

UNEMPLOYMENT COMPENSATION

THE CASE FOR A FREE MARKET ALTERNATIVE

by George C. Leef

THE SOCIAL SECURITY ACT OF 1935 that created the government's retirement insurance system also established the system that pays workers during periods of unemployment. For decades any officeholder or aspirant considered it political suicide to even hint at privatizing Social Security. That issue is no longer the third rail of politics; privatization is now considered a viable option. Perhaps it is time to discuss the merits of privatizing the other primary income-security program: unemployment compensation.

Government unemployment insurance unfairly transfers funds to help some businesses and individuals at the expense of others, reduces incentives for the jobless to accept work, and imposes a drag on the economy. A market-based system would avoid those costs while permitting workers to devise for themselves the kind of income-security plan that is best for their particular circumstances.

THE ORIGIN OF THE SYSTEM

By the late-nineteenth and early twentieth centuries, the major European nations had enacted unemployment insurance (UI) programs. The United States had not, but it was not for lack of advocates. University of Wisconsin economist John R. Commons, for instance, had championed the cause based on the mistaken notion that the goal of entrepreneurs is to employ workers. He wrote in 1922 that, "neither the wage earner nor the state can prevent unemployment. All they can do is to partly relieve it. . . . But the business-like way of doing it is to place the responsibility on the businessman who alone is in a position to prevent it."

Bills to create state unemployment compensation programs were introduced and defeated with regularity. Many state legislators opposed UI legislation on the grounds that it was not a proper function of government and that it would put their state in a poor competitive position if theirs was the first state to enact such a program. Nor was a UI system enacted at the federal level, mainly because it was thought that Washington had no constitutional authority to enact one. Therefore, federalism and a reluctance to engage in economic experimentation prevented government involvement in income-maintenance for the unemployed.

The Great Depression, with unemployment reaching the unprecedented level of 25 percent, spawned numerous programs intended to cure or at least ameliorate our economic misery. The Social Security Act of 1935 included a provision for a federal-state UI program built around a federal payroll tax that 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 its 1936 *Steward Machine Co. v. Davis* decision.

Under the system today, the federal government levies a 6.2 percent unemployment insurance tax on the first seven thousand dollars 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 only .8 percent, in part to pay the administrative costs of the states' programs, to pay for federal extended unemployment benefits, and to provide funds for state programs that are 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 the state. The cost to employers of having to file federal unemployment tax forms is estimated at \$290 million per year, and it costs the IRS an additional \$70 million to process the forms.

State government taxes cover the actual benefit payments. The states are given considerable latitude over the details of their systems. Minimum and maximum tax rates vary considerably. In some states, employers can have a zero tax rate, while in three states, the maximum rate is 10 percent. The states can also establish higher taxable wage bases than the seven thousand dollars on which the federal tax is calculated. Many have done so. Hawaii's taxable wage base is the highest, at \$25,800. Benefit amounts are also nonuniform, although most states replace roughly 50 percent of the worker's pretax income up to a ceiling amount, for twenty-six 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. Not unexpectedly, since unemployment rates have been low, for several years

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United States Unemployment Programs 1996 (in millions)

State	Contributions collected	Benefits Paid	Reserves as of 12/31/95
United States	\$21,578	\$20,635	\$38,632
Alabama	127	206	483
Alaska	96	113	194
Arizona	211	159	627
Arkansas	160	174	203
California	3,408	2,806	2,877
Colorado	176	174	203
Connecticut	566	418	278
Delaware	68	96	258
District of Columbia	111	86	99
Florida	642	639	1,948
Georgia	360	284	1,634
Hawaii	154	173	211
Idaho	100	76	266
Illinois	1,126	1,221	1,639
Indiana	217	233	1,273
Iowa	127	178	719
Kansas	34	114	651
Kentucky	226	221	501
Louisiana	176	143	1,131
Maine	115	103	112
Maryland	384	339	691
Massachusetts	1,060	720	915
Michigan	1,181	947	1,831
Minnesota	362	339	513
Mississippi	93	128	553
Missouri	355	287	308
Montana	54	59	126
Nebraska	44	51	195
Nevada	173	144	348
New Hampshire	38	39	268
New Jersey	1,365	1,357	2,029
New Mexico	82	74	386
New York	2,012	1,824	470
North Carolina	96	381	1,336
North Dakota	21	32	50
Ohio	807	700	1,751
Oklahoma	101	98	564
Oregon	245	367	941
Pennsylvania	1,490	1,502	2,031
Puerto	153	215	596
Rhode Island	173	183	116
South Carolina	196	192	603
South Dakota	10	16	50
Tennessee	261	312	827
Texas	931	920	642
Utah	89	68	524
Vermont	45	48	218
Virgin Islands	9	7	42
Virginia	247	195	897
Washington	615	795	1,333
West Virginia	123	141	157
Wisconsin	414	470	1,557
Wyoming	25	30	147

the total UI account reserves have been growing and in 1996 stood at \$38.6 billion.

The magnitude of the UI program can be seen from the following figures: in 1997, on average 6.7 million Americans were out of work in a workforce of 129.6 million. Of those, in any given week 2.3 million were receiving UI benefits and collected an average of \$192.73 per week. The average duration of unemployment was 15.8 weeks; the median duration was only eight weeks.

JUSTIFICATIONS FOR GOVERNMENT UI PROGRAMS

There are three principal arguments used to justify a mandatory government program of unemployment insurance. First, that voluntary measures will not suffice. Second, that government UI programs help to stabilize the economy and maintain a ready work force for employers. Third, that they help the unemployed find new employment. Let us examine each rationale.

There are two time-honored means of protecting oneself against financial hazards—saving and insurance. For millennia, people saved when times were good to tide them through the expected bad times. Americans used to save much more than they do currently. In 1950, the national savings rate was 12.3 percent, but by 1994 it had fallen to 3.5 percent. One of the reasons for that decline is the fact that government programs, including unemployment insurance, have done much to make people feel secure. Dr. James W. Christian, senior economist at the U.S. League of Saving Institutions wrote in 1990 that, “Uncertainty about the future is also a powerful saving motive. . . . To the extent that individuals feel that corporate or governmental provisions have been made for the unforeseen contingencies that might strike them, their motivation to save from current income to meet those contingencies from their own resources is reduced.”

Owing to the country’s low saving rate, it is widely assumed that many workers today cannot provide their own safety nets. Saul Blaustein, one of the foremost proponents of a governmental UI system, wrote in 1993 in *Unemployment Insurance in the United States*, “It is generally recognized that some unemployment is unavoidable in a dynamic and free industrial society and that most workers do not have adequate resources to tide themselves over temporary spells of unemployment without some hardship.” Personal savings would not keep many families going for long today.

But from the fact that many Americans now choose not to save enough to cover a possible protracted period of unemployment, it does not follow that a governmental UI program is the only answer. Alternatively, the federal government could establish a UI system designed to encourage individual saving to provide income during times of unemployment. A proposal for Individual Unemployment Accounts will be discussed later in this article.

Saving need not be done only by individuals. It can be done through unions, employers, or other institutions. In Britain, prior to the adoption of a government UI system in 1911, nearly all unions had established some kind of unemployment compensa-



tion plan for members who lost their jobs. In 1910, 30 percent of all union expenditures went towards the payment of unemployment benefits. Workers saved through their unions.

Union and employer plans had also begun to develop in the United States in the early twentieth century. Blaustein writes that, “During times of depression in the late eighteen hundreds and the early part of the nineteen hundreds, practically all trade unions gave assistance to their unemployed members and many unemployment benefit or relief plans sprang up, only to be discontinued when employment conditions improved.” 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.

Employer plans began in 1917 and between then and 1933, thirty-eight firms had established unemployment benefit programs. One such plan, that of J.I. Case, called for an employee contribution of 5 percent of earnings that was matched by the company until one year’s earnings had been accumulated. General Electric, Eastman Kodak, and Procter and Gamble were other large firms that established unemployment benefit plans, all differing in their details.

INSURANCE

Insurance is the other means of providing a financial safety net against the interruption of income. Would it be possible to have unemployment insurance on the free market? Some have argued that it would not. Robert Tannenwald of the Federal Reserve Bank of Boston and Christopher O’Leary of the W.E. Upjohn Institute contend in a May/June 1997 *New England Economic*

Review article that, “If unemployment insurance were voluntary, [low risk] workers would break away and form their own low-risk pool. As a result, workers with a severe risk of unemployment would face prohibitively high premiums.”

It is undoubtedly true that low-risk members tend to break out of risk pools in which they are grouped with high-risk members. It happens in health insurance and automobile insurance. It does lead to escalating premiums for the remaining members; but a high premium is not necessarily prohibitive. When faced with a high insurance premium, some people pay it and others do not, depending on their evaluation of the worth of being insured. It might prove to be true that workers in industries where layoffs are especially likely would be uninsurable, just as people who already have fatal diseases are not insurable. But that some part of a risk pool might prove to be uninsurable does not lead to the conclusion that there can be no free market for insurance of that kind at all.

Of course, it might be that without government unemployment insurance, wages in jobs with higher turnover would reflect that turnover rate. That is the theory of compensating differentials. If an employer wants to attract and keep people in jobs with undesirable characteristics—physical risk or financial risk—they will have to compensate them.

Contrary to the theory that unemployment insurance could not be provided if government did not do it, Professor Michael Rappaport found that, beginning as early as 1910, two Michigan insurers profitably sold unemployment insurance, but state law limited the market to railroad conductors. Furthermore, selling unemployment insurance was of interest to some large firms, most notably Metropolitan Life. Then president of Metropolitan Life, Haley Fiske, was adamant that the insurance could and should be sold. Rappaport writes in a 1992 *Wisconsin Law Review* article that, “Fiske first tried to sell UI almost twenty years before the Social Security Act, but the laws of New York State prohibited its sale.”

Fiske sought legislation to permit Metropolitan Life to sell UI, but it was blocked in the New York Senate in 1919 when the Superintendent of Insurance argued against it on the grounds that it was untried and would endanger policyholders’ money. In 1924, the bill passed the state Senate, but was blocked in the Assembly, thanks in part to opposition from labor leader Samuel Gompers, who feared that unemployment insurance would strengthen company unions. In 1931, the bill passed both chambers only to be vetoed by Governor Franklin D. Roosevelt, who was planning a conference to study government UI and worried that a successful private venture in UI might preempt government action.

New York was not unique in prohibiting insurers from trying to market UI. According to Rappaport, in the twenty-five years prior to the passage of the Social Security Act, no state clearly authorized the sale of UI policies in general. He concludes that a free market in UI would develop in the absence of government intervention.

A system relying on personal institutional saving, backed up with market unemployment insurance would provide a sub-

stantial “safety net” for most individuals. While such a system cannot guarantee that no unemployed person ever runs out of money, neither does the current system. Many workers exhaust their benefits and have to turn to family or charitable resources until they are able to find new employment. A utopian system in which no one suffers any less because of unemployment is not possible and the adequacy of a voluntary system should not be measured against that impossible standard.

ECONOMIC STABILIZATION

A commonly-claimed benefit of having government UI programs is that they help to stabilize the economy. The theory is that when the economy has fallen into a recession, it needs increased consumer spending, which is immediately provided by a surge in UI benefits to the unemployed. On the other hand, when the economy is strong, UI taxes exceed benefit payments, thus helping to restrain the development of an inflationary boom.

That “automatic stabilizer” theory is based on the Keynesian notion that economic peaks and valleys are due to excesses or deficiencies in aggregate demand. If that were true, then it would follow that a policy that withdraws demand in good times and injects it in bad times helps to stabilize the economy.

However, persuasive nonKeynesian explanations for macroeconomic fluctuations exist. The Austrian explanation, for example, identifies inflation due to expansion of the money supply as the principal cause of economic cycles. The problem during a recession is not that there is insufficient demand, but that certain industries that expanded under the artificial stimulus of inflation are in a necessary process of contraction. From that perspective, UI does not stabilize the economy but, by increasing the incomes of unemployed workers, slows the economy’s adjustment process by reducing the incentive for workers to seek employment in different fields. A thorough discussion of macroeconomic theory and policy implications is beyond the scope of this article, but there are strong reasons to doubt that the “countercyclical” benefits claimed for government UI programs exist.

Even if the Keynesian macroeconomic theory were true, however, government UI programs are not necessarily unique in providing economic “stimulus” when unemployment is abnormally high. If income security were sought through individual saving, voluntary collective action, or insurance, the result would be that withdrawals, claims, and benefit would rise and fall with the level of unemployment, just as is the case under the status quo. Therefore, if there is any benefit in the cyclical nature of UI policy, much the same benefit would result from voluntary, free market arrangements, but without the drawbacks of current policy.

Finally, the surplus UI funds are “invested” in government debt, covering other federal spending and masking the real size of the federal deficit. If such funds were in private accounts, they would be invested in the private capital market, thereby contributing to stronger job creation and lower unemployment.

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. As Blaustein writes, “The compensation tends to preserve the workforce intact, with its particular skills, training, and experience, until it can be recalled. Laid off workers are not forced to scatter in search of jobs, at least during short layoffs.”

In some cases that is undoubtedly true. Resort owners in northern Michigan, for example, can lay off their employees during the off-season and the workers will qualify for unemployment benefits until the beginning of the next tourist season. That minimizes employers’ search and training costs compared to the alternative of a system under which employers (and employees) internalize the cost of job and workforce security. The question, however, is why those employers should not have to bear the full cost of meeting that objective themselves.

If maintaining a ready-to-go workforce after shutdown periods is important to a business, it can take preemptive steps to deter laid off employees from leaving the area or taking another full-time job. 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 auto makers following a down period. That negotiated deal gives each side benefits without imposing any cost on other parties. The UI system, in contrast, allows employers with high labor turnover to externalize some of the cost of maintaining their workforce.

Another means of keeping a workforce intact during economic slowdowns is with flexible wages. In Japan, for example, workers often receive a large portion of their compensation in the form of bonuses—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 have their wages in effect cut when bonuses are reduced or eliminated. Under such an arrangement, the full cost of keeping the workforce in place is borne by the company and its workers. The stable workforce objective is achieved by voluntary action to the extent that employers and workers are willing to bear the costs.

REEMPLOYMENT ASSISTANCE

Another claimed benefit of the current UI system is that it assists those out of work to find new jobs. Eligibility for benefits is usually contingent upon registering with the state’s job-search agency and failure to accept “reasonable” employment proffered through such an agency can result in termination of benefits. It supposedly benefits workers, and the economy in general, by getting the unemployed back into the workforce as soon as possible.

That argument suffers from the same weakness as the previous ones: voluntary action can provide the same benefit at least as well. Helping people find new or better employment is a valuable service rendered by private employment agencies. Because private employment agencies are subject to the test of the marketplace, they have stronger incentives to maximize value and minimize costs than do government agencies charged with the same task.



Government UI systems provide benefits and services some people desire. Precisely because those benefits and services are desired, they would be provided through voluntary action on the free market. As will be seen in the next section, however, governmental action unavoidably leads to some unwanted and undesirable side effects.

CROSS-SUBSIDIZATION

The UI system is financed through state and federal payroll taxes on employers. Every state makes some attempt to have its tax burden correspond to the extent to which the employer “uses” the UI system. The tax burden falls on employers roughly to the extent that they lay off workers who then collect benefits. That is known as “experience rating” in UI parlance. Experience rating is usually touted as showing that the UI system is fundamentally fair.

But taxes virtually never duplicate voluntarily-borne costs in the market and certainly do not when it comes to the costs of unemployment. Despite experience rating, “positive-balance” employers pay more, sometimes significantly more, in taxes than the costs they impose on the system. Many employers go for years without laying off employees and “using” the system at all. And some “negative-balance” employers impose costs sometimes significantly greater costs, on the system than they pay in taxes. Thus, the UI system compels employers whose business operations tend toward stable employment conditions to subsidize those employers whose business operations tend toward unstable employment conditions. In the *Harvard Business Review* (March-April, 1975) Professor Martin Feldstein of Harvard explains the problem this way:

Because unemployment compensation provides a subsidy to people in . . . unstable work situations, it reduces the wage differential required to attract them to seasonal, cyclical, and temporary jobs. Also, because employers pay a relatively small premium for their unstable employment, there is little incentive to reduce this instability. Thus, the prices of the good so produced do not reflect the higher social costs of production of those goods, for the production of such goods creates the most unemployment.

Construction is an example of an industry where employment tends to be unstable. In northern states, much construction work is seasonal and the construction industry itself is highly susceptible to economic peaks and valleys. In their work on unemployment insurance in New England,

Tannenwald and O’Leary found that construction was “the most heavily subsidized” sector of the Massachusetts economy. During the 1988-1996 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.” Some manufacturing sectors also were significant beneficiaries, such as petroleum and transportation equipment. On the other hand, they note, “The largest subsidizers of other industries have been eating and drinking places, food stores, health services, and apparel trade.”

As is the case with any government subsidy, whether intended or not, 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 otherwise be.

There is, moreover, an individual redistributive problem that cannot be ignored. While the payroll taxes to finance the UI system are levied on employers, it is well understood that the incidence of payroll taxes falls largely or entirely upon the workers themselves. Business taxes must ultimately be borne by people. There is debate over the exact incidence of the UI payroll tax, but widespread agreement among economists that it falls on workers to a large extent.

In his book *Jobless Pay and the Economy*, economist Daniel Hamermesh writes, “Since in the United States the extent of monopoly profits as a fraction of all profits is not . . . large, 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.” Hamermesh assumes that the burden of the tax is evenly divided between workers and consumers in the absence of more precise knowledge about the adjustments that businesses make in the face of the UI tax.

Other analysts conclude that the tax falls entirely on employees. 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, “[T]he 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.” His analysis applies equally to the UI payroll tax.

Payroll 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

leads to the conclusion that the UI system is a means of transferring income from workers who have stable employment to other workers, whose employment is unstable.

Making some employment artificially more attractive than it otherwise would be raises not only efficiency concerns, but also moral concerns. Is it right to compel Worker A to subsidize Worker B, especially when UI beneficiaries are often among the highest paid workers? Reflecting back on the Massachusetts study discussed earlier, construction workers, the greatest beneficiaries, are among the best paid workers, whereas many of the lowest paid workers are found in retailing and food service, industries that are net losers under the system.

The UI system also entails redistribution from workers who become unemployed, but, for whatever reason, are ineligible for benefits, to unemployed workers who are eligible to collect. A common reason for ineligibility is failure to have earned enough money to qualify. In all states, benefit 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 twenty times the state minimum wage (\$5.15 per hour) in twenty of the previous fifty-two weeks. The rationale for that requirement and similar requirements in other states is that UI benefits should only go to those workers with a significant attachment to the labor force.

Many part-time workers fail to meet the criterion. The employer, however, still has to pay the UI tax on their earnings, which are correspondingly reduced. If laid off, those workers are not eligible for benefits. Very low-earning workers are required to pay for a system that does not benefit them.

Workers are also ineligible if they were discharged “for cause.” The theory behind that provision is that it would be easy for someone who wanted to collect benefits rather than work to provoke his own firing. Some might do that, but most terminations are over job flare-ups or unsatisfactory performance. Whatever the reason for discharge, fired workers still need income and have “contributed” to the UI system through the employer’s payroll taxes. Nevertheless, they cannot collect.

Federal data show that in 1991, during the last recession, only 42 percent of the unemployed received any UI benefits in an average month. The UI system’s “safety net” is one that

THE SYSTEM ESTABLISHED TO HELP PEOPLE DEAL WITH PERIODS OF UNEMPLOYMENT ACTUALLY ENCOURAGES MORE UNEMPLOYMENT.

imposes costs on all workers, but benefits only some. Public choice theory easily explains this redistribution—the costs are small and widely diffused while the benefits are significant for well-organized interest groups. What is difficult to see is any moral or economic justification for it.

ENCOURAGING UNEMPLOYMENT

Unemployment insurance benefits are designed to reduce the hardship of being unemployed. To the extent that they do so, however, they also reduce the incentive for the unemployed to seek work. In most states, UI benefits replace approximately half of the worker's former pretax income. For some unemployed, the difference between UI benefits and returning to work at or close to the former rate of pay acts as a strong incentive to find new employment. For others, however, the differential is not sufficient to prompt serious job search. Economist Lawrence F. Katz in a 1988 National Bureau of Economic Research Working Paper, wrote,

**THE UI SYSTEM TRANSFERS INCOME FROM WORKERS
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We find big differences in the distribution of 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. The absence of such increases in the escape rate from unemployment for nonrecipients provides strong evidence of an impact of the potential duration of UI benefits on firm recall policies and workers' willingness to start new jobs.

The availability of UI benefits, in other words, serves to depress the desire to find a new job, the search for which often begins in earnest only after benefits have been exhausted. Moreover, the UI system increases the incentive for some employers to choose to lay workers off in the first place. For employers who are at the maximum tax rate, layoffs often make better sense than other adjustments that might be made in the face of falling demand. That is true, because as Professor Robert H. Topel of the University of Chicago explains in a 1984 *Journal of Law and Economics* article, "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."

Some unemployment of human resources is inevitable in any but the most tightly regulated economies. Unemployed workers, like owners of other temporarily unutilized or underutilized resources, have strong incentives to search for the optimal reemployment opportunity, and minimize the disuse of productive resources. Unfortunately, the UI system, by subsidizing individual and business decisions to keep human resources unemployed, undercuts the economy's overall productivity.

REDUCING THE INCENTIVE TO SAVE

That is not to say that the UI system will cause those who

anticipate spells of unemployment to stop saving altogether, but only that the extent of saving is likely to be reduced to the extent that people believe that UI benefits will be available to supplement income from savings or other family assets.

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.

Saving is the key element in economic growth, but the UI system depresses private saving, instead of accumulating funds in private accounts that expand the pool of capital, as would be the case under a voluntary UI system, the governmental UI system accumulates money in government trust funds invested in federal debt securities. It thereby diverts resources from market-determined uses to politically-determined uses.

Due to 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. But those funds represent no real wealth. Like the Social Security trust funds, they are merely accumulations of I.O.U.s. Unlike private saving that flows into the capital markets the UI trust funds do not fuel economic development.

The federal government also has bulging UI trust funds. The three funds that pay for state administrative costs, extended UI benefits, and make loans to insolvent state trust funds were holding over \$15 billion, "invested" in federal debt, at the end of fiscal 1996. As long as unemployment stays low, the UI system is a big revenue producer for the federal government, but at the cost of diverting significant amounts of capital away from the private sector.

In short, the UI system that the nation adopted during the Depression seems to accomplish little if anything that could not be accomplished through voluntary action, but has several detrimental side effects. It is time to consider alternatives.

A MARKET APPROACH TO UNEMPLOYMENT COMPENSATION

Government intervention has locked the country into the current, disadvantageous 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. There is no need for national uniformity in that area and therefore all federal UI mandates should be repealed and federal involvement ended.

Having done that, federal tax policy should be changed to eliminate the disincentives for saving. One means of doing that would be to allow individuals to invest earnings in Individual Unemployment Accounts (IUAs) that would be treated in much the same way as Individual Retirement Accounts. Workers would choose whether to establish such accounts and could either manage the funds themselves or turn the management over to others. Contributions, perhaps up to a certain limit, would be tax deductible, and the earnings on the funds would be tax exempt until withdrawn. Professors Stephen Colarelli and Lawrence Brunner of Central Michigan University have advanced an IUA plan in a May 1994 paper, "Solving Problems in Unemployment Insurance," published by the Mackinac Center for Public Policy. And Michael Boskin, Chairman of the Council of Economic Advisors under President Bush, has advocated "IRAs with increased liquidity that permit penalty-free withdrawals for specific purposes." Providing income during unemployment should be one of those specific purposes.

With IUAs, individuals would draw upon their own wealth to finance periods of unemployment rather than collecting checks from the state. Consequently, they would tend to be more diligent in searching for work and would also have a stronger incentive to explore alternatives to layoffs with employers facing difficult times. Furthermore, it would no longer matter why an individual had become unemployed. There would be no administrative hearings over whether a discharge was "for cause" or not, or denial of benefits for insufficient earnings. Nor would unemployed workers have to spend time applying and then waiting, usually several weeks, for the bureaucracy to issue the first check. Individual saving would have salutary behavioral effects and would be far more responsive to the needs of the unemployed.

With the demise of federal mandates and a voluntary savings vehicle in place, the states could—and a bold one eventually would—phase out their UI systems over a period of years, perhaps stipulating that during the phase-out period, UI taxes would have to be deposited into individual accounts. States moving to a market based UI system would also have to repeal any laws that obstruct the sale of private UI policies, since people should have the option of pooling the risk of unemployment.

With those changes in place, individuals would be able to custom tailor the income security plan best suited to their needs and expectations. They would be free to save, insure, or search for the optimal combination of the two. The plan made by a nurse, for example, would almost certainly be different from the plan made by an auto worker. Neither would be compelled to bear costs because of employment choices or errors in judgment made by the other.

Changing to a voluntary, market-based system for income maintenance during unemployment will entail adjustment costs for some workers and industries. Some beneficiaries of the status quo, for example seasonal workers who make no

attempt to find work during periods of joblessness, will oppose change. However, the fact that the change to a more efficient and fair system causes adjustment costs for some is not a reason to remain wedded to the inefficient and inequitable system we have had for sixty years.

The elimination of the government's unemployment "safety net" will leave those individuals who are improvident, neither saving nor obtaining insurance, without any guaranteed source of income. The number of such people will undoubtedly shrink over time, as the imperative of individual responsibility becomes widely recognized. For the people who find themselves unemployed without any safety net (as many do now), the best prospect is a strong economy with many employment opportunities. The freeing of resources currently consumed by the governmental UI system would help to maintain a good job market for people who become unemployed.

Workers can and should internalize the cost of their income security measures. In a market environment, they would adopt the savings plan and/or insurance coverage that appears best, given their own circumstances. Furthermore, competition to provide workers with more attractive options in meeting their financial security needs would activate the market's powerful discovery process, resulting in more income security at lower cost.

The same market process that brings us better and less costly computers can bring us better and less costly income security programs if we allow it to work.

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