

Regulating premiums Regulation could control premiums in relation to the (changing) assessment of risks carried by insurers. In the USA, premiums have to be set to achieve ‘minimum loss ratios’. Under these, anticipated pay-outs from a scheme have to be at least 60 per cent of premiums requested. This allows some consumers to benefit from unanticipated improvements in the risks of needing care, or in lower than anticipated inflation, for instance. However, it is hard to ensure that existing, as opposed to new, policy-holders receive such benefits.

Regulating contract conditions Regulation could also control other contract conditions, for instance, ensuring some return of premiums to those whose policies lapse (who otherwise lose out substantially). However, this would raise costs and possibly premiums in general and could leave insurers vulnerable to ‘adverse selection’ - only those finding themselves to be at high risk maintaining their policies.

Regulating exclusions Insurers could be required not to exclude people on grounds of pre-existing medical conditions and not to use information which may become available through ‘genetic screening’. However, it would be hard to prevent potential purchasers gaining access to such information, again leaving insurers vulnerable to only high-risk cases seeking cover.

A national care insurance scheme The problems with private insurance and with using regulation to counter such problems have led to suggestions for a national scheme. This could be run in a variety of ways. It could be located within the public sector, with the costs borne by general taxation (as most formal care costs are now) or through an earmarked tax (as in the German scheme). Alternatively, it could be run at arm’s-length from government, but with contributions still made in relation to income (as proposed by the recent Joseph Rowntree Foundation *Inquiry into Meeting the Costs of Continuing Care*).

Pre-funded costs One feature of private insurance for long-term care is pre-funding (saving towards) later costs. This is helpful where such costs are expected to be greater than now, but creates the difficulty of forecasting them in order to set contributions in advance. A national scheme could also involve a degree of pre-funding, although the uncertainties would make it sensible to allow for later adjustment of contributions as calculations of the risks faced change (so-called 'in-flight correction'). An advantage of schemes at arm's-length from government is that such funds could be accumulated as private assets (and run by private fund managers), rather than being absorbed within overall public finances. (Note that the problems of private long-term care insurance described in the full report apply to the *risk* element being privately borne, not to private sector involvement in fund management which is well-established in the case of occupational pension schemes.)

Wider implications

Given the tax constraints on government it is tempting to see private replacements of welfare provision as an obvious way of reducing demands on government and hence its revenue requirements. However, the case studies illustrate the difficulties which can arise with this strategy. Such difficulties do not imply that social security or state provision financed by general taxation is the only alternative: depending on the particular market being considered, there may be intermediate solutions, ranging from regulation of profit-making private insurance through to compulsory national schemes, but run at arm's-length from government.

This study suggests that designing such solutions will require care and attention to the particularities of the risks and services concerned. In no case will private alternatives offer a painless solution and in some cases they may turn out not only to have regressive implications, but also to raise costs for typical families facing average risks and in the long run to tighten the tax constraints on government.

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