

Private Employment Insurance: a 2010 perspective

A Welfare Policy Paper including a basic tool for modeling Pennsylvania Unemployment Insurance financing
by *Ayan Kishore**

Unemployment Compensation (UC) in the U.S. has been a public benefit funded by federal and state UC taxes. There have been several widely researched socio-economic problems with unemployment compensation from lack of coverage to perverse incentives encouraging unemployment. Unemployment Compensation is basically a form of insurance, and is often referred to as Unemployment Insurance (UI) or employment insurance. Government-provided insurance such as Medicare and Medicaid have been becoming expensive for the state which is part of the reason for the re-haul of the health industry in the U.S. In fact, public option of health insurance has been dropped in health reform negotiations moving forward, with the requirement for signing up with private health insurers being instituted instead. Yet, unemployment insurance is a public provision which is not actively being challenged. This paper considers the private provision of unemployment insurance.

Rationale

a) Social Need

99.7% of all wage and salary workers, and 89% of the total civilian labor force is covered by all UC programs (2001). All those who are self-employed, part time workers, temporary workers, certain agricultural labor and domestic services, services for relatives, service of patients in hospitals, students, certain student interns, certain alien farmworkers, and certain seasonal camp workers are not covered by any UC program. Further, in order to qualify for Unemployment Compensation, an unemployed person must satisfy various requisites such as having worked for an employer for a specific period and earned a certain amount of wages. On average only 44% of unemployed persons were receiving UC benefits in 2002, and the percentage is probably lower now. National Public Radio (NPR) published an article on its website a year ago (January 2009) regarding UC benefits, and here is an excerpt from the same about UC qualification criteria.

What does it take to qualify?

There are four criteria, and many people who have been laid off don't meet all of them. First, your employer must have paid into the unemployment fund on your behalf (99 percent of employers do); this doesn't usually cover temporary or part-time employees. You had to have worked for your employer for a substantial period, usually at least one or two years, depending on the state. You cannot have been let go for cause or, with some exceptions, have left voluntarily. And you had to have worked each week for at least 35 hours and \$35, according to the antiquated law written in 1935.

How long do benefits last?

The standard length is 26 weeks, or about six months. Last June, Congress extended benefits for an additional 13 weeks, and in November it gave seven more weeks of support to workers who had gotten the 13-week extension. The November legislation also allows up to 26 extra weeks of unemployment benefits — for a total of 52 weeks — for workers in states with a jobless rate higher than 6 percent. These extensions are not permanent.

What could keep you from getting the money?

If you have any other kind of weekly income — including severance pay — it is subtracted from your unemployment check. If an employer offers severance pay, it may be more beneficial to take it in a lump sum rather than in installments, so you can get unemployment benefits. Also, if you own a home and rent it out, that rental income would be taken into consideration when calculating your unemployment benefit. Alimony is exempted.

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On average, the national replacement rate (unemployment benefits coverage rate) is 37.5% of salary. While higher coverage (number of weeks benefits are disbursed for, and the weekly compensation) has negative effects on unemployment (studies show that more coverage leads to longer or higher unemployment), there are several people who genuinely need more benefits than UC provides till they can secure employment with reasonable wages and to personal satisfaction. These are some of the problems faced by workers (unemployed) in the current public UC system, with several others such as perverse incentives to not work (all of which cannot be covered in this paper). This serves to prove that there is a social need and market that can potentially be addressed by private employment insurance.

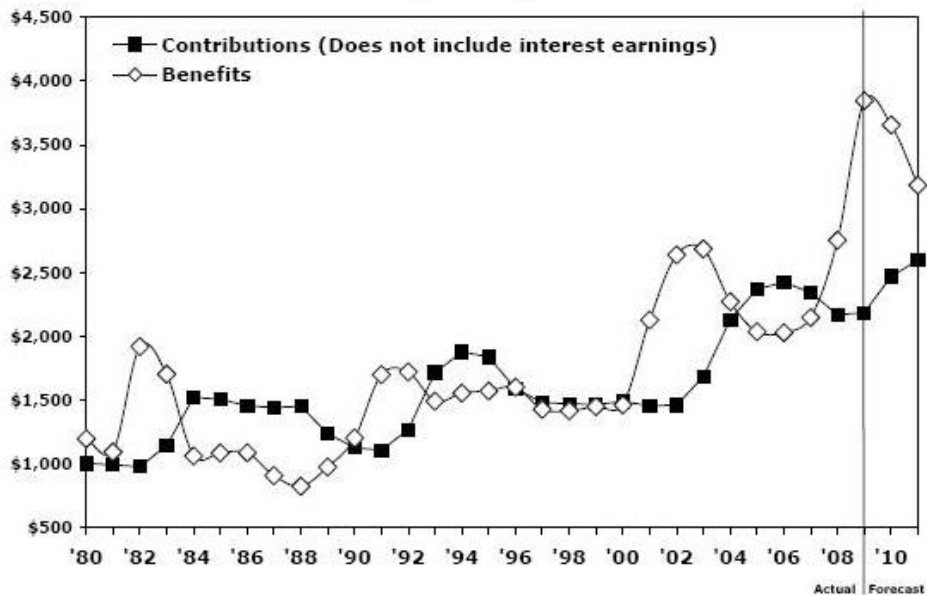
b) Fiscal Need

Several states, including Pennsylvania, are in financial debt to the federal government in trying to fund unemployment benefits. Pennsylvania's benefit cost of \$2,755 million in 2008 was up by \$605 million from \$2,150 million in 2007. Its UC Trust Fund balance fell, ending at \$980 million. The brief recovery in the previous years, 2006 and 2007, ended in 2008 with the UC Trust Fund balance declining by almost 37%. Based on UC benefit costs for 1982 (the year with the highest number of UC weeks paid) adjusted to 2008 dollars, the 2008 balance reflects reserves equal to 2.7 months of benefits. Below is the PA P&L for 2008:

Calendar Year 2008 (Dollars in Millions)	
Beginning UC Trust Fund Balance	\$1,555
Ending UC Trust Fund Balance	\$872
UC Trust Fund Balance as of June 30	\$1,726
Three Year Average Benefit Cost as of June 30	\$2,139
Solvency Percentage as of June 30 a/	80%
Revenue	\$2,238
Employer Contributions	\$1,863
Reimbursable Contributions	\$141
Employee Contributions	\$166
Interest	\$69
Disbursements	\$2,814
Regular Benefits	\$2,755
Extended Benefits	\$0
Reed Act b/	\$59
Weeks Paid for 2008	9,035,608
Average Weekly Payment	\$305
a/ The solvency percentage is calculated by dividing the UC Trust Fund balance by the three year average benefit cost.	
b/ Reflects Reed Act expenditures for administrative costs.	
Note: Detail may not add to totals due to rounding.	

The graph on the next page indicates that over the years contributions to and benefit payouts from the Pennsylvania UC Trust Fund are overall negative (the area under the Benefits curve is greater than the area under Contributions curve). This points to unsustainable financing with nearly persistent debt. More recently, Pennsylvania had a federal loan balance of \$527,945,040 on July 1st 2009, and is in danger of a FUTA (Federal Unemployment Tax Act) Credit Reduction in 2011. This is despite Pennsylvania having one the highest state tax rates for UC.

**UNEMPLOYMENT COMPENSATION TRUST FUND
BENEFIT AND CONTRIBUTION CASH FLOW
(In Millions)**



With the public UC system facing financial trouble, unemployment taxes on employers could increase, soon becoming a major cost for small businesses and other employers per employee just as health insurance is. Private Employment Insurance could provide for a better ecosystem that doesn't jeopardize development and economic growth. Further, the current taxation and experience rating UC system is fraught with issues such as stable firms subsidizing less stable firms, certain industries subsidizing others, and layoff encouragement for firms paying the capped maximum tax rate. These could be fixed by customized market-determined private insurance.

c) Historical Evidence

Michael B. Rappaport's 1991 Article on "The Private Provision of Unemployment Insurance" in the Wisconsin Law Review provides historical support and evidence for private employment insurance in the absence of government Unemployment Compensation. From 1916 to 1930, union and employer private employment insurance plans grew providing insurance to more than 150,000 workers. However, not organized by the insurance industry, the plans did not diversify across industries, sectors, localities or sometimes even firms, thus not pooling independent risks, which is the basics of actuarial economics. Harley Fiske, the President of the Metropolitan Life Insurance Company (MetLife) of New York, the premier life insurance company of the time, was devoted to the idea of selling UI. Finally, in 1931, an authorization bill passed both houses of the New York State Legislature, but Governor Franklin Roosevelt vetoed it. Actuaries have analysed MetLife's UI proposals and it appears they would have been profitable even in those times. The decades following the enactment of the 1935 Social Security Act which established the government UC system were extremely successful years for other private insurance such as hospital and medical. Had private UI been provided the legal environment to emerge, evidence suggests it might have prospered.

In order for UI to be feasible, unemployment must satisfy the conditions of an insurable risk. Such conditions require that unemployment be: (1) not subject to moral hazard; (2) verifiable, i.e., the contract defines with reasonable precision the distinction between insured and uninsured unemployment; (3) predictable; and (4) not subject to catastrophes. No insurance meets all these conditions perfectly. There are several policy and structural devices to reduce moral hazard in UI, to define insured unemployment, and to protect against catastrophes like the Great Depression, some of which will be mentioned in the next section. For a risk to be predictable, it is necessary (1) that there be a large group of relatively homogeneous exposures, and (2) that the average loss be calculable. Research on unemployment over several decades has led to more precision in predicting unemployment rates. Also, with the entire labor force there are large enough homogeneous groups to allow for pooling of independent risks.

Model

Private employment insurance, like other insurance, is purchased because workers are risk averse. Rather than bear the risk of a large loss of income from unemployment, the worker pays a small but certain premium to the insurer in exchange for monetary and other assistance to be rendered if the worker becomes unemployed. Workers purchase insurance rather than pursuing the alternative strategy of quickly finding the next available job because they may be unable to find attractive jobs immediately upon becoming unemployed. Therefore, workers insure against unemployment in conditions when a desirable job is unavailable.

Private UI can be provided on either an individual or group basis. As individual insurance, UI would be purchased directly by workers or households. As group insurance, UI would be purchased most often by employers, although other groups, such as professional associations or labor unions, might also provide it. Based on other types of insurance like health insurance, it is probable that both employer and individual private UI can co-exist. Unlike health insurance though, lay-offs by a company makes employer insurance risky for an insurer, and the risk may not be able to be pooled across similar employers since they are likely to have lay-offs as well then. Also, just as high health insurance costs for employers is leading to employers shying away from providing health insurance in very recent years, the same could apply for employment insurance. For the purpose of the model provided with this paper, individual insurance is therefore considered, and at a household level.

An insurer determines the price for employment insurance for a worker based on several factors such as their occupation, the firm they are working for (industry and firm's employment history/experience rating), the geographical location, the amount of savings they have, their mortgage payments, their income, the size and nature of their household (similar information for every household member), their history of employment, the current unemployment rate and the like. An insurer develops a market niche, and pools risk much like any insurance setup. The provided private employment insurance model uses income and known unemployment rates in different income brackets to determine premium prices and replacement rates for employment insurance.

Several insurance policy measures can be in place to reduce moral hazard. Co-insurance (replacement rate of less than 100%) and deductibles (first few days/weeks of unemployment not covered) can be put in place to increase the unemployed worker's incentive to search intensely and to accept comparable jobs. The provided private employment insurance tool models co-insurance with an editable replacement rate, or, benefit coverage rate. Apart from this, the insurers could also limit moral hazard by providing free placement services. The provision of placement services by the insurer would guarantee that some job search would be conducted at a sufficient intensity. It would enable insurers to determine what opportunities the worker had and how vigorously they were pursued - information for monitoring whether insureds were resisting comparable job offers. Such services would benefit workers as well, since private placement firms are more effective than state unemployment offices in general.

The provided spreadsheet analysis tool models employment insurance financing - benefit distribution (cost) and charge for individual workers or households (revenue). It provides for two customizable modelling techniques:

(i) Linear Step Model: This is a step function with a gradient straight line increase that is used to model costs and revenue in the current public UC system. It can be modified (gradient, cap and start) by changing the two points defining the model function.

(ii) Inome Bracket Configurable Model: This is a model that allows for different benefit distributions and contributions for different income brackets as a % of their annual salary. It can be modified by changing the Benefit Coverage Rate (Replacement Rate) and UI Charge Rate for different income brackets.

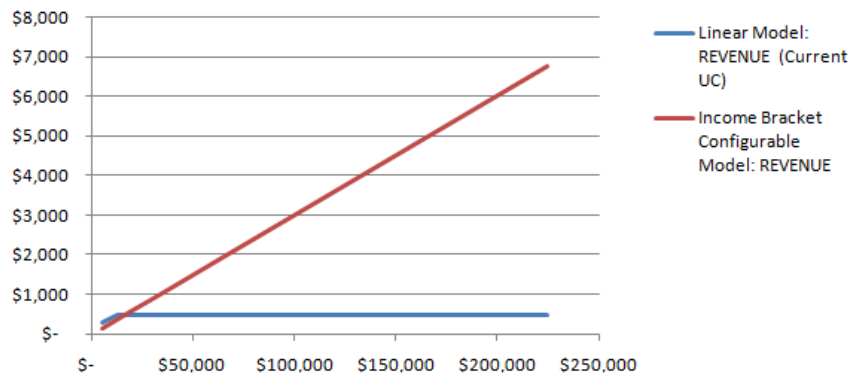
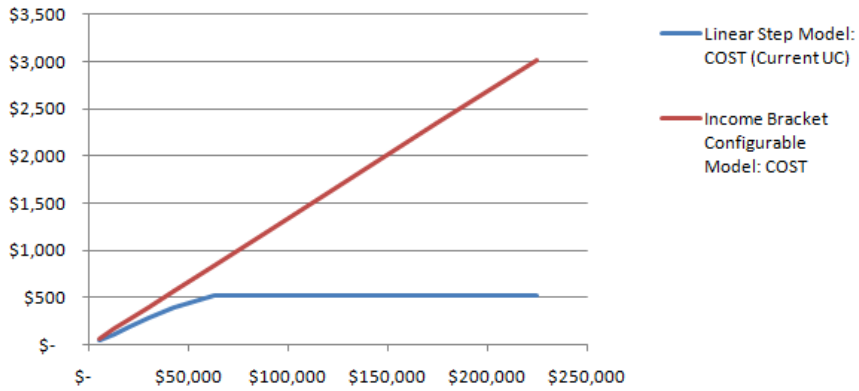
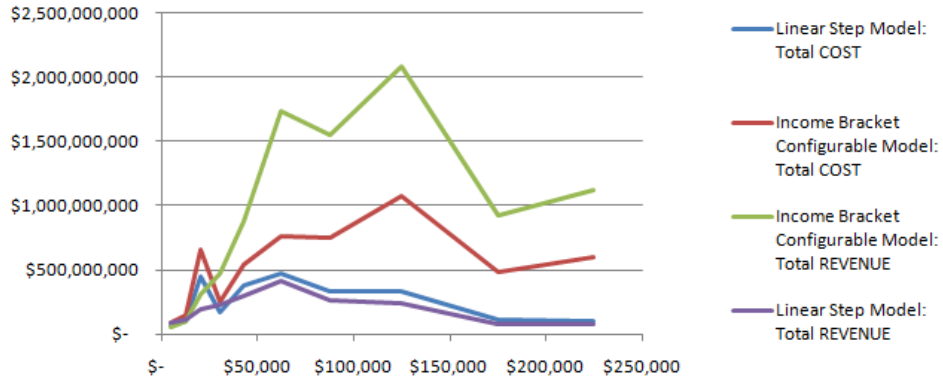
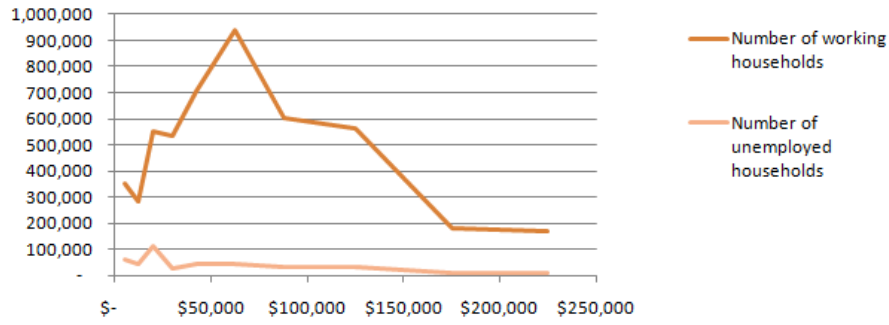


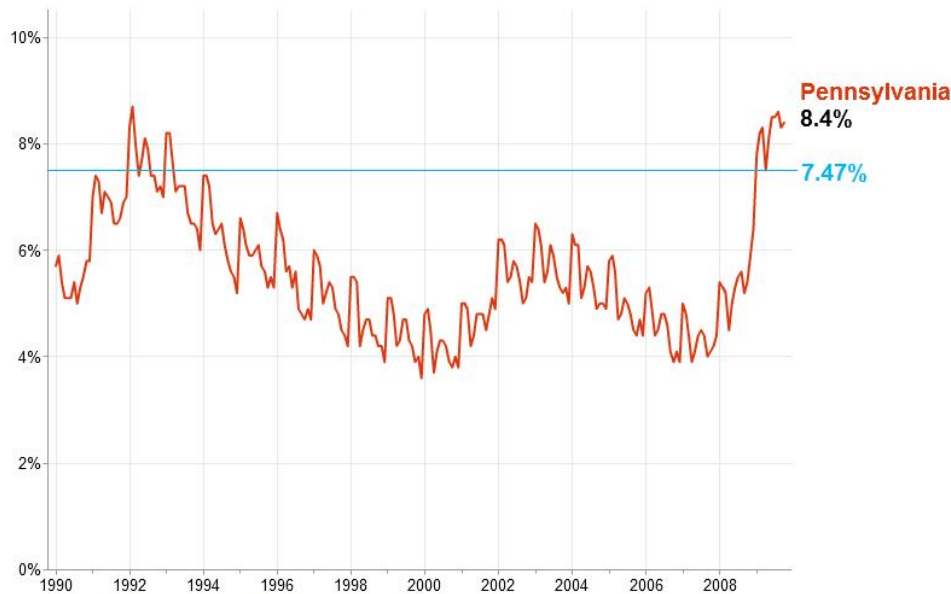
Figure above (top-down): a) Labor force and number of unemployed households by income, b) Revenue and Cost by income bracket for UI, c) Linear Step and Income Bracket Cost Model, d) Linear Step and Income Bracket Revenue Model.

The model is populated with data from the year 2007 for Pennsylvania. 2007 was chosen since it represented the most recent data that was not affected by the recent recession with very high unemployment. To update the model for another year, firstly the labor force size and income distribution, and unemployment distribution across different income brackets must be updated. Different busts and booms have different unemployment distribution across income brackets. The tool doesn't differentiate between self-employed and firm-employed, to model for universal coverage, an improvement over the current UC system. An insurer can use the tool to change the average number of weeks benefits are claimed for in different income brackets, and the market share the insurer has in a particular income bracket. By default, the model is populated with the claim duration being the same across different income brackets, and the market share being 100%, so that private employment insurance can easily be compared with public PA unemployment compensation. As mentioned earlier, for the linear step model, the defining points can be edited. It is setup by default as the 2007 PA UC parameters. For the income bracket customizable model, an insurer can edit the Benefit Coverage Rate (Replacement Rate) and UI Charge Rate for different income brackets. By default, the replacement rate is set at 70% for all income brackets, which is much higher than any UC program in the US, and similar to a 70/30 private health co-insurance plan. Also, the charge rate is set at 3% of household income by default. This is lower than what a household pays on average for health insurance in the US (3.15% of total income for health premium, and 7.77% including health deductible). This setup leads to model functions for the Linear Step Model and Income Bracket Configurable Model as visualized in graphs c and d on the previous page.

For the linear step model, or the PA state UC model, revenue and cost are very similar for the 2007 unemployment rate of 4.4%. For the implementation of the income bracket configurable model, the default parameters lead to a simple net income of \$3.87 billion for 2007. This equates to a Return on Total Revenue (i.e. net income/total revenue) of 42%. With the overall insurance industry average around 3%, this model indicates that unemployment insurance can be highly profitable. However, this was modeled for the unemployment rate of 4.4% (2007). Assuming 2007 labor, income and unemployment distribution, the unemployment rate can be up to 7.47% and the insurer will still be profitable under the simple default income bracket configurable model. In fact, there have only been two years in recent history (1992 and 2009) with higher annual unemployment rate in Pennsylvania. The graph below shows the monthly PA unemployment rate over the last decade. Yet, to protect against catastrophes like the Great Depression or the recent depression, a contract could be devised under which insurers initially charge a premium based on expected unemployment, but then, through either rebates or surcharges, retroactively adjust the premium at years end to reflect the actual unemployment rate.

Unemployment rate

The percent of the labor force that is unemployed, not seasonally adjusted. [More info »](#)



Data source: [U.S. Bureau of Labor Statistics](#) - Last updated December 10, 2009

It should be noted that this tool models only a few of the factors used to determine risk and pricing for unemployment insurance, based on the access of PA unemployment and UC claim information to the author. Some of the other factors mentioned before such as occupation and industry must be incorporated in a more significant actuarial analysis.

Empirical Results

The author of this paper interviewed some UI scholars, and international bankers and insurers from companies such as HSBC, AIG, ICICI etc. in 2009 to get an academic and industry perspective on unemployment insurance.

First and foremost, it is widely agreed that the Social Security Act of 1935 that created the government's unemployment insurance system, led to crowding out of the market, which is why private banks and insurers are not providing UI. This is also ratified by the fact that while Supplemental Employment Benefits (SUB) is open to private insurers, government provision of the same that makes use of the government UC framework, crowds out the market. Limiting private insurers to only the supplemental market significantly raises the fixed costs per worker and dollar of private insurance.

State and federal laws are still not well in place for private provision of unemployment insurance. The government has to take steps to privatize unemployment insurance: mandatory subscription to private unemployment insurance (much like the new healthcare reforms), and tax deductible contributions for workers to unemployment insurance (like some health insurance) can catalyze the industry and make it sustainable. It is speculated that both public and private unemployment insurance will coexist. However without any change in the current UC system, the only scope for a private insurer is perhaps for niche provisions to those with very high salaries and to the self-employed.

Insurers and reinsurers are reluctant to insure employment primarily because of fear of litigation costs. They worry about lack of clarity in insurable unemployment, selection bias, and gaming of the system. For instance, below is an excerpt of an email exchange with John Hartline, the President and CEO of Producers Financial Network, who was involved with Paycheck Guardian. Paycheck Guardian was a private unemployment insurance company that started in 2008 but was no longer in business within a year and a half. They used the eligibility as determined by the current UC system to provide different levels of benefits with different priced plans.

"Given the current economic environment, with unemployment skyrocketing, our product was a "target" for folks who knew, at some level, that they would lose their job, and probably after the vesting period of 4 months or 6 months from now, so their claim would probably be honored. We had people whose "unemployment" (lay-off day) was exactly 4 months (to the day) after the effective date, which was the exact date they were "vested" and would be covered. If the person to be insured is able to make the decision to purchase this type of coverage, the insurance company gets adversely selected against, as you get a more than normal percentage of people who are trying to 'game the system' and buy coverage they have a good idea they will need.

If unemployment coverage is sold, it seems to us it has to be sold along with 'something' else, such that the unemployment insurance is not the primary objective of the buyer, but it makes the 'combined' product more valuable. We now offer a 'sponsored version' where the IUI is purchased by a vendor and given to the buyer as an inducement to purchase something else: a house, a car, a home remodeling job, etc. The sponsored version means the vendor (the auto dealer) offers it to all potential auto buyers as an inducement to buy from him, and he would buy and give the coverage to everyone: those more likely to file a claim and those less likely. Risk of claim is spread."

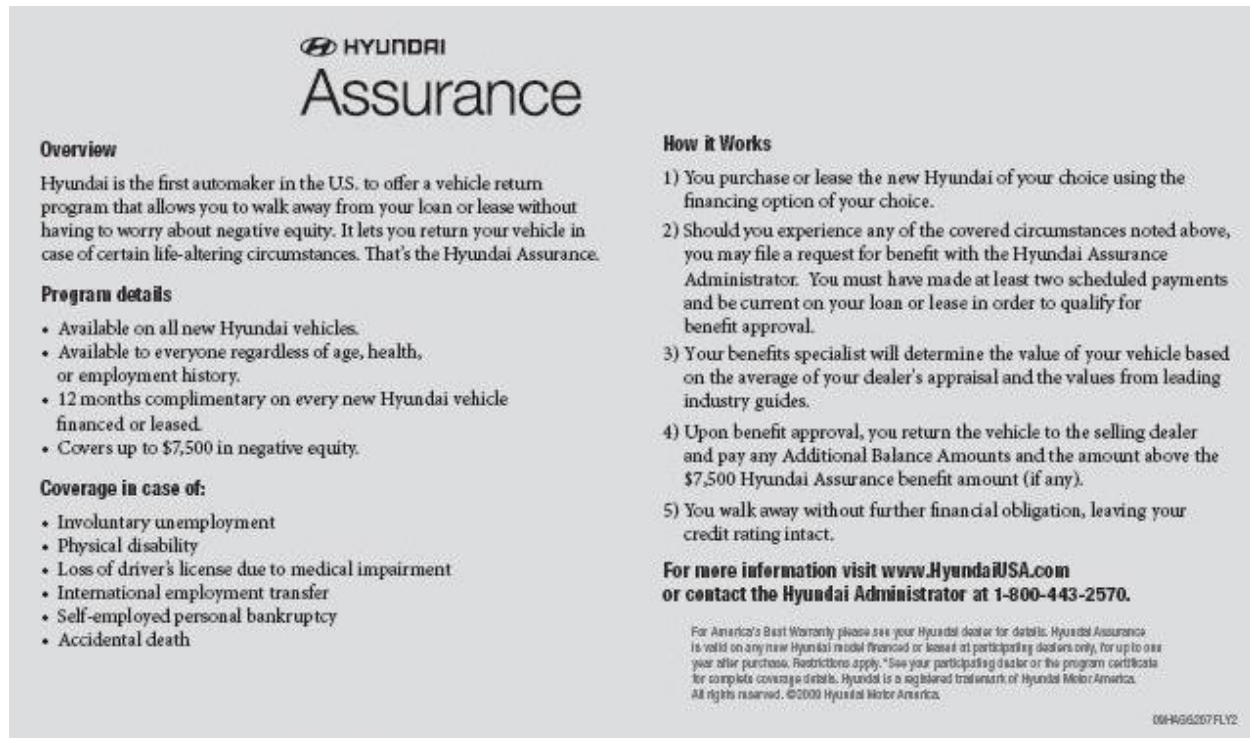
Insurers today therefore provide benefits to help the insured person in times of unemployment as a resultant cover e.g. covering mortgage loan when a person is unemployed, covering credit card payment when a person is unemployed, etc. Companies are increasingly providing for covers of unemployment with other policies as top-offs that one has to pay extra for. There are innovative schemes today to encourage economic activity by protecting against unemployment, such as Hyundai Assurance (*see next page*).

Michael Rappaport claims that today without any reform, on a scale of ease to make money for an insurer, employment insurance is on the harder side. He nevertheless suggests that employment insurance coupled with placement services, as mentioned earlier, can possibly thrive. For economies of scale, he proposes agencies helping people find jobs and ensuring that people take them up when available. If the job placement agency is good enough, people will buy employment insurance just for the placement services.

Perhaps the greatest alternative to unemployment insurance is savings. With savings levels historically low for the US, a savings structure for unemployment can be put in place just like Individual Retirement Accounts (IRA), or how a Flexible Spending Account (FSA) or Health Savings Account (HSA) is used for medical expenses. This is primarily applicable for those who don't have a hand-to-mouth existence. Individuals could invest earnings in Individual Unemployment Accounts (IUAs), choosing whether to establish such accounts, and either managing the funds themselves or turning the management over to others.

Contributions, perhaps up to a certain limit, could be tax deductible, and the earnings on the funds would be tax exempt until withdrawn.

In conclusion, the author's views are that private employment insurance can be feasible, possibly fraught with fewer issues than the government's Unemployment Compensation, and can find markets not catered by UC. However, state and federal governments need to take measures to create an environment for private employment insurance. To this effect, the concept has to first gain popularity with insurers, constituents and the media. Whether private employment insurance takes the form of private provisions for health insurance, or Individual Retirement Accounts, or something else, the UC system needs reform.



HYUNDAI
Assurance

Overview
Hyundai is the first automaker in the U.S. to offer a vehicle return program that allows you to walk away from your loan or lease without having to worry about negative equity. It lets you return your vehicle in case of certain life-altering circumstances. That's the Hyundai Assurance.

Program details

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- Available to everyone regardless of age, health, or employment history.
- 12 months complimentary on every new Hyundai vehicle financed or leased.
- Covers up to \$7,500 in negative equity.

Coverage in case of:

- Involuntary unemployment
- Physical disability
- Loss of driver's license due to medical impairment
- International employment transfer
- Self-employed personal bankruptcy
- Accidental death

How it Works

- 1) You purchase or lease the new Hyundai of your choice using the financing option of your choice.
- 2) Should you experience any of the covered circumstances noted above, you may file a request for benefit with the Hyundai Assurance Administrator. You must have made at least two scheduled payments and be current on your loan or lease in order to qualify for benefit approval.
- 3) Your benefits specialist will determine the value of your vehicle based on the average of your dealer's appraisal and the values from leading industry guides.
- 4) Upon benefit approval, you return the vehicle to the selling dealer and pay any Additional Balance Amounts and the amount above the \$7,500 Hyundai Assurance benefit amount (if any).
- 5) You walk away without further financial obligation, leaving your credit rating intact.

For more information visit www.HyundaiUSA.com or contact the Hyundai Administrator at 1-800-443-2570.

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