Fundamental Restructuring of Unemployment Insurance

Wage-Loss Insurance and Temporary Earnings Replacement Accounts

THE INNOVATION, COMPETITION, AND SHIFTS in business practices that fuel the dynamism of the American economy also create a turbulent labor market with substantial turnover. On an average day in 2005, for example, about 3.7 million people who had lost their jobs through no fault of their own were unemployed and actively looking for work.

The current unemployment insurance system helps cushion the shock of job loss by providing limited income support for up to six months to workers who are involuntarily unemployed. The system offers no assistance, however, if those workers become reemployed at a lower wage and face significantly lower lifetime earnings, which is the case for about one-third of people who take new jobs after being permanently laid off.

In a new discussion paper for The Hamilton Project, Jeffrey Kling of the Brookings Institution proposes a fundamental restructuring of the unemployment insurance system to better protect workers against the long-term effects of involuntary unemployment, provide a more progressive allocation of benefits, reduce incentives for firms to lay off workers, and encourage reemployment. If adopted, the new system would cut in half—from 14 percent to 7 percent—the share of permanently laid-off workers who experience very large drops in wages at new jobs.

<div style="background: green">THE CHALLENGE</div>

Workers who lose a job through no fault of their own (such as those who are laid off due to a plant closing or adverse business conditions) tend to incur substantial short-term and long-run costs. In recent years, such workers have remained unemployed for an average of four months. In addition to wages lost during unemployment, many workers face lower long-term earnings: Those who are reemployed at a new job have earnings that average 13 percent less than their previous earnings. Workers with more experience generally face even larger earnings losses, and those losses tend to persist for many years.

Dealing with the economic consequences of unemployment presents American workers with a particular challenge. For most events that lead to economic hardship—such as illness, death, accidents, or theft—Americans can turn to private markets for some form of insurance. In the case of unemployment, however, private markets are unlikely ever to offer widespread insurance against either of the two main costs of job loss: the short-term cost of being without income for a time and the long-term cost of having reduced lifetime earnings from needing to accept lower wages in order to gain reemployment. If a private firm were to sell insurance against the costs of job loss, it would face the problem that employees would know more about whether they are likely to lose their jobs than the insurance company could reasonably discover. As a result, the insurer would find it difficult to determine an actuarially fair price for the insurance. Similarly, private sector banks are generally unwilling to make weekly loans to people who are unemployed and who will be unable to repay the loans until after they are reemployed.

In the absence of a private market for unemployment insurance, Americans have looked to the government for assistance. Since 1935, the Federal-State Unemploy-ment Compensation Program, commonly known as unemployment insurance (UI), has provided qualifying workers with up to 50 percent of their previous weekly earnings for up to six months after involuntary job loss. UI is financed by a payroll tax; although paid by firms, the tax is thought to be borne principally by workers in the form of offsetting lower wages. Subject to broad federal guidelines, states set both benefit levels and tax rates; as a result, there is significant variation in both tax and benefit levels across states.

Kling's proposal addresses shortcomings in both the benefit structure and the method of financing for the current UI system. Regarding benefits, Kling notes that the UI system provides no long-term assistance to individuals who become reemployed at a lower wage, and thus face lower lifetime earnings. At the same time, short-term UI benefits seem to have a modest effect on the duration of unemployment, extending unemployment by a small amount beyond the time that many workers need to find jobs appropriate to their skills.

Regarding financing, Kling notes that the UI payroll tax creates incentives for excessive layoffs by some firms. The tax rate on each firm is supposed to reflect that firm's experience rating, or history of layoffs: Those firms that lay off workers more frequently are supposed to contribute more to the UI system. Because the UI tax has a minimum rate and a maximum rate, among other reasons, the experience rating system is imperfect: Firms at the maximum will pay no more if they increase layoffs, and firms at the minimum will pay no less if they reduce layoffs. Because the maximum rate is so low in most states, firms in several industries (such as construction, mining, and agriculture) do not pay the full cost of assistance to the workers they lay off, which encourages them to lay off workers more frequently than they otherwise would.

Kling also notes that the payroll tax, which is borne largely by workers, declines sharply as a percent of in-

come for higher-wage workers. This might be fitting if the UI program were viewed strictly as insurance, because the payroll tax and the associated UI benefits are roughly proportional for all but the very lowest-wage group of workers. As a mechanism to help families cope with the effects of unemployment, however, the UI program is less well targeted, since higher-wage individuals and those with savings or other assets experience much less of a drop in their standard of living in the six months after job loss than do individuals with lower wages and less wealth.

A NEW APPROACH

Kling proposes a fundamental restructuring of the current UI system in order to redirect existing resources toward those who suffer longer-term harm (specifically, those who must accept lower wages in order to regain employment) and to make the system both more progressive and more efficient. Kling's approach uses a combination of wage-loss insurance (to protect partially against long-term earnings loss) and temporary earnings replacement accounts (to meet short-term cash needs). Kling also would change the financing of UI to reduce the extra tax burden now borne by low-wage workers and to provide incentives for more economically-efficient decisions by firms and workers.

Wage-Loss Insurance. Wage-loss insurance would provide a wage supplement to laid-off workers who are subsequently reemployed at lower wages. Specifically, a covered employee would receive 25 percent of the difference between her old wage (up to a maximum of $15 per hour, initially) and her new wage, for up to six years. The duration of benefits would be tied to the duration of the worker's prior employment. Wage-loss insurance would be available only to those who had worked at least one year for their previous employer; other eligibility requirements would be the same as those for the existing UI program.

> The new system would cut in half the share of permanently laid-off workers who experience very large drops in wages at new jobs.

Temporary Earnings Replacement Accounts. The current UI assistance would be replaced by a new system of temporary earnings replacement accounts (TERAs), which would require all workers except those with the lowest wages and those close to retirement to self-insure against the short-term costs of unemployment. Workers could make voluntary contributions to their TERAs through paycheck deductions while employed. In the event of involuntary job loss, workers could apply for withdrawals from their TERAs, with eligibility determination and payment amounts the same as under the current UI system. Workers who exhaust their TERA balances would be allowed to borrow from their accounts, and would repay the loans out of future income at a rate of 5 percent of earnings. Any positive balance in a TERA at the end of a person's working years could be withdrawn at retirement. The government would provide TERAs with repayment insurance, which not only would forgive any outstanding balances at retirement, but also would exempt individuals with very low wages from having to repay their TERA withdrawals at any time. These features would essentially leave in place the transfers provided by the current UI system for those who do not return to work after job loss and for those with very low wages prior to job loss.

Financing. Kling's proposal would have no net effect on federal and state budgets, because the combination of wage-loss insurance and TERAs would have the same

Key Highlights of the Proposal

Wage-Loss Insurance

- Unemployed workers whose new jobs pay less than their prior jobs would receive a wage supplement.

- That wage supplement would equal 25% of the difference between the old wage (up to $15 an hour) and the new wage, for up to six years.

Temporary Earnings Replacement Accounts (TERAs)

- Workers voluntarily contribute to a TERA that then provides income during periods of unemployment. The default contribution is 1 percent of pretax earnings.

- Unemployed workers receive payments equal to payments under the present law.

- Unemployed workers who deplete the funds in their TERAs may borrow, but must then repay the loan from future earnings.

- Those with low wages or those near retirement would have part or all of their loans forgiven, and would receive subsidies similar to those under the current UI system.

- At retirement, any balance in the TERA would revert to the worker.

Financing

- Firms make the same total payments as under the existing UI regime.

- Two-thirds of those paid funds would be used for wage-loss insurance; the remainder would be used to subsidize TERAs.

- Payroll tax base is broadened while the tax rate is lowered, reducing the tax burden on lower-wage workers.

- Payments by firms are tied more closely to their layoff history, reducing incentives for layoffs.

cost as the current UI system. Approximately one-third of the proposal's cost would arise from subsidizing TERA withdrawals made by those with very low wages and by those who do not return to work after job loss. The remaining program costs would arise from payments for wage-loss insurance.

As with UI, the subsidies for TERAs would be financed with a payroll tax levied on firms. However, Kling proposes two significant changes to the tax. First, he would spread the tax burden more broadly by lowering the tax rate substantially, but then applying the tax to all earnings up to the Social Security earnings cap (which was $90,000 in 2005) rather than the current state UI cap (which in 2005, was $10,000 or less in 27 states). Doing so would eliminate much of the extra tax burden now borne by low-wage workers. Second, Kling would tie each firm's tax rate more closely to that firm's layoff history, thereby discouraging the firm from making excessive temporary layoffs.

Payments for wage-loss insurance would be funded by charging each firm an amount based on how much that firm's laid-off workers used the wage-loss insurance system. By making firms face the full cost of unemployment assistance to those they lay off, the wage-loss system would discourage firms from making excessive permanent layoffs.

The Economic Effects of Wage-Loss Insurance and TERAs

Kling argues that adopting wage-loss insurance and TERAs would affect firms' decisions about temporary and permanent layoffs, and would affect individuals' consumption habits after job loss and their search for re-employment.

Temporary layoffs. Kling estimates that replacing UI with TERAs would reduce temporary layoffs by 10 to 15 percent. The reduction in layoffs would result from

two forces. First, the payroll tax under TERAs would be tied to each firm's layoff history more directly than it is under current law. As a result, these firms would face new incentives to retain their current employees. Second, firms that lay off workers more frequently would face new costs in the form of higher wages paid to workers. Since employees would have to repay any borrowing from TERAs (unless they were on the verge of retirement or had very low wages), they would work for a firm that was likely to have layoffs only if the firm paid a higher wage than it would under the current UI system.

Permanent layoffs. Wage-loss insurance would give firms new incentives to reduce permanent layoffs and would smooth the transition of workers out of declining firms or industries and into growing firms or industries. Firms in declining industries would face the prospect of larger wage-loss insurance payments because individuals who were laid off by such industries would likely be reemployed in jobs where their accumulated experience was of less value (and, thus, their wages would be lower). Rather than maintain or increase wages and then have to lay off some workers permanently, these firms would gradually reduce wages to reflect the growing potential liability for wage-loss insurance. As wages declined, however, so would the risk of actually having to lay off workers permanently. Firms in growing industries, expecting fewer permanent layoffs (and thus a lower payroll tax for wage-loss insurance), would have greater incentives to increase wages. Overall, employees still would shift from declining to growing firms and industries, but the transition would be smoother: Workers in declining industries still would face challenging economic conditions, but their wages would begin to fall sooner and decline more gradually, with fewer sudden disruptions to their lifetime earnings path.
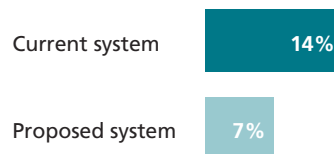
Worker consumption after job loss. The UI system is designed, in part, to help workers avoid sharp swings

Figure 1. Percentage of Workers with Insured Wage Losses during the 10 Years Following Job Loss Who Have:

Income loss of 25 percent or more

Income loss of 50 percent or more

Author's calculations based on data from PSID, 1984-96. Complete citations for this and other evidence are in Jeffrey R. Kling, "Fundamental Restructuring of Unemployment Insurance" (Discussion Paper 2006-05, The Hamilton Project, Washington, DC, 2006). The discussion paper provides details for various author's calculations described in this brief.

in their standards of living. Kling argues that wage-loss insurance combined with TERAs would accomplish this more effectively than the current UI system does. TERAs would provide both a savings vehicle and a borrowing facility to ensure that workers have the same access to cash immediately after job loss as they do under current law. In the longer term, those who are subsequently reemployed at wages lower than the insured rate would receive wage-loss insurance, so their long-term consumption would be higher than under current law, while those who were reemployed at higher wages would be able to pay back any borrowing from TERA over time with a relatively small effect on long-term consumption. The percentage of workers who experience the steepest long-term drop in earnings—50 percent or more—would decline by half (Figure 1).

Kling estimates that wage-loss insurance and TERAs would substantially increase the share of unemployment benefits received by those making less than the median income. Compared to the current UI system, wage-loss insurance and TERAs would reduce the share of program benefits received by those in the top quartile of the income distribution, leave unchanged the share of benefits received by those in the second quartile, and increase (from 43 percent to 54 percent) the share of benefits received by those in the bottom half of the income distribution (see Table 1).

Job search and reemployment. Both wage-loss insurance and TERAs would modestly shorten the average duration of unemployment.

By increasing the wage available from new jobs, wage-loss insurance would make reemployment more attractive than does the current unemployment system. Using evidence from state-level experiments and from a Canadian earnings experiment, Kling concludes that wage-loss insurance will speed reemployment modestly.

Because TERAs would be self-financed for most workers, they also would provide stronger incentives for reemployment. Citing, among other evidence, studies of the relationship between changes in UI benefits and the duration of unemployment, Kling concludes that TERAs will reduce the overall duration of unemployment by 5 to 10 percent.

Importantly, Kling notes that taking a new job more quickly is not always beneficial for either the individual or society. Both the worker and society will be worse off if the worker quickly takes a low-wage job than if he waits for a job that better matches his skills—that is, one that would allow his productivity and wages to be higher. At the same time, both the worker and society will be worse off if the worker waits too long and turns down lower-

Table 1. Share of benefits by income quartile, in percentages

	UI	WL + TERAs
Lowest	8	8
3rd	35	46
2nd	37	37
Top	20	9

Source: Author's calculations based on data from PSID, 1984-96.

wage jobs in favor of a hoped-for higher-wage job that never arrives. Based on a variety of empirical evidence, Kling concludes that wage-loss insurance and TERAs together would be more effective than the current system at encouraging work without significantly reducing the quality of subsequent jobs.

Implementation Issues

Wage-loss insurance. All forms of wage-loss insurance raise the possibility that some workers may receive insurance even when their new jobs have better non-wage benefits (such as health benefits or working conditions) that compensate for lower wages. Further analysis is needed to assess whether this theoretical concern also has practical consequences.

Measuring hours worked. Kling's proposal for wage-loss insurance relies on information about hours worked and hourly wages paid both at the previous job and at the new job. Implementation would require many states to start collecting data in a systematic way on hours worked. Doing so would allow part-time and seasonal work to be incorporated into the system in a straightforward way. Looking at the experience of three states that already collect information on hours—Oregon, Washington, and Minnesota—Kling concludes that states could gather this information without a substantial administrative burden.

CONCLUSION

In one of his famous fireside chats, when discussing the Social Security Act that created UI, President Franklin D. Roosevelt explained, "The unemployment insurance part of the legislation will not only help to guard the individual in future periods of lay-off against dependence upon relief, but it will, by sustaining purchasing power, cushion the shock of economic distress." Jeffrey Kling argues that the UI system can better meet this purpose—without burdening the federal budget—by helping individuals cope with the persistent long-term effects of job loss rather than with smaller, short-term needs, which can more easily be met through saving, borrowing, and repayment.

Under Kling's proposal, two-thirds of the financial resources currently used for UI would be shifted to wage-loss insurance that would augment the hourly wages of individuals who find new jobs at reduced wages. The remaining funds would be used to support TERAs, which would provide the same amount of cash during unemployment as under UI.

Unemployment would be reduced by removing subsidies for layoffs and by creating stronger incentives to return to work. The proposed system would provide a significantly greater share of net program benefits to workers in the lower half of the income distribution when compared to the current system of UI benefits alone. By targeting system resources to those whose hourly wages are lower in their new jobs, significant hardship would be reduced.

Kling argues that restructuring UI in this fashion would focus the system on the most pressing hardships associated with job dislocation, and thus help workers cope better with the vicissitudes of the labor market.

Learn More About This Topic

The Hamilton Project has released two discussion papers that take rather 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, *Fundamental Restructuring of Unemployment Insurance: Wage-Loss Insurance and Temporary Earnings Replacement Accounts,* which was authored by Jeffrey R. Kling, Senior Fellow, The Brookings Institution.

An alternative approach to reforming the unemployment insurance system is described in a second discussion paper, *Reforming Unemployment Insurance for the Twenty-First Century Workforce,* which was authored 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.

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 recipiency rates. Second, they propose wage loss insurance to provide a wage supplement for those workers who become reemployed at a wage lower than what they earned at their previous job. Third, Kletzer and Rosen would allow self-employed workers, and perhaps others, to contribute 0.25 percent of income into Personal Unemployment Accounts (PUAs). These contributions would be matched by government grants and could be withdrawn later to cushion severe income losses or to finance training or job search.

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

The Hamilton Project seeks to advance America's promise of opportunity, prosperity, and growth. The Project's economic strategy reflects a judgment that long-term prosperity is best achieved by making economic growth broad-based, by enhancing individual economic security, and by embracing a role for effective government in making needed public investments. Our strategy—strikingly different from the theories driving current economic policy—calls for fiscal discipline and for increased public investment in key growth-enhancing areas. The Project will put forward innovative policy ideas from leading economic thinkers throughout the United States—ideas based on experience and evidence, not ideology and doctrine—to introduce new, sometimes controversial, policy options into the national debate with the goal of improving our country's economic policy.

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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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