

How Government Disables Private Disability Insurance

by Robert E. Wright

Taxed Social Security earnings determine the level of three major types of Social Security benefits—the life annuity at the center of most discussions of Social Security, survivors’ benefits, and disability benefits—available to individual working Americans at any given time. All three benefits were originally the bailiwick of privately owned and managed business firms. Those firms, called life insurance companies, remain the most efficient and just method for protecting individuals from the economic travails of dying too young (life insurance), dying too old (life annuity), or losing the ability to work (disability). The economics of disability will be discussed here.

In the late 1910s, life insurers in the United States began to offer insurance against the risk of “total” and “permanent” inability to work by offering, in return for a rationally calculated premium, periodic cash payments to life-insurance policyholders if and when they became disabled. Rather unwisely, the companies linked the amount of the payment to the face value of the policy rather than to the policyholder’s current income. Predictably, during the Great

Depression disability claims skyrocketed. Though not as liable to abuse as unemployment insurance, disability insurance claims are subject to fraud, misrepresentation, and ambiguity. Insurance companies suffered losses, but at the same time they learned that disability insurance will be abused unless the monthly payment is less than the policyholder’s net remuneration from work. As the payment approaches or exceeds take-home pay, the policyholder will find it increasingly tempting to claim disability.

Life insurers also learned that individuals are not equally likely to suffer from a disabling illness or accident. As they learn more about the variables that increase the likelihood of disability, they develop premium rate books which ensure that each policyholder pays an actuarially sound premium based on the probability that he will become disabled. Moreover, simple business competition ensures that disability premiums tend toward their rational or natural level. If an insurer charges premiums that are too high, it makes large profits and attracts new entrants that in turn create downward pressure on premiums. If an insurer charges premiums that are too low, it suffers losses until it raises premiums or exits. Regulations and artificial barriers to entry limit the efficiency of the market to some extent, but all in all, market forces prevail and disability premiums are as rational and fair as the government allows.

In addition, life insurers have incentives to

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pay legitimate claims in a timely manner, to deny spurious claims, and to monitor disability beneficiaries closely. Any insurer that fails to pay legitimate claims, or that delays payment, will see its reputation suffer. Likewise, any insurer that pays fraudulent claims incites further instances of moral hazard and soon becomes unprofitable. Similarly, the profitability of insurers that do not regularly check to ensure that beneficiaries remain disabled also suffers. Insurers therefore give their claims representatives incentives to treat policyholders fairly, which means catching fakers but not begrudging the truly disabled their contractual due.

Equitable Market

Indeed, the private system of disability is, like all free markets, equitable. Individuals can choose to go uninsured if they desire; healthy individuals who desire coverage may obtain it at a rational and competitive market price. Claimants are treated fairly; if a disagreement arises, both parties have access to objective courts of law, arbitration proceedings, or private negotiation. In borderline cases, for example, parties are free to settle the claim with a lump sum payment or a reduced level of periodic payments.

Private disability insurance became an even better bargain in the 1950s because of the rapid proliferation of “group insurance,” a fringe benefit many employers offered to employees. For a variety of reasons, group insurance greatly reduced insurers’ administrative costs, allowing them to offer the same coverage for lower premiums. The same incentives to offer low-cost policies and excellent claims services held as strongly for group insurance as for individual disability insurance.

Private disability insurance, then, be it of the individual or group variety, is economically efficient. Wealth is redistributed from healthy policyholders to disabled ones, but only by the terms of inviolable contracts properly priced. Consumers are free to choose the companies with which they wish to attempt to contract. Albeit subject to certain regulations, companies are free to

accept or reject applicants as their underwriters see fit. Accepted applicants exchange cash premiums for “peace of mind,” the knowledge that should they become disabled they and their families will not be left destitute.

The Social Security Administration’s (SSA) disability benefit is supposed to create that same “peace of mind.” The mechanism through which it functions, however, is much different from that of private disability insurance. Those differences render the Social Security disability-benefit system both unfair and inefficient.

The system began in 1950 as a joint federal and state grant program called Aid to the Permanently and Totally Disabled. Coverage was expanded in 1956 to include cash payments to disabled workers age 50 to 64. As is typical of government entitlement programs, coverage ballooned with each passing decade. By 1960, over half a million Americans were receiving monthly disability payments.¹ Age restrictions were dropped; in the 1970s supplemental disability coverage (Supplemental Security Income or SSI) was extended to all Americans regardless of work history. (SSI, in other words, is essentially a welfare benefit, so it will not be explicitly examined here except inasmuch as it shares certain administrative characteristics with the disability “insurance” program for workers.)

Social Security disability (SSDI) payments are a function of each claimant’s individual work history, specifically the average of taxed Social Security earnings. At first blush, the system seems fair; those who paid more in taxes should receive more in benefits. However, the distribution of earnings over time is neglected, so it is quite possible for an individual with a declining income, a common phenomenon in today’s fast-changing economy, to receive a disability check that far exceeds his current wage.

For instance, a 35-year-old who began work in 1988 earning \$20,000 a year, and who received a \$2,000 raise each year, would have earned \$46,000 in 2001. According to the SSA’s online calculator, if he became disabled he would receive a bene-

fit of \$1,480.30 per month regardless of how much he made in 2002 or was likely to earn in the future. According to that same calculator, an individual who earned \$100,000 each year between 1988 and 2000, inclusive, would, if disabled, receive \$1,925.80 per month, even if he earned nothing in 2001 or 2002. As private insurers long since discovered, such incentives will cause claim levels to rise, especially during recessions, be they national or merely sectoral in scope.

Process Tightened

To buffer upward trends in claims, the SSA tightens its claim process. Initial claims screening is conducted not by the administration itself but by state agencies called “disability determination services.” The SSA at first instructed the disability determination services “to adjudicate claims with the presumption that a claimant was eligible when the preponderance of the evidence so indicated.” In the face of the recession that gripped the nation in the late 1970s and early 1980s, however, it raised the bar, insisting that the claimant establish eligibility “beyond any doubt.” Disability claim allowance rates plummeted between 1977 and 1982, but then trended higher as politicians and courts brought pressure on the SSA to make its claim process less stringent. It relented, but grudgingly. Unbelievably, it allowed claims-acceptance criteria to vary by state and region based on federal court rulings, which held only in the district where propounded. Clearly, the claims process was, and remains, a highly politicized one.

Moreover, the claims process is often a slow one. In 2001, the average processing time for a Social Security Disability claim was 106 days.² Average processing times for private disability policies are far shorter.

Social Security disability decisions may be appealed, but only to the government’s own courts. The first appeal is heard by a regional administrative law judge, the second by the SSA’s own Appeals Council, the third by a federal judge. It is extremely difficult to win on appeal without the aid of an attorney and

even then success is far from assured. The process can take years, and even a decade or more, to play out. The government will pay interest if it loses on appeal, but that does nothing to put food on the table of the disabled’s family.

Worse yet, if you are one of the 90 percent of Americans covered by Social Security, you cannot opt out of the disability coverage. You must pay the tax whether you want to or not. This coercion is necessary because the tax rate, which is a flat rate not adjusted by risk factors, not even major risk factors such as age and gender, is inherently unfair to many taxpayers: it far exceeds the premiums they would have to pay for comparable coverage from a private insurer. The purpose of the system, after all, is to redistribute wealth. The primary redistribution is from those less likely to become disabled (young, male, high-income) to those more likely to do so (old, female, low-income), and the secondary redistribution flows from all citizens to the government bureaucratic machines that collect the taxes and administer the program.

The political economy of the Social Security disability movement is in this regard most telling. After World War II, increased income tax rates and reinvigorated labor unions both pressured employers into providing employees with more fringe benefits, including pensions and group life, health, and disability insurance. Many employers (but notably not life insurers) saw expansion of the Social Security system as a means of reducing their labor costs. With expanded Social Security benefits, employees put less pressure on employers for extensive fringe benefits because the employers appeared to be footing half the Social Security bill. In reality, however, employers’ contributions to Social Security are mere accounting ledgerdemon; employees pay the entire tax, half in the form of a direct payroll deduction and half in the form of reduced wages. Contrast that situation with bargaining for fringe benefits, which employees knew reduced their gross pay but increased their net remuneration because of their differential tax treatment. Moreover, employees realized that

group insurance was cheaper than individual insurance, other things equal.

Perhaps worst of all, SSDI is economically inefficient. Due to its coercive nature, no competitive business pressures are, or indeed can be, exerted on the SSA. Its claim and appeals process can remain slow, expensive, inaccurate, and politically motivated without any fear that it will somehow lose business. No private insurer can cut into its market share. Unfortunately, the converse is untrue. The existence of Social Security disability benefits, no matter how inefficient

and inadequate, reduces consumer demand for private insurance. That “crowding out” reduces the efficiency of private disability insurers by reducing private insurers’ gains from scale and by complicating consumer purchasing decisions. Many of the faults of the market for disability insurance, insignificant as they are compared to the problems with Social Security, stem directly from the government’s awkward and inefficient intrusion into the disability business. □

1. See www.ssa.gov/history/history6.html.
2. Disability FAQ, www.ssa.gov.

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