

Universal Insurance: Enhancing Economic Security to Promote Opportunity



THE ECONOMIC RISKS FACED BY AMERICAN FAMILIES have increased dramatically over the past three decades: Middle-class families in the 1970s could expect annual income swings averaging about 15 percent; by the end of the 1990s, average annual income swings were twice as large. Similarly, the chance of experiencing a drop in income of 50 percent or more increased from slightly more than 7 percent at the beginning of the 1970s to nearly 17 percent by 2002.¹

It is a substantial policy challenge to help families cope with this increased economic insecurity. Inadequate economic security can reduce economic growth and harm families, but poorly designed economic security programs can distort economic incentives and impair overall economic performance. The Hamilton Project's strategy for strengthening economic security in a growth-enhancing manner begins with two key components: better preparation before economic difficulties arise, and better-targeted and pro-work assistance after economic difficulties arise.

In a discussion paper released by The Hamilton Project, Jacob S. Hacker of Yale University reviews the evidence on the heightened economic risks facing American families, and puts forward a potential approach to addressing economic difficulties after they arise.

Hacker proposes the creation of Universal Insurance to provide temporary and partial relief from severe economic shocks and to help families get back on their feet economically. Universal Insurance would build on, rather than supplant, existing social insurance programs and would be available to the majority of American families. Hacker argues that this type of broad-based, stop-loss insurance—covering a range of risks but focused on particularly dramatic cases to minimize incentive problems and assist those most in need—could enhance economic security by providing a backstop to the current, fragmented collection of categorical-assistance programs. Hacker suggests, for example, that the program could cut in half the risk of a large (50 percent or greater) decline in income. Determining whether Universal Insurance represents the most effective way to address economic insecurity, however, will require additional study and an active debate regarding Hacker’s proposal and other potential policy responses.

1. See Peter Gosselin, “The Poor Have More Things Today—Including Wild Income Swings,” *Los Angeles Times*, December 12, 2004, <http://www.latimes.com/business/la-fi-poor12dec12,1,5929236.story>; and see <http://www.latimes.com/newdeal> for a description of research conducted by the *Los Angeles Times* in cooperation with Robert Moffitt of Johns Hopkins University and others. See also Jacob S. Hacker, *The Great Risk Shift* (New York: Oxford University Press, 2006).

The chance of family income dropping by 50 percent or more increased from slightly more than 7 percent at the beginning of the 1970s to nearly 17 percent in 2002.

THE CHALLENGE

Over the past generation, the economic risks faced by American families have increased substantially, yet public programs have largely failed to adapt, even as 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 shift in risk not only creates anxiety but also threatens opportunity and economic growth.

Perhaps the most telling evidence of increased insecurity is the widely documented growth in the volatility of family income. When a family’s income drops today, that drop is likely to be much larger than it was in the recent past. Hacker finds that the median drop in income has risen over the past three decades from about 25 percent of income to about 40 percent of income; other research also finds a substantial increase in the volatility of family income. Income volatility has increased for a range of socioeconomic groups, and has risen almost as quickly at high as at low educational levels.

Rising income instability is not the only evidence of increased economic insecurity. Personal bankruptcy rates have risen, and catastrophic health events have become more dangerous to family finances. In 2004, more than 14 million nonelderly Americans—10 million of them with insurance—paid more than 25 percent of their earnings on out-of-pocket medical costs and health premiums. According to one recent study, medical costs and crises may be a factor in nearly half of all personal bankruptcies in the United States.

The substantial income volatility and economic insecurity that now confront many American families impose costs not just on these families, but also on the economy as a whole. Families lacking a foundation of financial security are less likely to make the investments—in

skills, assets, or education—that are needed to get ahead in a dynamic economy. Without such security, families also may fail to bounce back onto a productive path after adverse economic events. Perhaps most importantly, absent a basic level of economic security, support may build for heavy-handed economic regulations, trade protections, and other measures that are likely to reduce growth.

Effective government policies can help strengthen economic security in growth-enhancing ways. For example, programs that encourage saving and asset accumulation can boost economic growth and simultaneously help families prepare for adversity by encouraging them to create a cushion against economic shocks. Hacker argues that such programs are important, but not sufficient: Savings do not provide true insurance because catastrophic events will quickly exhaust the savings of even the thriftiest middle- and lower-income families. Furthermore, unless contributions to savings accounts are mandatory, programs to encourage savings will not fully address the problems of myopia and risk misperception that often cause families to underestimate the savings they need to deal with economic shocks.

In addition to policies that encourage better preparation against economic adversity, a variety of existing programs—such as unemployment insurance, disability programs, Medicare and Medicaid, and survivor’s benefits—help families cope with the life events that can lead to income volatility. Hacker argues that these categorical assistance programs, some of which reflect program structures that have remained relatively unchanged since their inception in the 1930s, are no longer sufficient to the task. Because they address discrete risks, and because their benefit structure has changed little over time, these programs leave a significant amount of economic insecurity unaddressed: Hacker’s statistics on rising income volatility (including those cited above) reflect income fluctuations after taking

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account of government assistance. Responding to the growth in economic insecurity seems to require new policies or the updating of existing programs. Hacker suggests the adoption of a new, more comprehensive approach, perhaps in combination with the updating of existing programs.

A NEW APPROACH

Hacker argues that economic insecurity could be addressed most directly through a new program that provides short-term assistance when families experience severe economic shocks. Such a program could be designed in a variety of ways, in terms of both scale and scope. For example, it could begin modestly and evolve as fiscal conditions allow and as needs require. Alternatively, it could begin on a much more comprehensive basis, to have the most immediate impact.

To encourage discussion and to clarify some of the costs and operational issues involved, Hacker develops a proposal for a version of Universal Insurance that is designed to provide limited protection against large and sudden income declines that are not addressed by existing social programs.

Universal Insurance would provide short-term assistance in dealing with four categories of shock to family income that are serious, largely beyond individual control, and

Key Highlights of Hacker's Proposal

Benefit Structure

- Universal Insurance would provide assistance to families experiencing sharp income declines following unemployment, disability, illness, or the death of a spouse. Universal Insurance would also provide assistance for families experiencing catastrophic health costs.
- Families would be eligible for benefits if income declined by more than 20 percent after benefits from other public programs were taken into account, or if out-of-pocket medical expenses exceeded 20 percent of family income.
- Once this threshold was reached, additional losses would be partially covered on a sliding scale.
- Benefits would replace a larger share of income losses for lower-income families than for higher-income families.
- Duration of benefits would be similar to the duration of benefits provided by related categorical programs (for example, up to six months for unemployment).

Cost and Financing

- Hacker estimates that Universal Insurance would cost approximately \$35 billion annually.
- Universal Insurance could be financed with a payroll-based contribution or a broad-based tax on capital income and earnings.

Implementation Issues

- Hacker envisions Universal Insurance being administered through the IRS; doing so would require significant improvements to that agency's infrastructure.
- Further analysis is needed to assess the behavioral effects of Universal Insurance and its interaction with other public and private insurance programs.

incompletely protected against by present policies: (1) unemployment, (2) disability, (3) illness, and (4) the death of a family earner. Hacker recommends that Universal Insurance also provide limited coverage against catastrophic health costs—a leading source of economic strain.

These benefits would be available to most families (excluding only the wealthiest families), but the share of income replaced by the program would be more generous for lower-income families than for higher-income families. Hacker argues that such progressivity is appropriate because lower-income families generally have little or no wealth to protect their standard of living when income declines. In addition, they are less likely to have access to insurance provided at their workplace.

A key objective of Universal Insurance would be to provide protection against large and sudden income declines that can impair family finances. Although Universal Insurance would offer relatively modest protection in order to target resources and avoid incentive problems, Hacker argues that it nonetheless would provide a more secure backstop against catastrophic economic loss than Americans now enjoy. Hacker estimates that if this program were in effect in 2002, it would have cut in half, approximately, the chances of a 50 percent decline in income. Universal Insurance would provide this backstop, moreover, through the proven method of inclusive social insurance, pooling risks broadly across the population, and providing some benefits to virtually all families.

Benefit Structure

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). Under the version of the proposal put forward by Hacker, the deductible would be 20 percent of income; thus, Universal Insurance would provide benefits only if family income fell by more than 20 percent relative to the prior year. This relatively high threshold would target assistance to those experiencing the most severe economic shocks.

Once this threshold is reached, additional losses would be partially covered on a sliding scale; this fractional coverage is intended to limit potential incentive problems and avoid excessive costs. Because out-of-pocket catastrophic health costs also represent a severe economic shock that is frequently not well covered by existing public and private insurance, Universal Insurance also would provide coverage on the same sliding scale to families whose out-of-pocket health costs in any year exceed 20 percent of family income.

The determination of benefits would be based on family income after other public programs are taken into account. In other words, Universal Insurance would apply only if existing public policies did not adequately protect family incomes. The program is thus designed as a backstop to the nation's existing social insurance programs.

The duration of Universal Insurance benefits would be similar to the duration of benefits currently provided by related categorical programs—six months for unemployment and inability to work due to disability, 12 weeks for temporary unemployment due to illness, and one year for the death of a spouse. Hacker proposes that the program administrator would collect any difference between losses determined at the time of qualification and actual subsequent losses. Universal Insurance benefits would be taxable as income.

Cost and Financing

Hacker estimates that the income insurance component of Universal Insurance would provide benefits costing just over \$27 billion annually, the bulk of which would be benefits for the disabled and unemployed (43 percent and 42 percent of total benefits, respectively). The cost of catastrophic health coverage under his proposal would be slightly more than \$7 billion per year. If Universal Insurance turns out to be more or less expensive than projected, policy makers could adjust program parameters to meet a given budget goal. Indeed, the cost of the program could be dialed up or down by adjusting qualifying conditions, replacement rates, and other variables, so Hacker's budget estimates should not be the principal criteria used in assessing Universal Insurance.

Hacker describes several possible mechanisms for financing Universal Insurance. He notes that a payroll-based contribution of 0.6 percent of wage and salary income—0.3 percent each for employees and employers—would raise approximately \$34 billion, roughly equal to his estimate of the program's costs. Alternatively, Universal Insurance could be financed through a broad-based tax that includes capital income as well as earnings.

Hacker estimates that this program could cut by about half a family's chance of experiencing a 50 percent decline in income.

Implementation Issues

To be successful, Universal Insurance would need to be implemented in a manner that effectively addresses several potential design issues.

Administration

Hacker envisions Universal Insurance being administered primarily by the Internal Revenue Service (IRS), which would assess income, authorize checks, and evaluate tax filings to ensure that workers actually qualify for benefits they receive (similar to the way the Advance Earned Income Tax Credit is handled now). 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. The latter would be required to maintain existing programs that provide benefits in areas covered by Universal Insurance. A substantial challenge is that the IRS would find it extremely difficult to implement Universal Insurance with its existing computing infrastructure; doing so would thus require significant improvements to that infrastructure. In addition, when considering Universal Insurance as a potential response to economic insecurity, policy makers will need to look carefully at the cost and feasibility of administering the program—including potential interactions between Universal Insurance and existing categorical programs.

Moral Hazard and Incentive Problems

All insurance, social or private, raises the possibility of what insurance experts call *moral hazard*—the tendency for insurance to foster excessive risk taking or related opportunistic behavior. In the case of Universal Insurance, the main concern is that the program would create incentives for people to game the system or otherwise behave irresponsibly because of the availability of benefits. For example, workers may remain unemployed longer, or find a way to classify themselves as ill or disabled, to take advantage of Universal Insurance.

Hacker argues that Universal Insurance would have several features that attenuate the effects of moral hazard. First, the high deductible and significant cost sharing required by Universal Insurance would discourage many workers and their families from gaming the system. The program would not take effect until family income had fallen by a substantial amount (20 percent), and even then would cover only a fraction of the subsequent losses. Second, the risks and costs covered by Universal Insurance would be tied largely to existing categorical programs, each of which has a series of verification and monitoring processes to limit moral hazard concerns. Despite these structural safeguards, policy makers would need to consider carefully the potential moral hazard risks in evaluating this proposal.

Effect on Existing Insurance Programs

Hacker notes that if the government were to provide more social insurance, the private sector might provide less, even curtailing the availability of private alternatives that now exist, such as disability or health insurance. If government stepped in to protect against catastrophic health costs, for example, private insurers might exclude coverage for very high medical costs. Universal Insurance is designed to minimize such effects: It focuses on areas of risk where few good private alternatives exist. Moreover, the private alternatives that exist are often unavailable or unaffordable for people with lower incomes or higher risks—precisely those people who need those alternatives most. Nonetheless, comparing Universal Insurance to other methods of providing greater economic security will require a careful assessment of potential interactions between Universal Insurance and existing insurance programs (both public and private).

CONCLUSION

American families are facing an increasing risk of substantial income declines, raising significant public policy issues. As one example, the nation's unemployment insurance system has not been updated to address the evolving nature of risks facing American workers. In addition to improving existing programs such as unemployment insurance, the nation should debate whether different or new approaches are warranted. Jacob S. Hacker's Universal Insurance proposal represents such a new approach. It would provide a cushion against the sharp edges of a dynamic capitalist economy—a cushion that is far preferable to the more intrusive measures that individuals that are anxious about their economic futures might demand: extensive regulation of the economy or protectionist barriers, for example.

To be sure, Hacker's proposal for Universal Insurance represents just one approach. Even within the basic concept of Universal Insurance, a number of different designs are possible. Hacker's design is limited to severe risks and the coverage of catastrophic losses. Alternatives that are more generous would provide broader coverage and higher benefit amounts; alternatives that are more limited would focus on fewer risks or less-generous benefits. In addition, important questions remain about the administrative aspects and incentive effects of his proposal.

Implementation questions should not obscure the aspiration of this proposal. By creating a flexible foundation for protecting nearly all families against a wide range of catastrophic economic shocks, Universal Insurance aims to provide the basic security that families need to reach for, and hold on to, the American Dream. Hacker's proposal should thus be debated as one mechanism among many possibilities to address growing economic insecurity.

Learn More About This Proposal

This policy brief is based on the Hamilton Project discussion paper, *Universal Insurance: Enhancing Economic Security to Promote Opportunity*, which was authored by:

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Hacker's research interests include the politics of U.S. social policy, American political development, and the comparative political economy of the welfare state. He is the author of four books—most recently, *The Great Risk Shift: The Assault on American Jobs, Families, Health Care, and Retirement—And How You Can Fight Back* (Oxford University Press, October 2006).

Additional Hamilton Project Papers

Additional Hamilton Project discussion papers and policy briefs can be found at www.hamiltonproject.org, including:

- **[A Growth-Enhancing Approach to Economic Security](#)**
The Hamilton Project's strategy for strengthening economic security in a growth-enhancing manner begins with two key components: better preparation before economic difficulties arise, and better-targeted and more pro-work assistance after economic difficulties arise.
- **[Fundamental Restructuring of Unemployment Insurance: Wage-Loss Insurance and Temporary Earnings Replacement Accounts](#)** This proposal would shift unemployment assistance toward those who are reemployed at lower wages, halving the share of laid-off workers who experience very large drops in earnings at new jobs.
- **[Reforming Unemployment Insurance for the Twenty-First Century Workforce](#)** This proposal would strengthen the federal role in UI by adopting new standards regarding program eligibility, benefits, and financing; by supplementing basic UI with wage-loss insurance; and by providing new assistance to the self-employed.
- **[An Economic Strategy to Advance Opportunity, Prosperity, and Growth](#)** The Hamilton Project's economic strategy calls for promoting broad-based growth and opportunity through renewed fiscal discipline and increased public investment in key growth-enhancing areas.

The Hamilton Project seeks to advance America's promise of opportunity, prosperity, and growth. The Project's economic strategy reflects a judgment that long-term prosperity is best achieved by making economic growth broad-based, by enhancing individual economic security, and by embracing a role for effective government in making needed public investments. Our strategy—strikingly different from the theories driving current economic



policy—calls for fiscal discipline and for increased public investment in key growth-enhancing areas. The Project will put forward innovative policy ideas from leading economic thinkers throughout the United States—ideas based on experience and evidence, not ideology and doctrine—to introduce new, sometimes controversial, policy options into the national debate with the goal of improving our country's economic policy.

The Hamilton Project Update

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The Project is named after Alexander Hamilton, the nation's first treasury secretary, who laid the foundation for the modern American economy. Consistent with the guiding principles of the Project, Hamilton stood for sound fiscal policy, believed that broad-based opportunity for advancement would drive American economic growth, and recognized that "prudent aids and encouragements on the part of government" are necessary to enhance and guide market forces.



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