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The Evolution of Unemployment Insurance in the United States

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The U.S. system of Unemployment Insurance (UI) was developed during the 1930's largely in response to layoffs in manufacturing industries. Although many minor modifications have been made to that system during the past 70 years, its basic structure has remained largely unchanged. Recently several new and innovative suggestions for altering and enhancing UI have been proposed and the goal of this brief review is to explore a few of them.

Two general paths have been advocated for achieving UI system reform. The first, incremental approach focuses on modest additions within the basic structure of the existing program. Recent proposals for various forms of "wage insurance" are perhaps the most prominent example of this approach (Parsons, 2000; Kletzer and Litan, 2001; Kletzer, 2004). An alternative scheme for UI reform takes a more holistic approach to the problem of earnings volatility by proposing the establishment of private accounts that mimic precautionary savings as a means for self-insuring against this volatility. Martin Feldstein (2005) has been perhaps the most persistent voice in advocating this position. The widely discussed proposal for Temporary Earnings Replacement Accounts (Kling, 2006; *The Economist*, 2006) also falls into this general category of reforms.

The goal of this review is to contrast these two approaches Section I provides a general rationale for reducing income (and consumption) volatility and outlines some of the conceptual problems involved in providing protection against such risks. Section II then summarizes a few recent initiatives in expanding UI to address a few limited aspects

of earnings volatility. In Section III, I take up the more far reaching proposals to re-structure UI along the lines of private accounts. Section IV provides some concluding remarks about the respective roles of these alternative approaches.

I. The Problem of Income[1] Volatility

The study of the effects of individual income volatility began in formal terms with studies of the Keynesian "consumption function" in the 1950s. Seminal work buy Friedman (1957) and Modigliani and Brumberg (1954) stressed that rational consumers would seek to smooth their consumption over time in response to fluctuating incomes so that the negative welfare consequences of such income volatility might be mitigated[2]. Empirical work following on this lead has tended to conclude, however, that individuals can only partially achieve such consumption smoothing. In the language of macroeconomics, consumption tends to exhibit "excess volatility" in that consumption changes seem to be more closely tied to fluctuating incomes than should be the case if consumers had adequate precautionary savings or could readily borrow when the need arises (Campbell and Mankiw, 1989).

Involuntary unemployment is, of course, one of the primary causes of income (and therefore consumption) volatility at the level of the individual household. Even the temporary loss of a job can cause a significant decline in household purchasing power – a

[1] Throughout this review I will treat "income volatility" as exclusively arising from variations in wage income. Volatility in returns on capital affects far fewer people and is subject to far different economic forces than examined here. Earnings volatility is also treated as a problem separate from the problem of "low wages". That is, event-caused changes in wage income create difficulties for households that can be addressed through social and private insurance-type programs. Low wages are addressed through a different set of programs such as means-conditions transfers or progressive income taxation. These latter types of programs are not discussed here.

[2] This focus on the individual worker's reactions to income variability represented a shift in approach from earlier literature which tended to treat the firm as both the cause and the cure for earnings volatility. Plans for guaranteed employment through worksharing were widely discussed in the 1920's and 1930's. Jacoby (1997) discusses how earnings risks were increasingly shifted to workers following World War II. Increasing job mobility in more recent years has further exacerbated this trend.

decline that is likely to show up quickly in consumption spending. For example, Gruber (1997) estimates that, in the absence of unemployment insurance, a job loss can cause a short term decline in household consumption of about 22 percent. The extent of this decline is reduced by almost two-thirds if the job loser is eligible for unemployment insurance. Broadly similar estimates are obtained by Bloemen and Stancanelli (2005) for the United Kingdom and by Browning and Crossley (2001) for Canada . Gunderson and Zilliak (2003) show that other forms of social insurance (Food Stamps) can also have important consumption smoothing effects in response to job loss.

The income-replacement benefits of unemployment insurance (and social insurance more generally) are not costless, however. As for any insurance scheme, one must be concerned with induced behavioral responses – the "moral hazard" problem. For example, receipt of unemployment insurance benefits has been shown to lengthen unemployment spells (for a summary, see Decker, 1997), increase the incidence of temporary layoffs (Feldstein, 1978), and reduce precautionary savings (Engen and Gruber, 2001). The need to control such effects is implicitly recognized by such structural features of the UI system as partial wage replacement, limited potential durations, and administrative procedures for checking on claimants' availability for work. There is continuing dispute about whether such provisions actually yield what might be considered an "optimal" degree of insurance against the income risks from job loss (Nicholson and Needels, 2006).

Job loss is, of course, only one of many causes of earnings volatility. Other contributors include:

- Changes in hours of work on a given job or as a result of a job change;
- Wage rate changes on a given job;
- Wage changes arising from voluntary or involuntary job changes;
- Temporary absences from work because of illness or family responsibilities;
- Work-related disabilities or injuries;
- Time out of employment for training needs;
- Declining worker productivity because of age or other reasons.

Although there are no empirical studies that seek to apportion observed volatility among these various causes, it seems likely that many of these may be quite significant, though all are perhaps somewhat less important than job loss. None of these events is adequately insurable through private markets, in part because of the adverse selection and moral hazard problems involved. In a few cases, such as short-time compensation programs or workers' compensation programs, social insurance-type mechanisms have been devised to address some of these earnings risks. But these programs are often very limited in scale and usually pose moral hazard-type problems of their own. Many of the earnings risks could in principle be ameliorated if individuals planned adequate levels of precautionary savings or had ready access to short-term credit, but the data suggest that these options are usually inadequate to the task of smoothing consumption.

II. Expanding Traditional UI to Meet the Risks

One approach to addressing some of these many risks of earnings volatility is to provide added coverage for such events through the traditional UI system. A primary advantage of this approach is that the administrative mechanisms for assessing eligibility and disbursing benefits are already in place. Two examples of this incremental approach are short-time compensation (STC) programs and temporary disability insurance.

Currently eighteen states operate STC programs which provide pro-rated UI benefits for workers that have had their workweek reduced by at least 20 percent. An important additional rationale for the program is to reverse the "pro-layoff" bias inherent in the traditional UI program by encouraging workers to remain with their employers during periods of reduced demand. Whether the program achieves this goal is subject to some dispute, but it is clear that STC benefits can help to cushion what might otherwise be significant short-term reductions in wage incomes (Walsh et al., 1997).

Six states currently operate temporary disability programs (TDI). The general intent of these programs is to provide income compensation to individuals who are not able to work because of non-work-related sickness or injury[3]. Specific connections between TDI programs and state UI programs are administratively complex. In some cases (New Jersey, for example), eligibility and benefit schedules for TDI closely parallel those for UI. Essentially TDI recipients are would-be UI recipients for whom the "able to work" requirement has been waived. In other states (California[4] and New York) TDI eligibility rules and benefit schedules are quite different from those for UI. These differences can further complicate already complex application processes for the

[3] UI coverage of sickness and family responsibilities is more extensive in many other countries than in the United States. For example, in Canada all such special benefits amount to almost one-third of total UI benefits paid.

[4] In 2002 the California temporary disability program was enhanced to include compensation for work absences due to family responsibilities.

programs. To date no formal evaluations of state TDI programs have been completed, so the potential behavioral effects (which may be important) associated with them are largely conjectural.

Perhaps the most significant new proposals for augmenting UI coverage of income risks concern what has come to be called "wage insurance". This term is a bit misleading because only a very narrow risk to wage income is being considered – the risk that a laid-off worker will become re-employed at a job that pays much less than his or her prior one. Under a proposal by Representative McDermott (Washington), for example, a worker could collect 50 percent of the difference between his or her old wage and the new one (up to a maximum of $10,000 annually) for up to two years. This proposal is similar to a far more restrictive provision for Alternative Trade Adjustment Assistance (ATAA) contained in the Trade Adjustment Assistance Reform Act of 2002. Under ATAA eligible workers over age 50 can collect a benefit equal to that specified in the McDermott bill in lieu of their regular UI benefit (as extended under the Trade Adjustment program) provided that they become re-employed within 26 weeks and earn less than $50,000 per year on the new job. Experiences under the ATAA provisions have not been fully evaluated, but the incentives under the program are complex and it is unclear how it will eventually affect worker behavior (Baicker and Rehavi, 2004).

The motivation behind wage insurance proposals is clear. Numerous studies have shown that workers who suffer permanent job separations incur average wage losses of perhaps 5-20 percent on their new jobs[5] and that these losses can persist for many years

[5] These figures are usually calculated for full-time work to full-time work transitions. Calculating losses when hours of work change significantly pose problems both because often workers have experienced hours reductions before they are laid off and because it is hard to know how to value "leisure" time for workers who choose part-time work.

(Jacobson et al., 1993; Kletzer, 1998; Kuhn, 2002; Farber, 1995). There is, of course considerable variability around these average figures. Significant numbers of workers experience only negligible earnings losses following layoffs and some even experience gains. Two facts seem to account for bringing wage insurance to the forefront of policy debate. First, many reemployment wage losses seem to derive from international trade pressures (Kletzer, 2004). Because the nation as a whole benefits from such trade, there is the feeling that workers who suffer such losses should be compensated. A second, related reason for the prominence of wage insurance proposals is that often these losses are concentrated in certain industries or geographic locales. This not only makes such losses highly visible, but can also pose major spillover effects to workers who have not been directly affected.

Although there is some debate about the underlying cause of reduced earnings by re-employed dislocated workers, a significant portion no doubt stems from the loss of "job-specific human capital". That is, a long-term worker tends to increase his or her productivity as job tenure increases because of learning to do a given job better. These productivity gains (and their related wage increases) are lost worker is laid off. Other explanations for earnings losses from job dislocations include the possibility that workers may have earned wage premiums on prior jobs, perhaps because of unionization or employment in especially high wage industries. Private insurance against such losses is largely unavailable though in some cases the losses may be partly compensated through severance pay packages. It appears, however, that existing plans are not well structured to replace the actual losses of human capital that do occur (Feng and Parsons, 2006).

Developing wage insurance within the existing UI system poses both advantages and disadvantages. The primary advantages are administrative in nature. UI eligibility rules can be adapted to decide who can receive such payments and the UI wage-reporting system can be used to calculate the amounts to be paid. The primary disadvantage of a UI-based approach is that this severely limits the types of earnings changes that might be compensated. Workers who change jobs involuntarily without collecting UI might be difficult to identify, individuals who decide to pursue some form of self-employment would not be covered if they incur wage losses, and those with long absences from the labor market (such as women who have taken time off for child care responsibilities) would probably be excluded as well. Wage insurance amounts might also be highly influenced by the idiosyncratic patterns of pre- and post-layoff earnings. Those with large drops in earnings prior to layoff or who take jobs with steep earnings trajectories might be over-compensated whereas those in the opposite situations would be under-compensated. In addition, some of the eligibility rules (such as the ATAA limit to $50,000 per year jobs) might introduce significant spikes in implicit rates of taxation of earnings on new jobs, increasing the pressure to make poor job matches. This is one reason that some wage insurance proposals have been criticized as providing inefficient incentives to take lower wage jobs (*New York Times,* March 18, 2007). Hence, the overall efficiency of any UI-based wage insurance scheme depends importantly on precisely how it is designed.

III. Individual Accounts

An alternative approach to moderating the impact of earnings volatility is to enhance ways for individual workers to insure or self-insure against these risks. This is

the general philosophy behind Feldstein's (2005) proposal for Unemployment Insurance Savings Accounts and Kling's (2006) suggested Temporary Earnings Replacement Accounts. Under such plans, individuals would maintain private accounts that would mimic precautionary savings, but with both strings and subsidies attached. The primary advantage of this approach is that it would provide incentives for individuals to internalize the effects of various decisions they make, thereby reducing many of the moral hazard problems associated with traditional social insurance programs. The disadvantages of the private account approach derive primarily from their administrative complexity and from doubts that self-insurance is feasible for many types of earnings risks.

The most important current initiative using private accounts as a replacement for social insurance is in the health care arena. Health Savings Accounts (HSAs) were created as part of the Medicare Prescription Drug Improvement and Modernization Act of 2003. Any adult with a high deductible health plan may make tax-advantaged contributions to such a plan and withdrawals from the plans are not taxed if they are used to pay qualified medical expenses. According to some projections, HSAs may enroll as many as 10 million Americans by 2010. The general conception behind the accounts is that re-orienting health care plans away from "first dollar" coverage toward covering only catastrophic expenditures will bring greater cost-consciousness into the system. Simulations suggest that the cost savings from such a re-orientation may be relatively modest, however (Baicker et al., 2006). There is also some concern that eliminating coverage for routine office visits or low-price prescription drugs may be counter-productive (Newhouse, 2006).

The development of individual accounts in other areas of social insurance policy has been much slower, at least in the United States. Private retirement accounts as a partial replacement for Social Security were widely debated in 2004/2005, but gained little political traction[6]. With regard to UI, a pilot program for Personal Reemployment Accounts (PRAs) was authorized in 2003 and this pilot is currently operating in seven states. PRAs provide grants of up to $3,000 to UI claimants who are judged (under state "profiling" systems) to be likely to exhaust their benefit entitlements. These funds may be used to purchase reemployment services and any unexpended funds can be reimbursed to the claimant if he or she finds work quickly and retains the job for a defined time period. The accounts are similar in some ways to re-employment bonuses that were the object of several (largely unsuccessful) experiments in the 1980s and 1990s (Meyer, 1995), though the emphasis on purchasing re-employment services is new. The modest size of the PRA experiment coupled with controversies over its implementation suggest that large scale initiatives such as those envisioned by Feldstein or Kling are unlikely in the current political climate, however.

Nevertheless, it is probably worthwhile to look in detail at these proposals to assess how they differ from more incremental approaches to UI system reform. Because Kling's (2006) proposal for Temporary Earnings Replacement Accounts (TERAs) is perhaps the most fully articulated such proposal, I will use it as an example of the private account approach to the problem of earnings volatility[7]. The basic elements of the TERA proposal are:

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[6] Nations that have recently moved toward privatizing their retirement systems include Australia, Chile, China, England, Mexico, Sweden and a number of Eastern European countries.

[7] I focus only on those portions of the Kling proposal that address earnings volatility. He also makes a number of proposals for increasing experience-rating of firms that are beyond the scope of this review.

- Accounts would be funded by a voluntary contribution of one percent of pre-tax earnings;
- Unemployed individuals would draw weekly benefits from their accounts. Benefit amounts and eligibility provisions would be the same as under current UI rules;
- Workers with zero-balance accounts would be able to borrow to pay UI benefits owed. Very low wage workers would have a portion of their borrowing subsidized through government-provided coinsurance;
- Workers would repay their net TERA borrowing with an increased (five percent) contribution rate on their new jobs. Remaining loan balances would be forgiven at retirement.
- Re-employed workers would be eligible for wage loss insurance equal to twenty-five percent of lost hourly wages between the prior job and the current one (up to a maximum earnings rate of $15 per hour). These payments could last for up to six years.
- Wage insurance payments would be deposited to TERAs until they reached a positive balance of $5,000. After that wage insurance payments would be remitted directly to the worker.
- TERAs would be treated as private assets – in particular they could be inherited by spouses or other beneficiaries.

Kling provides simulations which purport to show that his system is budget neutral relative to the current UI system. This result is achieved by reallocating 50 percent (the

assumed participation rate for TERAs) of current UI taxes to finance: (1) Repayment of TERA loans outstanding when a worker retires; (2) Coinsurance for loans to low wage workers' TERAs; and (3) Wage-loss insurance. The bulk of UI payments are financed through workers' own contributions and repayments. The net result of all these changes is to redirect significant amounts of net UI benefits away from the upper quartile and toward lower quartiles of the earnings distribution.

As for most private account proposals, TERAs would have a number of potentially beneficial incentive effects. The implicit "cost" of collecting UI would rise for workers who must draw down their own funds or borrow with the likelihood of repayment. Hence unemployment durations may fall. Wage insurance may enhance this effect by increasing some workers' net gains from returning to work. For firms, inclusion of wage insurance payments in experience-rated UI taxes may help to internalize some of the social costs of permanent workforce reductions. Kling discusses many other potential effects, most of which also appear to be beneficial. He also mentions the possibility that TERAs could be expanded to cover other earnings-related risks such as sickness, family responsibilities, or training needs. Although no explicit analysis is presented of these possibilities, it appears that incentive effects under such expansions also might be more efficient that providing such coverage in a more traditional social insurance framework.

There are a variety of potential problems with the TERA proposal that warrant further investigation, however. Perhaps most important is the problem of adverse selection. Because TERA contributions are voluntary, only workers who can foresee a net benefit from participating will do so. Because simulations suggest that higher wage workers will, on average, experience net losses from such participation (relative to the

current UI system), it seems likely that few would choose to opt for TERAs. Even among median wage workers, those that see little chance of a layoff or subsequent wage losses would probably find that the current UI system offers a more attractive package. Such adverse selection can significantly raise the expected per-participant net cost of operating the TERA system and ultimately make it unsustainable. A potential solution, of course, would be to make participation in TERAs mandatory. But the redistribution inherent in the proposal might make the program politically unpalatable for a large segment of the workforce.

Even if the TERA proposal were financially viable, its operation would involve significant administrative costs. Individual accounts would have to be monitored and there would have to be some sort of certification process for withdrawals or wage insurance payments. Compulsory repayments through the wage withholding system are likely to be contested in some cases and it seems likely that complex appeals processes would be necessary. Expanding TERAs to provide coverage of other types of earnings volatility would be involve additional layers of administrative complexity to ensure that specified withdrawal criteria are met.

Finally, although incorporating existing UI benefit schedules and eligibility rules into the TERA system has much to recommend it in terms of simplicity, such an approach does little to update UI itself. Existing differences in generosity across the states would remain in place and the adjustments needed to adapt to emerging employment trends would not be made (for a discussion see Nicholson and Needels, 2006). Focusing on TERAs (or other types of private accounts) might therefore divert attention from more important and more easily attainable UI reforms.

IV. Concluding Remark

Achieving an optimal design for a social insurance program is a difficult problem in balancing participant gains, administrative and funding costs, and induced behavioral responses. The UI program in the United States has evolved in many ways over the past seventy years as it constantly seeks to balance these competing objectives. Any proposed incremental reform must recognize the constraints imposed by this history. The strategy of testing out such reform on a limited experimental basis (as in the cases of re-employment bonuses or short-time compensation) has proven to be an advantageous way of identifying potential problems and honing the design of new features. This might be a good way to proceed in developing a wage insurance component by building on the experiences from the recent ATAA experiences.

Proposals for more far-reaching structural changes will always have an attraction, in part because they are free from the historical constraints imposed by incremental reform. Private account approaches to the problem of earnings volatility have undeniable conceptual attractions, especially in their ability to constrain adverse behavioral responses and to provide more flexible ways of addressing newly emerging labor market trends. Some carefully designed experiments with private accounts would do much to clarify the potential administrative and financing problem discussed here. At this time, however, there is scant empirical evidence on which to base a more wholesale adoption of the private account strategy.

Pressures to adopt major expansions of the UI system might be lessened if there were greater confidence that most workers are in a good position to self-insure against earnings volatility. Historically low U.S. rates of personal savings coupled with recurring

problems in high risk credit markets suggest that for many workers such an approach is currently infeasible, however. Whether incentives for private saving or improvements to markets for small loans would be superior to some of the more complex plans studied here is a topic that is beyond the scope of this review. But such strategies should certainly be considered in any comprehensive assessment of social insurance reform.

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