THE HAMILTON PROJECT

Advancing Opportunity, Prosperity and Growth

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Reforming Unemployment Insurance for the Twenty-First Century Workforce

THE U.S. ECONOMY AND ITS WORKFORCE have changed dramatically since the Federal-State Unemployment Compensation Program, commonly known as unemployment insurance (UI), was created in 1935. Structural changes in the economy—including a shift from manufacturing to service industries as the principal source of employment, widespread deregulation, and a more open economy have been associated with improved macroeconomic performance, but also have changed the nature of employment and unemployment. Permanent job loss and long-term unemployment are now more common, and contingent and part-time work are increasingly routine. Changes in the nature of employment, among other factors, have contributed to a decline in the *recipiency rate* (the share of unemployed workers who receive UI assistance) from an average of about 50 percent in the 1950s to an average of about 35 percent in the 1990s.

In a new discussion paper released by The Hamilton Project, Lori G. Kletzer of the University of California, Santa Cruz, and the Institute for International Economics, and Howard F. Rosen of the Institute for International Economics and the Trade Adjustment Assistance Coalition propose three broad policies designed to make the UI system more responsive to a twenty-first century economy and labor force. Kletzer and Rosen would strengthen the federal role in UI by setting federal standards regarding program eligibility, benefits, and financing; supplement basic UI with a wage-loss insurance program to assist those who are reemployed at lower wages; and allow self-employed workers, and perhaps others, to contribute to Personal Unemployment Accounts.

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THE CHALLENGE

In the 1950s, the typical recipient of UI was a man who worked at a manufacturing firm and who had enjoyed long-term employment; job displacement generally involved a temporary layoff followed by a return to the same job. Over the past 50 years, the "typical" worker and the U.S. labor market in general have changed substantially.

Since 1960, the percentage of women who participate in the labor force has increased by 20 percentage points, while the percentage of men in the labor force has declined slightly. This demographic shift has been accompanied by changes in the composition of employment: Between 1960 and 2000, manufacturing jobs as a share of total employment fell from 34 percent to 18 percent, while the share of jobs in service industries rose from about 60 percent to just over 70 percent. At the same time, part-time work has become more common.

The nature of unemployment also has changed. After rising during the 1960s through 1980s, the average unemployment rate fell during much of the 1990s and has remained moderate since then. While the rate of unemployment has fallen, the duration of unemployment has increased steadily: The average duration rose from about 12 weeks in the 1960s to just over 16 weeks during the early 2000s, while the median duration more than doubled. These trends—a lower unemployment rate coupled with longer spells of unemployment—reflect a change in the character of joblessness from one of largely temporary layoffs to one in which permanent displacement plays a more prominent role.

Limitations of the Current UI System

Despite these substantial changes in the U.S. labor market, the basic structure of the UI system has remained relatively unchanged since its creation. Kletzer and Rosen argue that the current system no longer meets the needs of a twenty-first century workforce, and point to three areas that raise particular challenges: (1) program variation among states, (2) overly restrictive eligibility criteria, and (3) shortcomings with regard to the level, duration, and financing of benefits.

Program Variation among States

Since its creation, the UI system has been the shared responsibility of the federal and state governments. The federal government administers the overall system and sets broad guidelines for state programs. Subject to these federal guidelines, each state determines the eligibility criteria, level and duration of benefits, and method of financing for its own program. As a result, state UI programs vary significantly.

Kletzer and Rosen argue that the variation in state programs has become a significant drawback of the existing UI system. First, they note that state-level variation leads states to fear that creating programs that are more generous will harm their ability to compete for business; the resulting interstate competition can lead to a "race to the bottom" in program benefits. Kletzer and Rosen also observe that, while state UI programs vary significantly, state labor markets are increasingly similar. Over the past 30 years, as manufacturing employment has become less concentrated in certain regions such as the Northeast and Midwest, state unemployment rates have slowly converged toward the national average. Kletzer and Rosen argue that state unemployment rates are now explained more by national factors than by individual state or regional factors. They argue that state UI programs, therefore, should converge as well, so that the UI system better reflects the nationwide character of the labor market and the economy.

Overly Restrictive Eligibility Criteria

To qualify for UI benefits, applicants currently need to meet three broad criteria established by the federal government and implemented by the states. First, applicants

must meet certain state-specified thresholds regarding earnings and employment history. Second, unemployment must be the result of job separation for "good cause," as determined by state law. Third, applicants must be able and willing to seek and accept suitable employment.

Kletzer and Rosen see three primary problems with current eligibility rules. First, the methods used by states to assess prior employment and earnings too often disqualify workers with intermittent work histories—such as those who lose their jobs shortly after reentering the labor force, including workers who move from welfare to work or women who return to work after child rearing. In addition, using prior earnings (rather than prior hours worked) to determine eligibility means that lower-wage workers and workers who have difficulty maintaining stable employment (often due to a lack of skills) may have a harder time satisfying the earnings criteria for UI eligibility.

Second, Kletzer and Rosen argue that allowing states to determine what constitutes good cause for job separation leads to variation in eligibility criteria that may have little evident economic rationale. Among the reasons for good cause that are allowed by some states but not others are being a victim of sexual or other harassment, relocating to be with a spouse, leaving in anticipation of a plant closing in order to accept another job, and taking a leave of absence to care for a sick family member (in this instance, benefits are provided only if the job is unavailable at the end of the leave of absence).

Finally, no state UI program covers the self-employed. Kletzer and Rosen note that this restriction leaves more than 10 million self-employed workers without protection in case of economic downturn. Kletzer and Rosen observe that these restrictive eligibility criteria, together with structural changes in the economy and other factors, have contributed to the decline in the recipiency rate.

Shortcomings with Regard to Level, Duration, and Financing of Benefits

Kletzer and Rosen argue that the level and duration of UI benefits are inadequate, and that the current tax system used to finance UI is regressive.

The Level of State UI Benefits. One of the initial goals of UI was to replace half of lost wages. In 2004, however, only Hawaii had a replacement rate that met this goal, while over three-fourths of the states had an average replacement rate between one-third and one-half of the recipients' average lost weekly wages. Between 1975 and 2004, the average replacement rate for the United States as a whole was about 35 percent. In 2004, the average weekly UI benefit nationwide was $262, which Kletzer and Rosen note is almost 10 percent less than the weekly equivalent of the poverty rate for a family of three set by the U.S. Census Bureau.

The Duration of UI Benefits. Currently, 51 programs—48 states, the District of Columbia, the Virgin Islands, and Puerto Rico—provide UI benefits for a maximum duration of 26 weeks, and two states provide up to 30 weeks of benefits. During most of the past 30 years, the average duration for receiving UI has been about 15

> "The share of unemployed workers who receive UI assistance has declined from about 50 percent in the 1950s to about 35 percent in the 1990s."

weeks. Kletzer and Rosen note, however, that approximately one-third of UI recipients exhaust their benefits before they find a new job.

Extended Benefit Program. Congress established the Extended Benefit (EB) program in 1970 to provide an additional 13 weeks of assistance during periods of high unemployment. States and the federal government share the cost of extended benefits. Given their role in financing extended benefits, states are allowed to modify, within limits, the automatic trigger that is used to determine when they can be offered in response to high unemployment rates. Kletzer and Rosen argue that inflexible and outdated triggers have undermined the effectiveness of the EB program. As a result, Congress frequently has enacted legislation to extend UI benefits on a case-by-case basis. Kletzer and Rosen note that, since 1980, these ad hoc extensions have provided a greater share of UI benefits than has the permanent EB program. Due to delays in congressional action, Kletzer and Rosen argue, these temporary measures often begin too late after the onset of a recession, or sunset well before employment has recovered. Even with extended unemployment benefits, moreover, the UI system only addresses the short-term cost of unemployment, and does nothing to help workers deal with long-term losses of earnings that result from being reemployed at a lower wage. The average reemployed worker experiences a 13 percent loss in wages. Workers with more experience generally face even larger earnings losses, and those losses tend to persist for many years.

Financing UI Benefits. Basic UI benefits are financed by payroll taxes; extended benefits are typically financed by some combination of payroll taxes and general revenues. The federal taxable wage base has not been changed in over 20 years and stands at $7,000. The majority of states set their taxable wage bases below $10,000. As a result, the UI payroll tax accounts for a higher share of income for lower-income workers and a lower share of income for upper-income workers. Kletzer and Rosen argue that UI should not impose such a disproportionately high tax burden on lower-wage workers.

A NEW APPROACH

Kletzer and Rosen propose three broad reforms, each designed to help the UI system better meet its original goals of reducing hardship for the unemployed and providing a countercyclical economic stimulus during periods of widespread unemployment. First, Kletzer and Rosen propose strengthening the federal role in UI by setting federal standards that would require states to harmonize their eligibility criteria and benefit levels. These standards would increase average benefit levels and average recipiency rates. Second, they propose a wage-loss insurance program similar to the one recently introduced under the Trade Adjustment Assistance program. This program would provide a wage supplement for those workers who become reemployed at a wage lower than the wage they earned at their previous job. Third, Kletzer and Rosen propose allowing self-employed workers, and perhaps others, to contribute 0.25 percent of income into Personal Unemployment Accounts (PUAs). These contributions would be matched by the federal government and could be withdrawn later to cushion severe income losses or to finance training or job search.

Strengthen the Federal Role through Eligibility and Benefits Standards

Kletzer and Rosen propose new federal standards to expand eligibility and benefits and reduce the variation across state UI programs. The changes to eligibility rules would be designed to restore the UI recipiency rate to the 50 percent that prevailed in 1975.

Changes in Eligibility Rules

- Standardize the base period for determining eligibility. States now assess earnings and employment dur-

New federal standards could expand UI eligibility and benefit levels. In addition, new programs could assist the self-employed and those who were laid off and then reemployed at lower wages.

ing a base period, generally defined as the first four of the last five completed calendar quarters before the job loss. Under this definition of base period, the most recent three to six months of an applicant's employment history are not counted. As noted above, discounting the most recent months of employment can lead to the disqualification of those with intermittent work histories (such as those who have recently reentered the workforce).

- Require the use of hours, not earnings, when determining eligibility. Using hours rather than earnings would link the receipt of benefits to work activity, not income.

- Harmonize nonmonetary eligibility standards, and allow the good cause criteria to include some voluntary job separations.

- Allow those individuals who are eligible for UI at the time of job separation to leave the labor force and defer the receipt of benefits until they begin to search for a new job. For example, such a provision might cover workers who leave the labor force to care for a family member, but find their job is no longer available when they seek to return to work.

- Amend the work test to allow job search for part-time employment. This would allow individuals searching for part-time work to receive benefits.

Changes to the Level and Duration of Benefits

- Standardize benefit levels to at least half of lost earnings with a maximum weekly benefit equal to two-thirds of state average weekly earnings. Kletzer and Rosen estimate that this would increase the average weekly benefit to $370 from its 2004 level of $262, and would increase the average national replacement rate to 50 percent from its recent historical average of about 35 percent.

- Require the maximum duration for basic benefits to be at least 26 weeks. This would codify existing state practice.

- Make benefits more responsive to work experience and local labor market conditions. Kletzer and Rosen call for the development of a formula that would vary benefit levels with work experience "i.e., wage history, local labor market conditions, and reason for separation."

- Develop standard rules to cover benefits for partial unemployment. At present, only a few states allow benefits in the case of involuntary reduction in hours worked. Kletzer and Rosen argue that covering such circumstances would reflect the new labor market reality of part-time work that is more widespread.

- Make the triggers for extended benefits more automatic. Kletzer and Rosen call for standards that would be more predictable and that would allow more workers to receive benefits during extended economic downturns.

Financing Program Expansions

Kletzer and Rosen estimate that their proposals to expand eligibility would cost approximately $7 billion per year and their proposals to increase benefits would cost about $1 billion per year. These costs are sensitive, however, to the particular manner in which the recommendations are implemented; the programmatic details could be adjusted as fiscal conditions warrant. Kletzer and Rosen propose fi-

nancing these changes by increasing the taxable wage base (to adjust for inflation over past decades). In addition to raising revenue, this change would make the incidence of the tax more progressive by reducing the share of the total tax burden borne by low- and moderate-income workers.

Augment UI with Wage-Loss Insurance

To help workers cope with the long-term consequence of job loss, Kletzer and Rosen propose introducing wage-loss insurance as a supplement for UI. Similar to the program already existing under the Trade Adjustment Assistance program, wage-loss insurance would be available to workers who find a new job within 26 weeks of initial job loss, and would provide eligible workers with up to half of the difference between their weekly earnings at their previous job and the (lower) weekly earnings at their new job. The actual percentage of wage replacement would depend on age and worker tenure. Wage-loss insurance would be limited to two years and would be capped at $10,000 per year. Kletzer and Rosen estimate that this proposal would cost between $2.6 billion and $4.3 billion per year, depending on overall economic conditions and on the manner in which the program were implemented. Kletzer and Rosen propose that wage-loss insurance be financed through general revenues or an expanded payroll tax.

Kletzer and Rosen note that partial wage replacement insurance would raise the return to job search, especially for workers with larger reemployment losses, and thus provide new incentives for workers to find new jobs. Limiting eligibility to those who find new work within 26 weeks of initial job loss also would provide a strong incentive to find work more quickly.

Enable Individuals to Make Tax-Favored Contributions to PUAs

The UI system currently provides no assistance to the roughly 10 million individuals who are classified as self-employed. Kletzer and Rosen propose that the self-employed, and perhaps other workers, be allowed to contribute up to 0.25 percent of annual wages, up to a maximum of $200, into a PUA. These contributions would be matched by the federal government; the worker could withdraw them to cushion severe income losses or to finance training or a job search. Withdrawals would be taxed as income. Kletzer and Rosen estimate that the government's match would average about $125 per person per year, making the total cost of the matching contributions from the federal government approximately $300 million annually. Contributions to PUAs also would result in an unspecified amount of lost revenue as a result of their tax-favored status.

Implementation Issues and Concerns

Fully assessing the costs and benefits of these proposals would require specifying a number of additional programmatic details. Outlined below are some of the questions that are raised by the proposals in their current form.

Allow individuals searching for part-time work to receive benefits. Raising the replacement rate to 50 percent and simultaneously allowing workers to receive benefits even if they search only for part-time work could affect workers' motivations to accept a new job. If a UI recipient were moving from full-time employment to half-time work, and if the level of UI benefits were unaffected by whether the recipient was looking for full-time or part-time employment, it is possible that UI benefits could equal 100 percent of the job seeker's potential earnings at the half-time job. Policy makers would need to assess how such an incentive might affect reemployment patterns.

Establish PUAs. Unlike UI, which is paid only in the event of separation from a job, the tax benefits and government match provided with PUAs would be available to all self-employed workers, and perhaps others, regardless of job separation. Upon a worker's retirement, any

PUA balances would revert to an Individual Retirement Account. Further analysis is required to assess how well such assistance would be targeted to those with the most pressing needs.

Expand the wage-loss insurance program. Because the wage-loss insurance program that Kletzer and Rosen propose would be available only to those who are reemployed within 26 weeks, workers would face an incentive to accept a new job quickly, even if further search might have led to a different job that was a better match for their skills. For this reason, other researchers have proposed wage-loss insurance without such a limitation. In addition, all forms of wage-loss insurance raise the possibility that some workers may receive insurance even when they accept new jobs that have better nonwage attributes (such as health insurance or retirement benefits) that compensate for lower wages. Further analysis is needed to assess practical consequences of these theoretical concerns.

CONCLUSION

The current UI system was designed to address unemployment problems that differ in significant ways from the unemployment challenges of today. UI currently provides assistance to a little more than one-third of unemployed workers. In addition, the UI payroll tax is regressive, with lower-income workers paying a higher share of their earnings to finance the system. Kletzer and Rosen propose reforming the existing UI program to better address permanent job loss and cover part-time, self-employed and other nontraditional workers. Kletzer and Rosen call for strengthening the federal role in UI by standardizing and expanding eligibility and benefits. They also call for new assistance to the self-employed and to those who become reemployed at lower wages. These reforms are designed to make the UI system more responsive to the economy and the labor force of the twenty-first century.

Learn More About This Proposal

The Hamilton Project has released two discussion papers that take different approaches to restructuring UI. The release of these two papers underscores the project's role in stimulating serious debate on important economic issues; policy makers would not implement both proposals.

This policy brief is based on The Hamilton Project discussion paper, "Reforming Unemployment Insurance for the Twenty-First Century Workforce," which was written by Lori G. Kletzer of the University of California, Santa Cruz, and the Institute for International Economics, and Howard F. Rosen of the Institute for International Economics and the Trade Adjustment Assistance Coalition.

An alternative approach to reforming unemployment insurance is discussed in a second discussion paper, "Fundamental Restructuring of Unemployment Insurance: Wage-Loss Insurance and Temporary Earnings Replacement Accounts," by Jeffrey Kling of the Brookings Institution. Under Kling's proposal, wage-loss insurance would provide long-term assistance to laid-off workers who are subsequently reemployed at lower wages. In addition, a newly created borrowing mechanism and system of self-funded accounts would assist workers during periods of unemployment. Kling argues that, compared to the current system, this alternative would better protect workers against the long-term effects of involuntary unemployment, better target benefits toward those who most need assistance, and encourage reemployment. Kling's budget-neutral reform would shift the bulk of government unemployment assistance from those who are laid off temporarily to those who are laid off permanently, and who face longer-term hardship when they are reemployed at a lower wage. Kling estimates that the new system would cut in half—from 14 percent to 7 percent—the share of laid-off workers who experience very large drops in earnings at their new jobs.

Additional strategy papers, discussion papers, and policy briefs from The Hamilton Project can be found at www.hamiltonproject.org.

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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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