Universal Risk Insurance

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Over the past generation, the economic risks faced by American families have increased dramatically. Yet public programs have largely failed to adapt to these new and newly intensified risks, and private workplace benefits have substantially eroded. As a result, risks have increasingly shifted from government and corporations onto the balance sheets of American families. This "Great Risk Shift" not only creates anxiety, but also threatens opportunity by undermining the security that families need in order to feel optimistic about their futures and to recover when economic shocks occur.

Perhaps the most telling evidence of increased insecurity is the growing risk of large drops in family income. About half of American families experience a drop in real income over a two-year interval, a share that has remained steady over time. However, the size of the median decline rose from around 25 percent of income in the early 1970s to around 40 percent by the late 1990s and early 2000s. Meanwhile, the predicted probability (based on a multivariate analysis) that an average working-age individual will experience at least a 50 percent drop in family income also increased substantially—from 7 percent at the beginning of the 1970s to nearly 17 percent by 2002.

One probable reason for these growing drops is that the character of job loss has changed. Once, unemployment was largely cyclical: workers lost a job when the economy slowed, but they returned to a similar position when the economy regained steam. Increasingly, however, unemployment is structural: persistent, perhaps even permanent, and often requiring changes in job types and work skills.

Unfortunately, this transformation is completely missed by the unemployment rate. In recent years, for example, unemployment has remained low. Yet the chance that workers will involuntarily lose a job over a three-year period has been rising steadily and is now essentially where it was in the early 1980s—during the steepest recession since the Great Depression. The earnings loss associated with job separations has also risen. Meanwhile, the share of workers experiencing unemployment for longer than six months has tripled since the 1960s, comparing business cycle peak to business cycle peak. And in each of the last two recessions, long-term unemployment has approached crisis levels, rising higher than ever recorded and persisting for many months after recovery commences. Contrary to the common impression, the long-term unemployed are likely to be professionals and the educated, not workers with limited skills and education.

Despite the shift toward structural unemployment, however, unemployment insurance has eroded dramatically. Between 1947 and 1995, the share of workers in covered employment who actually received benefits fell from 80 percent to less than 40 percent. Low-wage workers are particularly unlikely to receive unemployment benefits. In 1995, only about 18 percent of unemployed low-wage workers were collecting anything from unemployment insurance. Moreover, unemployment insurance is poorly equipped to deal with structural unemployment. Unless Congress extends it, it lasts only six months, and it is not designed to deal with permanent job loss—to make up for the diminished earnings and benefits that plague workers whose skills are no longer needed, or to help with retraining. In short, the declining reach of unemployment insurance is emblematic of the way in which existing benefits are both eroding and increasingly out of step with the needs of the new world of work and family.

Rising income volatility is not the only evidence of increased insecurity. Personal bankruptcy has also become more common, with the number of households filing for bankruptcy rising from fewer than 290,000 in 1980 to more than 2 million in 2005. Health care costs also pose substantial financial risks. Medical costs and crises are a factor in perhaps as many as 46 percent of all personal bankruptcies. These various risks combine to create a greater sense of insecurity than any one of them alone would generate. Perhaps not surprisingly, then, poll after poll shows that the majority of Americans today are concerned that their economic security is slipping away.

The Rationale for Universal Insurance

The ideals and institutions of economic security need to be refashioned for the 21st century. The starting point is a simple but forgotten truth: economic security is a cornerstone of economic opportunity. Like businesses, people invest in the future when they have basic protection against the greatest downside risks of their choices. The worker who fears being laid off at any moment may be more productive in the short run. But in the long run, insecure workers tend to underinvest in specialized training; they are more reluctant to change jobs; they try to minimize their sense of job commitment to protect themselves against psychological loss. Similarly, the family barely scraping by may work more hours, but in the long run insecure families are not going to be able to make the investments in education and other keys to their future that they should.

In sum, the increased income volatility and insecurity faced by many families imposes costs not just on those families, but also on the economy as a whole. Substantial economic insecurity may impede risk taking, reduce productivity by failing to help families that have suffered an adverse shock get back on their feet, and feed demands for growth-reducing policies. While some measure of financial risk can cause families to respond with innovation and prudence, excessive insecurity can cause them to respond with caution and anxiety. As a result, families lacking a basic foundation of financial security may fail to make the investments needed to advance in a dynamic economy.

Perhaps the most important of these investments—and the hardest to insure privately—is investment in human capital. Human capital is by far the most lucrative asset in the portfolio of most Americans. Yet it is an investment that is not only much more costly than it used to be, but also much more risky than we commonly assume. There is a huge range of possible outcomes for those who have gained the same amount of education, and this range (known as "within-group inequality") is growing. For example, while the earnings of a full-time worker with a bachelor's degree in 2000 were $1,700 a week at the 90th percentile, similarly educated workers were earning only $423 a week at the 10th percentile.

Furthermore, human capital is an exceedingly difficult asset to insure on one's own, not least because we cannot generally commit the future returns of our human capital to others. Because human capital is essentially a nontradable asset, diversification of its risks is extremely difficult in the private market. It requires public risk pooling.

It has long been recognized that policies that encourage risk taking can benefit society as a whole because, in their absence, individuals may be unwilling to undertake valuable investments that involve high levels of risk. This is all the more true because people are highly "loss averse," meaning that they fear losing what they have more than they welcome the possibility of substantially larger but uncertain gains. Moreover, the gains of risky investment may entail positive externalities, that is, benefits that are not exclusive to the individual making the investment, but that accrue to others outside the transaction. When investments involve large positive externalities, individuals may not have sufficient incentive to invest in achieving these societal gains.

Providing a basic level of security appears even more economically beneficial when considered against some of the leading alternatives that insecure citizens may otherwise back. Heavy-handed regulation of the economy, trade protection, and other intrusive measures may gain widespread support from workers when they are buffeted by economic turbulence. Yet these measures are likely to reduce growth. The challenge, then, is to explore ways of protecting families against the most severe risks they face, without clamping down on the potentially beneficial processes of economic change and adjustment that produce many of these risks.

Universal Insurance in Brief

Universal Insurance is one approach to providing protection against severe risk. It would insure against major economic shocks stemming from unemployment, ill health, disability, and the death of a family breadwinner. Its benefits would be generous enough to help families truly get back on their feet.

The label "Universal Insurance" is meant to connote two key features of the program. First, Universal Insurance would cover almost every citizen with any direct or family tie to the labor force, providing at least some direct benefits to virtually all families that experience the risks against which it insures. Second, Universal Insurance would cover a wide range of risks to family income. The philosophy of Universal Insurance is that Americans should have at least some protection against the major threats to their economic well-being, regardless of whether those threats fit neatly into existing program categories. Universal insurance is not a health program, a disability program, or an unemployment program. It is an income security program.

Universal Insurance would aim to fill the gaps left by existing social insurance programs, rather than to substitute for those programs. It would thus be similar to private stop-loss insurance purchased by corporations to limit their exposure to catastrophic economic risks.

The starting point is a simple but forgotten truth: economic security is a cornerstone of economic opportunity.

By providing limited protection against large and sudden income declines that can cripple family finances, Universal Insurance would enhance economic security. Although the protection it would offer would be relatively modest in order to target resources and avoid incentive problems, it would nonetheless provide a more secure backstop against catastrophic economic loss than Americans now enjoy. Universal Insurance would provide this backstop, moreover, through the popular and successful method of inclusive social insurance, pooling risks broadly across all working families.

Under Universal Insurance, all workers and their families would be automatically enrolled through their place of employment, paying premiums in the form of a small income-related contribution (preferably, a levy that included capital gains as well as labor income). In return for their premiums, workers would receive coverage for four potential shocks to family labor income that are large, serious, primarily beyond individual control, and incompletely protected against by present policies: (1) unemployment, (2) disability, (3) illness, and (4) the death of a family earner. In addition, Universal Insurance would provide coverage against catastrophic health costs—a leading source of economic strain. This coverage would apply to all families whose income was below a relatively high threshold (the 95th percentile of state family income), and would be available to families with assets as well as those without assets (however, families with very extensive assets would not be covered).

Universal Insurance would provide short-term, stop-loss protection to families whose income suddenly declines by a fifth or more.

Although nearly all families would be protected, Universal Insurance would be especially generous for lower-income families, which are most likely to experience large financial shocks and be most in need of help when they do. Lower-income families generally have little or no wealth to protect their standard of living when income declines, and they are least likely to have access to workplace health or disability insurance. Not surprisingly, therefore, unemployment has a much larger effect on the consumption patterns of lower-income families than it has on those of higher-income families.

Administration and Structure

Universal Insurance would be administered primarily by the Internal Revenue Service, which would assess income, authorize checks, and evaluate tax filings to ensure that workers actually qualify for benefits they receive (much as is now done with the Advance Earned Income Tax Credit). The IRS would work in cooperation with the U.S. Department of Health and Human Services and the U.S. Department of Labor, as well as with state governments. State governments would be required to maintain existing programs that provide benefits in areas covered by Universal Insurance. Although some of the administration of Universal Insurance could be contracted out, the federal government would play the core role in pooling risk across all working families and regulating the system.

Universal Insurance would insure all legal residents and their families with direct or family ties to the workforce. It would require at least four quarters of employment before an individual would be eligible to receive benefits for the first time. In addition, in order to qualify for benefits at the time of application, workers would have to have minimum earnings equivalent to 20 hours of work at the minimum wage in at least two of the last four quarters, or the same level of earnings for all three months of the most recent quarter. When two or more members of the family work and contribute, they would receive coverage for their combined incomes.

To the extent possible, triggering events that lead to substantial income loss or catastrophic health costs would create automatic coverage. For instance, employers would report to federal authorities when they terminate workers; those authorities would then contact employees to advertise coverage. Similarly, health providers and insurers would be required to provide information about filing for Universal Insurance to families that have been struck with illness. And state unemployment and workers' compensation programs, as well as the federal disability program, would assist in reaching out to the unemployed and disabled. To be sure, any significant degree of automaticity would require substantial advances in IRS and other government agency computing power and capabilities.

Even if those investments were successfully made, some families would still have to file for help themselves. People would be more likely to file for Universal Insurance than many other programs, however, for at least two reasons. First, Universal Insurance would cover a wide range of risks, so people would likely be aware of the option to file for help. Second, because the program would be universal, wage-related, contributory, and structured similar to private insurance, there would likely be little stigma associated with applying for coverage. Families would be able to apply online, at their local post office, or through companies contracting with the government to handle applications.

All beneficiaries of Universal Insurance would be required to file tax returns for years during which they receive benefits. If losses determined at the time of qualification were different from actual subsequent losses, the IRS would collect the difference, preferably in the form of additional withholding. Universal Insurance benefits would be taxable as income.

Benefits

Universal Insurance would mimic private insurance in its basic features: a premium (in this case, related to wages), a coinsurance rate that varies with family income, and a deductible (that is, a threshold expenditure or drop in income that must be reached to trigger compensation). As shown in the table below, the deductible is 20 percent of income. In other words, in the case of income losses, family income must fall by at least 20 percent relative to the prior year. This relatively high threshold reflects the desire to target assistance to those experiencing the most severe economic shocks. Once this threshold is reached, additional losses are partially covered on a sliding scale. The replacement rate for losses above the threshold would be 35 percent for a family with median income. For families that, after the loss, are below the 25th percentile of state family income, the rate would be 50 percent—the maximum replacement rate for losses in excess of 20 percent. The replacement rate would gradually taper to 20 percent for families between the 75th and 95th percentile of state family income. Families with income above the 95th percentile, or with wealth that places them above the 95th percentile of household wealth, would not be covered. Initial maximum annual benefits would be $10,000; this maximum would be updated in line with average family income in subsequent years.

Out-of-pocket catastrophic health costs also represent a severe economic shock that is not always well covered by existing public and private insurance. Universal Insurance would therefore provide coverage on the same sliding scale to families whose out-of-pocket health costs in any year exceeded 20 percent of family income. Thus, for example, Universal Insurance would cover half of out-of-pocket health costs that exceeded the threshold of 20 percent of family income for families with incomes in the lowest quartile.

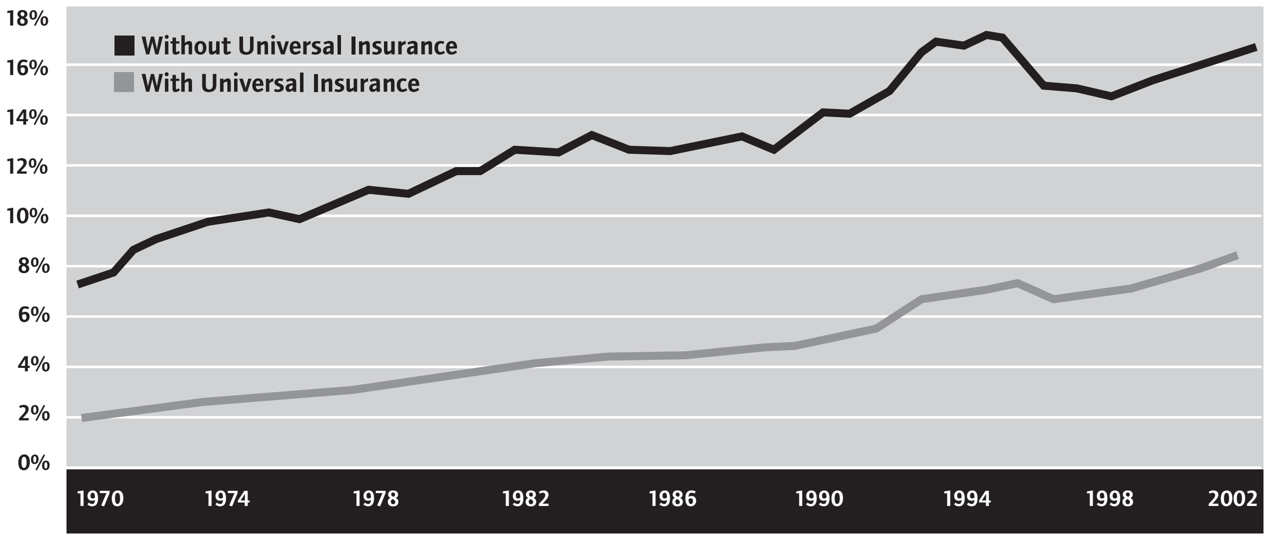
A crucial point is that determination of benefits would be based on family income after other public programs were taken into account. In other words, Universal Insurance would apply only if existing public policies did not adequately protect family incomes. Because Universal Insurance is an income-protection program, it would not take into account in-kind benefits such as Medicaid and subsidized childcare. Moreover, Universal Insurance benefits would not be counted in the determination of eligibility for means-tested antipoverty assistance, although they would be counted as taxable income.

The duration of Universal Insurance benefits would be similar to the duration of benefits currently provided by related categorical programs. In the case of an unemployed individual, or an individual who is unable to work due to a disability, Universal Insurance would continue for up to six months, as long as the policyholder continues to look for work (unemployment) or the debilitating condition remains (disability). In the case of

COINSURANCE RATES FOR UNIVERSAL INSURANCE

	FAMILY PAYS	UNIVERSAL INSURANCE PAYS
Initial 20 percent drop in income or expense	100 percent	0 percent
Remaining loss/expense for...		
Families between 95th & 75th percentiles (inclusive)	80 percent	20 percent
Families from 75th percentile to median (inclusive)	80–65 percent	20–35 percent
Families from median to 25th percentile (inclusive)	65–50 percent	35–50 percent
Families below 25th percentile	50 percent	50 percent

PREDICTED PROBABILITY OF 50 PERCENT OR GREATER INCOME DROP, 1970–2002



Sources: Panel Study of Income Dynamics, University of Michigan; Cross-National Equivalent File, Cornell University.

Note: Probabilities are based on the time trend from a logistic regression, with all other variables set at their annual means. Variables include age, education, race, gender, income (mean of five prior years), and a series of events (such as unemployment and illness) that affect income. The time trend is highly significant and robust to the inclusion of fixed effects; all standard errors are robust and adjusted for clustering.

temporary unemployment due to illness, Universal Insurance would continue for up to 12 weeks. In the case of the death of a spouse, insurance payments would last one year, or until income rebounds, whichever comes first. Health costs would be covered in any year for which they exceed 20 percent of family income.

Cost and Effects

Based on an analysis of the Panel Study of Income Dynamics (PSID), the total annual cost for the income-loss components of Universal Insurance would be just over $27 billion in 2005 dollars. These figures are admittedly uncertain. On the one hand, they assume 100 percent participation, which may lead to overestimating the true cost. On the other hand, the PSID estimates do not take into account any potential behavioral effects of Universal Insurance, which could push up costs. But this upward pressure on costs would be limited by key features of Universal Insurance that militate against the problem of false or induced claims.

The main cost of the income-protection portions of Universal Insurance would be benefits for the disabled and unemployed (43 percent and 42 percent of total benefits, respectively), followed by benefits for the spouses of deceased workers (13 percent), and 12 weeks of coverage for income losses due to sickness (2 percent).

The costs of coverage for catastrophic health expenditures cannot be estimated from the PSID. To estimate them requires using the Medical Expenditure Panel Survey (MEPS), a nationally representative survey of medical use and costs. According to the MEPS (author's calculations), in 2003 more than 7.7 million households had out-of-pocket medical expenditures that exceeded 20 percent of family income. Coverage of all of these expenses under the terms of Universal Insurance—that is, with a deductible of 20 percent of income and the same sliding-scale coinsurance rate—is estimated to cost slightly over $7 billion (in 2005 dollars). In sum, the annual cost of Universal Insurance given the specific parameters proposed would amount to roughly $35 billion.

Despite the targeting of the proposed program to severe economic losses and its temporary and partial assistance to families even in those cases, Universal Insurance would still have a major positive effect on the incomes of the families it helped. For example, according to the PSID, more than a third of the households affected by the four categories of income risk covered by Universal Insurance—more than 3 million Americans in total—end up below the federal poverty line even after receiving public transfers. Although the small numbers of such households in the PSID make any estimates of insurance effects uncertain, the PSID suggests that Universal Insurance would essentially eliminate poverty among these least-advantaged households.

Universal Insurance would have a more limited, yet still substantial, effect on the risk of large income drops among nonelderly adults. If Universal Insurance had been in place in 2002, according to the PSID it would have roughly cut in half the predicted chance of a 50 percent or greater income drop.

The Road Forward

Today, many see the ideal of economic security as dated, yet the opposite is true. The big economic trends of the past generation—deregulation, deindustrialization, increased foreign competition, the decline of unions, the transformation of the family—have unleashed new and newly intensified economic risks. Americans are facing much more dramatic income swings. As economic insecurity has intensified, moreover, it has moved up the income ladder, affecting middle-class Americans who once were relatively insulated from economic turbulence and hardship.

Universal Insurance responds to this new economic insecurity in a way that is likely to promote broad-based growth. Although it aims to cushion major economic shocks, it is not just about preventing financial disaster. It also has a more optimistic goal: to help families get ahead. Just as businesses and entrepreneurs are encouraged to invest and take risks by basic protections against financial loss, so Universal Insurance aims to encourage families to make the sacrifices necessary for economic opportunity and advancement. In doing so, Universal Insurance would provide a necessary cushion against the sharp edges of a dynamic capitalist economy—a cushion that is far preferable to the more intrusive measures that anxious citizens might otherwise demand, such as extensive regulation of the economy or restraints on international trade and finance.❖

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