37. Unemployment Insurance

> ***Congress should*** eliminate federal unemployment insurance.

The Social Security Act of 1935 that created the federal government's retirement insurance system also established a system to pay workers during periods of unemployment. But at any given time as many as half of the workers who lose jobs are barred from collecting benefits from the system into which they have been forced to pay, while a large portion of those who do collect benefits are repeat claimants. Further, the system unfairly helps some businesses and individuals at the expense of others and reduces incentives for the jobless to accept work. Now that Social Security privatization is a serious policy option, it is time for Congress to consider privatizing the other primary income-security program, unemployment insurance.

The Origin of the System

In the early 20th century, proposed state legislation to create unemployment insurance (UI) was regularly defeated. Most state legislators believed that providing such insurance was not a proper function of government and would put their state in a poor competitive position. And in the U.S. Congress many lawmakers understood that the federal government had no constitutional authority to enact UI policy.

Further, at the beginning of the 20th century the private sector was developing ways to provide assistance for the unemployed. For example, in Britain before the adoption of a government UI system in 1911, 30 percent of all union expenditures were for unemployment benefits. Union and employer plans also began to develop in the United States at that time as well. Worker contributions took the form of a percentage of earnings (as high as 10 percent) or a flat daily, weekly, or monthly amount. In 1933, the last year for which statistics are available, union plans paid

a total of $3.7 million in benefits. Between 1917 and 1933, 38 firms, including General Electric, Eastman Kodak, and Procter and Gamble, established unemployment benefit programs.

Michael Rappaport of the University of San Diego Law School found that, beginning as early as 1910, two Michigan insurers profitably sold UI, but state law limited the market to railroad conductors. Metropolitan Life first tried to sell UI almost 20 years before the Social Security Act, but the laws of New York State prohibited its sale.

The unprecedented depth and duration of the Great Depression, which left more than 30 percent of workers without jobs, spawned many programs intended to alleviate economic miseries. The Social Security Act of 1935 included a provision for a federal-state UI program, built around a federal payroll tax. The tax would be largely rebated in states that established UI programs conforming to federal guidelines. The constitutionality of that scheme was promptly challenged, but the Supreme Court narrowly upheld it in 1936 in *Steward Machine Co. v. Davis*.

The System Today

Under the current system the federal government levies a 6.2 percent unemployment insurance tax on the first $7,000 of each worker's earnings. If a state has established an unemployment system that meets federal standards, as all have, the federal government credits back 5.4 percent to employers, keeping 0.8 percent to cover the costs of administering the program, federal extended unemployment benefits, and support for state programs that become insolvent.

In fiscal 1997 net federal collections amounted to $6.1 billion, but only about $3.48 billion was sent back to the states, with some states receiving as little as 36 percent of what was collected from employers in those states. The cost to employers of filing federal unemployment tax forms is estimated at $290 million per year, and it costs the Internal Revenue Service $70 million to process the forms.

State taxes cover the actual benefit payments. The states are given considerable control over the details of their systems. In three states the UI tax rate on employers is as high as 10 percent. States can establish higher taxable wage bases than the $7,000 on which the federal tax is calculated. Many have done so. Hawaii's taxable wage base is $25,800.

Criteria for benefit eligibility and for benefit amounts also vary significantly, although most states replace roughly 50 percent of the worker's pretax income, up to a ceiling amount, for 26 weeks.

In 1996 the states collected $21.6 billion in UI taxes and added $2.6 billion in interest to their UI trust funds. They paid out $20.6 billion in benefits for a net surplus. Since unemployment rates are low, the total UI account reserves for the states in 1996 were $38.6 billion.

In 1997, 6.7 million Americans, of a workforce of 129.6 million, on average, were unemployed in any given week. Of those workers, 2.3 million were receiving UI benefits and collected an average of $192.73. The average duration of unemployment was 15.8 weeks, but the median duration was only 8 weeks.

Justifications for Government UI

The Savings Issue

One argument used to justify mandatory government UI is that voluntary measures will not suffice. The time-honored means of protecting oneself against financial hazards is savings. In 1950 the national savings rate was 12.3 percent, but by 1994 it had fallen to 3.5 percent. One reason for that decline is that government programs, including UI, give individuals a false sense of security. Another is that the rise in taxes and the share of gross domestic product consumed by government since the 1950s make it more difficult for individuals to save. Also, more individuals today have a larger portion of their wealth in assets such as houses, stocks, or other nontraditional forms of savings.

In any case, it does not follow that a governmental UI program is the only way to help the jobless. The facts that the private sector was providing unemployment assistance before the governmental programs were in place and that saving is easier now than it has ever been suggest that a return to private approaches would suffice to cushion against unemployment at least as well as the current program does.

Maintaining a Steady Workforce

A government UI system is also said to help maintain a trained workforce for businesses that have had to lay workers off. In some cases that is undoubtedly true. Resort owners in northern regions, for example, can lay off employees during the off-season, and the workers will qualify for unemployment benefits until the beginning of the next tourist season. The question, however, is, Why should not those employers bear the full cost of meeting that objective?

If maintaining a group of people who are ready to work after shutdowns is important to a business, it can take preemptive steps to deter laid-off employees from leaving the area or taking other full-time jobs. In the auto industry, laid-off workers receive 95 percent of their base pay, an arrangement that both gives the workers income stability and reduces the search and training costs of the automakers after a down period.

Another means of keeping a workforce intact during economic slowdowns is flexible wages. In Japan, for example, workers often receive a large portion of their compensation in the form of bonuses, of as much as one-third of income, based on their company's economic performance. Thus, during bad economic times for a company, the workforce can remain in place and workers can keep their base salaries, but their wages are in effect cut when bonuses are reduced or eliminated.

Reemployment Assistance

Another claimed benefit of the current UI system is that it assists people who are out of work to find new jobs quickly, since idle workers do not contribute to the economy. Eligibility for benefits is usually contingent upon registering with the state's job-search agency. Failure to accept ''reasonable'' employment proffered through such an agency can result in termination of benefits.

But in the absence of any governmental UI program, there would be, and indeed are, private employment agencies quite able to help the unemployed to find work. Those agencies are subject to the test of the marketplace and consequently have stronger incentives to maximize value and minimize costs. In contrast, the government system produces unavoidable and undesirable side effects.

The arguments in favor of government UI programs are not strong. However, there are a number of compelling arguments against them.

Cross-Subsidization

One of the most serious objections to the current UI system is that it requires some employers and employees to subsidize others. Every state attempts to make the taxes that a business pays correspond roughly to the extent to which the business imposes costs on the system—that is, lays off workers who subsequently draw benefits. Under this practice, known as ''experience rating,'' employers that have laid off more workers who collect benefits pay higher rates than employers who have laid off fewer

workers, or none. Experience rating is usually touted as showing that the UI system is fundamentally fair.

Yet employers with few or no lay-offs pay significantly more in taxes than the costs they impose on the system, and many employers with a large number of lay-offs impose significantly greater costs on the system than they pay in taxes. Thus, the UI system compels employers with stable workforces to subsidize employers with less stable ones.

Construction is an industry where employment tends to be unstable. In their work on unemployment insurance in New England, Robert Tannenwald of the Federal Reserve Bank of Boston and Christopher O'Leary of the W.E. Upjohn Institute found that construction was ''the most heavily subsidized'' sector of the Massachusetts economy. During the 1988–96 period, ''construction firms drew a net subsidy of over twenty five dollars per one thousand dollars of payroll, while employers as a whole were making a net contribution of $1.40 per one thousand dollars.'' On the other hand, they note that ''the largest subsidizers of other industries have been eating and drinking places, food stores, health services, and the apparel trade.''

The UI subsidy tends to artificially stimulate the recipients and depress the payers. Businesses in the ''positive balance'' category are underwriting some of the costs of the employment decisions of ''negative balance'' employers. That distorts the economy by making the latter businesses more profitable than they would be otherwise.

Lower and Distorted Wages

There is, moreover, an individual redistribution problem that cannot be ignored. While the payroll taxes that finance the UI system are levied directly on employers, in the end they fall largely or entirely on the workers themselves.

That has been understood for a long time. In his 1977 book *Jobless Pay and the Economy*, economist Daniel Hamermesh wrote, ''It is unlikely that employers will bear the tax burden in the long run. Eventually it will be shifted either backward onto workers or forward onto customers.'' Economist John A. Brittain argues in *The Payroll Tax for Social Security* that the Social Security payroll tax is borne entirely by workers. He writes, ''The presence of a payroll tax on employers tends to reduce the wage rate in dollars by roughly the amount of the tax. . . . It should be clearly recognized . . . that the entire payroll tax is just as clearly a component

of the cost of hiring labor as private fringe benefits or the nominal wage itself.''

UI taxes form part of the cost of providing the total compensation package to workers. If government mandates an increase in taxes, employers will make marginal adjustments at the earliest opportunity in other parts of the package. That implies that, under the UI system, not only do stable employers subsidize less stable ones, but people who work for less stable employers keep their wages higher than they otherwise would be at the expense of people who work for stable employers. Further, employees of many less stable employers, for example, construction workers, make higher salaries than many employees of more stable employers, for example, those in retailing and food service.

Workers Not Covered

Another serious problem with the current UI system is that at any given time as many as half of the workers whose employers must pay into the system do not actually collect benefits when they are unemployed. Federal data show that in 1991, during the last recession, only 42 percent of the unemployed received any UI benefits in an average month. All workers bear the costs, but only some benefit.

All UI systems have eligibility requirements. A common reason for ineligibility is failure to have earned enough money. In all states eligibility is contingent upon having earned a certain minimum amount in covered employment. To be eligible in Michigan, for example, a worker must have earned at least 20 times the state minimum wage ($5.15 per hour) in 20 of the previous 52 weeks. The rationale for that and similar requirements in other states is that UI benefits should go only to those workers with a significant attachment to the labor force.

Many part-time, often low-wage workers fail to meet that criterion. The employer still must pay the UI tax on their earnings, which reduces those workers' wages correspondingly, but if the employee is laid off, he or she is not eligible for benefits.

Workers are also ineligible if they were discharged ''for cause.'' That criterion is meant to prevent those that want to collect benefits rather than work from provoking their own firing. Some might do that, but most terminations are over job flare-ups or unsatisfactory performance. Whatever the reason for their discharge, such workers still need income and have contributed to the UI system through the employer's payroll taxes. Nevertheless, they cannot collect.

Encouraging Unemployment

UI benefits are designed to reduce the hardship of being unemployed. But the current system reduces the incentive for the unemployed to seek work. In most states, UI benefits replace approximately half of the worker's former pretax income for 26 weeks. For some unemployed people, the difference between UI benefits and returning to work at or close to the former rate of pay is a strong incentive to find new employment. For others, however, the differential is not sufficient to prompt a serious job search. Economist Lawrence F. Katz, in a 1988 National Bureau of Economic Research Working Paper, wrote,

> We find big differences in the distribution of [out-of-work] spell durations for UI recipients and nonrecipients. Sharp increases in both the recall and new job finding rates are apparent at durations when benefits are likely to lapse for UI recipients.

Further, UI increases the incentive for some employers to choose to lay workers off in the first place. For employers who are at the maximum UI tax rate, layoffs often make better sense than other cost adjustments that might be made in the face of falling demand. Professor Robert H. Topel of the University of Chicago explains, in a 1984 *Journal of Law and Economics* article, that ''the dollar value of benefits received by unemployed individuals typically exceeds their incremental cost to employers. That inequality of benefits and their cost implies that the UI system provides a net subsidy to the occurrence of unemployment.''

Reducing the Incentive to Save

UI insurance also reduces the incentive for individuals to save as a precaution against the possibility of unemployment. Economists Eric Engen and Jonathan Gruber, in a 1995 National Bureau of Economic Research Working Paper, stress that ''precautionary saving is a significant, and perhaps the most important, determinant of individual wealth accumulation.'' However, ''government provision of insurance for idiosyncratic unemployment risk . . . can cause a considerable decline in savings; for the median household, raising the UI benefit replacement rate by 10 percentage points lowers median wealth/income ratios by about 7 percent.'' That finding is not surprising. People usually prefer immediate spending to deferred spending; when the state reduces or eliminates one of the motives for saving, many people save less.

Slowing Economic Growth

Saving is the key element in economic growth. The UI system depresses private saving, accumulating funds, not in private accounts that expand the country's pool of capital, but in government trust funds invested in federal debt securities. As a result of years of low unemployment, the trust funds bulge with money, a total of $38.6 billion in 1996. California had $2.9 billion, New Jersey and Pennsylvania had $2 billion each, Florida had $1.9 billion, and Michigan had $1.8 billion. And the federal UI trust funds equal about $15 billion. But those funds represent no real wealth. Like the Social Security trust funds, they are merely accumulations of IOUs. Unlike private saving that flows into the capital markets, the UI trust funds cannot fuel economic development.

In short, the UI system that the nation adopted during the Depression accomplishes little if anything that cannot be accomplished through voluntary action, but it causes several detrimental side effects. It is time to consider alternatives.

Eliminate Federal Unemployment Insurance

Government intervention has locked the country into the current, suboptimal system of unemployment compensation. Because of the high cost to employers of not complying with federal UI guidelines, states are effectively barred from making anything but marginal changes in policy. Further, though the states collect most of the funds for the system and pay out the actual benefits, the federal tax to oversee the program adds billions of dollars in overhead. There is no need for a federal role in UI. The federal system with its federalism-destroying regulations and mandates should be eliminated.

Suggested Readings

Leef, George C. ''Unemployment Compensation.'' *Regulation*, no. 1 (1998).
Lips, Bradley. ''Temps and the Labor Market.'' *Regulation*, no. 2 (1998).

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